These notes refer to the Income Tax (Trading and Other Income) Act 2005 (c.5) which received Royal Assent on 24 March 2005

INCOME TAX (TRADING AND OTHER INCOME) ACT 2005

EXPLANATORY NOTES

1. These explanatory notes relate to the Income Tax (Trading and Other Income) Act which received Royal Assent on 24 March 2005. They have been prepared by the Tax Law Rewrite Project at the Inland Revenue in order to assist the reader in understanding the Act. They do not form part of the Act and have not been endorsed by Parliament.

2. The notes need to be read in conjunction with the Act. They are not, and are not meant to be, a comprehensive description of the Act. So where a section or part of a section does not seem to require any explanation or comment, none is given.

3. The commentary on each section indicates the main origin or origins of the section. (A full statement of the origins of each section is contained in the Act's Table of Origins.)

4. At the end of the commentary there is supporting material in two annexes.

   - *Annex 1* contains details of the minor changes in the law made by the Act.
   - *Annex 2* contains a table of destinations for the Extra-Statutory Concessions to which this Act gives statutory effect.

SUMMARY

5. The purpose of the Income Tax (Trading and Other Income) Act is to rewrite income tax legislation relating to trading, property and investment income so as to make it clearer and easier to use.

6. The Act does not generally change the underlying law when rewriting it. The only changes to the law which it does make are minor ones which are within the remit of the Tax Law Rewrite Project and the Parliamentary process for the Act.

7. In the main, such changes are intended to clarify existing provisions, make them consistent or bring the law into line with well established practice.

BACKGROUND

The Tax Law Rewrite Project

8. In December 1995 the Inland Revenue presented a report to Parliament on the scope for simplifying the United Kingdom tax system (*The Path to Tax Simplification*). The main recommendation was that United Kingdom direct tax legislation should be rewritten in clearer, simpler language.

9. This recommendation was welcomed, both in Parliament and in the tax community. In his November 1996 Budget statement the then Chancellor of the Exchequer (the Rt Hon Kenneth Clarke MP, QC) announced that the Inland Revenue would propose detailed arrangements for a major project to rewrite direct tax legislation in plainer language.

10. The project team was given the task of rewriting the United Kingdom's existing primary direct tax legislation. The aim is that the rewritten legislation should use simpler language and structure than previous tax legislation. The members of the project are from different backgrounds, including Inland Revenue employees, private sector tax professionals and parliamentary counsel including (as head of the drafting team) a senior member of the Parliamentary Counsel Office.

Steering Committee

11. The work of the project is overseen by a Steering Committee, chaired by Lord Howe of Aberavon CH, QC. The membership of the Steering Committee as at 31 October 2004 was:

the Rt Hon the Lord Howe of Aberavon CH, QC (Chairman)

Ian Barlow

Adam Broke

Ian Dewar

David Hartnett CB

the Rt Hon Michael Jack MP

Dr John Avery Jones CBE

Rachel Karp

the Rt Hon Lord Mustill

Eric Joyce MP

David Swaine

Consultative Committee

12. The work is also reviewed by a Consultative Committee, representing the accountancy and legal professions and the interests of taxpayers. The membership of the Consultative Committee as at 31 October 2004 was:

Robin Martin CB	Chairman
Graham Aaronson QC	Revenue Bar Association
Adam Broke	Special Committee of Tax Law Consultative Bodies
Derek Brownlow	Institute of Directors
Colin Campbell	Confederation of British Industry
Taha Dharsi	London Chamber of Commerce and Industry
Mary Fraser	Association of Chartered Certified Accountants
Malcolm Gammie QC	The Law Society of England and Wales
Terry Hopes	Institute of Chartered Accountants in England and Wales
Isobel d'Inverno	Law Society of Scotland
Keith Gordon	Chartered Institute of Taxation

Simon McKie	Institute of Chartered Accountants in England and Wales
Cunnie Rankin	Institute of Chartered Accountants of Scotland
Simon Sweetman	Federation of Small Businesses
Wreford Voge	Chartered Institute of Taxation
Professor David Williams	Office of the Social Security Commissioners
Mervyn Woods	Confederation of British Industry

Consultation

13. The work produced by the project has been subject to public consultation. This has allowed all interested parties an opportunity to comment on draft clauses. The consultation took the form of a series of Exposure Drafts which published clauses in draft. The relevant ones for this Act are numbers 1, 2, 4, 8, 10 and 13. They were published in July 1997, July 1998, March 1999, October 1999, May 2000 and March 2002 respectively. A draft Bill was published for consultation in March 2004.

14. In addition to formal consultation by way of Exposure Drafts and draft Bill the project also produced papers for the Committees which both informed the Committees and sought their views on particular issues. Draft clauses and explanatory notes were also posted on the Tax Law Rewrite website for comment.

15. Those who responded to one or more of the Exposure Drafts, to the draft Bill or to the draft clauses published on the website include:

Adam Broke & Co

Association of Partnership Practitioners

Association of British Insurers

Association of Friendly Societies Taxation Sub-Committee

Association of Unit Trusts and Investment Funds

Bank of Scotland

Building Societies Association

British Bankers' Association

Cardiff Law School, Cardiff University

Chartered Institute of Taxation

City of London Law Society

City of Westminster & Holborn Law Society

Clark Whitehill

Clement Keys Charted Accountant

Confederation of British Industry

Construction Industry Joint Taxation Committee

Consumers Association

County Land and Business Association

Covington & Burling

Daron H Gunson

David Brodie

David Southern

David Williams

Deloitte & Touche

Denton Wilde Sapte

Ernst & Young

Farrer & Co

F J Griffiths

Federation of Small Business

Hammond Suddards

Holborn Law Society

HSBC

Ian Hay Davidson

Institute of Chartered Accountants in England and Wales

Institute of Chartered Accountants of Scotland

Institute of Directors

Institute of British Payroll Management

Institute of Payroll and Pensions Management

John Jeffrey-Cook

KPMG

Law Society of England and Wales

Law Society of Scotland

London Society of Chartered Accountants

Maurice Parry-Wingfield

Moore Stephens

Motion Picture Association

National Farmers' Union

Office of the Legislative Counsel, Northern Ireland

Pannell Kerr Forster

Plain Language Commission

Plain English Campaign

Ralph Newns

Special Committee of Tax Law Consultative Bodies

Society of Trust and Estate Practitioners

Tax Aid

Tax in Industry

Terry Harvey

Wedlake Bell McKean

Note: this table excludes those who asked for their responses to be treated in confidence.

THIS ACT - THE END OF THE SCHEDULES FOR INCOME TAX

16. The Income Tax Act of 1803 charged income under five Schedules, A, B, C, D and E. Schedule F was added in 1965.

17. Three of these Schedules have already gone:

- Schedule B was abolished by FA 1988;
- Schedule C was abolished by FA 1996 (for income tax purposes); and
- Schedule E was rewritten by ITEPA 2003 (the project's first income tax Act) in terms of employment, pension and social security income.

18. This Act repeals, for income tax purposes, the remaining Schedules A, D and F.

Features of the Act

19. The Act:

- applies for income tax only;
- brings the charging and calculation rules for the different sorts of income together in updated classifications, such as trading income, savings and investment income etc;
- includes foreign income in the same Parts as equivalent United Kingdom income, confining any special rules that apply to foreign income to a different Part (Part 8); and uses the defined term "relevant foreign income" to ensure that the treatment of foreign income taxed under Schedule D Cases IV and V in the source legislation is maintained;
- unpacks the Schedule D Case VI charge in the source legislation to provide separate provisions for the various specific charges (routed through Case VI in the source legislation) and a pure sweep-up provision for both United Kingdom and foreign income not otherwise charged to tax while preserving the Case VI loss relief regime; and
- applies to all persons liable to income tax.

20. Not all the rules that impact upon the calculation of income are rewritten in this Act. For example, the rules in Part 17 of ICTA – Tax Avoidance – remain in ICTA for the time being.

THE ACT

21. The Act has 886 sections and 4 Schedules.

22. The sections are arranged as follows:

Part 1: Overview sets out what is covered in the Act and where to find abbreviations and definitions.

Part 2: Trading income

Part 3: Property income

Part 4: Savings and investment income

Part 5: Miscellaneous income

Part 6: Exempt income

Part 7: Income charged under this Act: rent-a-room and foster-care relief

Part 8: Foreign income: special rules

Part 9: Partnerships

Part 10: General provisions

23. The Schedules are:

Schedule 1: Consequential amendments

Schedule 2: Transitionals and savings etc.

Schedule 3: Repeals and revocations

Schedule 4: Abbreviations and defined expressions

24. Tables of Origins and Destinations have also been prepared. The Table of Destinations shows the destination not only of repealed provisions but of all provisions rewritten in the Act.

Glossary

25. The commentary uses a number of abbreviations. They are listed below.

CAA	the Capital Allowances Act 2001
ESC	Extra-statutory concession
FA 1971	Finance Act 1971 (and similarly FA 1985 and so on)
F(No 2)A	Finance (No 2) Act
ICTA	the Income and Corporation Taxes Act 1988
ICTA 1970	the Income and Corporation Taxes Act 1970
ITA 1918	the Income Tax Act 1918 (and similarly ITA 1945)
ITEPA	the Income Tax (Earnings and Pensions) Act 2003
TCGA	the Taxation of Chargeable Gains Act 1992
TMA	the Taxes Management Act 1970
VAT	value added tax

COMMENTARY ON SECTIONS

Part 1: Overview

Section 1: Overview of Act

26. This section summarises the charges to tax and other matters covered in the Act. It is new.

27. The charges are grouped in the four Parts listed in *subsection (1)*.

28. The section also provides, in *subsection (2)*, the link to the general charge to income tax in section 1(1) of ICTA.

29. *Subsection (3)* explains that exemptions from the charges are located in a separate Part but there are signposts in the charging Parts to the exempt provisions most likely to apply to a particular charge.

Section 2: Overview of priority rules

30. This section provides an overview of the sections in the Act containing the rules for deciding which charge takes priority where two charges could apply. It is new. The priority rules are located at the start of each Part immediately after the opening "overview" section.

31. *Subsection (3)* recognises that it is necessary to look at the scope of the charging provisions as well as the priority rules. It is also a pointer to ITEPA and to case law.

Part 2: Trading income

Overview

32. This Part contains the rules relating to trading income. The Part charges:

- the profits of a trade, profession or vocation (charged in the source legislation under Schedule D Cases I, II or V);
- amounts treated as income on a change of accounting basis (charged in the source legislation under Schedule D Case VI); and
- post-cessation receipts (charged in the source legislation under Schedule D Case VI).

33. The structure of the Part is to:

- identify the income taxed as profits of a trade (Chapter 2);
- calculate the profits of the trade (Chapters 3 to 7);
- apply the rules for particular trades (Chapters 8 to 11);
- apply other rules affecting the calculation of profits of the trade (Chapters 12 to 14);
- identify basis periods (Chapter 15);
- apply averaging (Chapter 16);
- identify other components of trading income (Chapters 17 and 18); and
- provide supplementary material (Chapter 19).

34. The rules in Chapters 3 to 14, dealing with profits of the trade, determine the profit of the period of account. Once the profit for tax purposes of the period of account has been calculated:

- the basis period rules convert the profit of the period of account to the profit for the tax year; and

- the averaging rules, if applicable, adjust the profits of tax years.

35. Two particular charges are located in Chapters 17 and 18.

36. References to "profits or gains" in the source legislation which relate only to income are rewritten in this Part omitting the reference to "gains". This continues the tidying up of such references started in section 46(3) of and Schedule 7 to FA 1998.

Chapter 1: Introduction

Section 3: Overview of Part 2

37. This section provides an overview of the trading income Part. It is new.

38. The section includes a signpost to the exemptions in Part 6 of this Act. The exemptions that are in practice most likely to be relevant are indicated in *subsection (3)*.

Section 4: Provisions which must be given priority over Part 2

39. This section sets out the priority rules that apply when a receipt or other credit item might otherwise fall within more than one head of charge.

40. *Subsection (1)* applies where there might otherwise be overlap between the charge on the profits of a trade and the charge on the profits of a UK property business. It is based on section 18 of ICTA.

41. *Subsection (2)* deals with potential overlap with ITEPA. It is based on section 18 of ICTA. In the source legislation Schedule D is the residual Schedule. So the charge in ITEPA on employment income, and other income formerly within Schedule E, has priority over the charge on profits of a trade (Schedule D in the source legislation). There is no potential overlap between pension and social security income in ITEPA that was formerly within Schedule D and the charge on profits of a trade.

Chapter 2: Income taxed as trade profits

Overview

42. This Chapter:

- explains what is taxed as profits of a trade;

- identifies different types of trade;

- treats certain activities which do not constitute a trade as the carrying on of a trade for tax purposes; and

- treats certain receipts which are not trading receipts on first principles as receipts of a trade for tax purposes.

Section 5: Charge to tax on trade profits

43. This section charges the profits of a trade, profession or vocation to tax. It is based on section 18(1) and (3) of ICTA.

44. Part 2 of Schedule 4 to this Act defines "trade" by reference to section 832(1) of ICTA. Section 832(1) of ICTA defines trade so as to include every "manufacture, adventure or concern in the nature of trade". This brings within the meaning of trade an isolated transaction (or a small number of transactions) which, while in the nature of trade, is not sufficiently extensive to amount to a trade.

Section 6: Territorial scope of charge to tax

45. This section sets out the territorial limits of the charge on trade profits. It is based on section 18(1)(a)(i) and (ii) of ICTA.

46. Trades within Schedule D Case I are those "carried on in the United Kingdom or elsewhere". That expression appears wide enough to include trades carried on wholly abroad. But Colquhoun v Brooks (1889), 2 TC 490 HL explained that the charge under Schedule D Case I covers only trades carried on at least partly in the United Kingdom. Trades carried on wholly abroad are within Schedule D Case V.

47. The distinction between Schedule D Cases I and V is important because only a person who is resident in the United Kingdom is chargeable on trade profits under both Cases. A person who is not resident in the United Kingdom is chargeable on trade profits only under Schedule D Case I. The abbreviated descriptions "UK resident" and "non-UK resident" are defined in section 878(1) of this Act.

48. *Subsection (1)* sets out the position for a person resident in the United Kingdom: the charge to tax covers all trade profits, wherever the trade is carried on.

49. *Subsection (2)* sets out the position for a person not resident in the United Kingdom: the charge to tax is restricted to profits from a trade carried on at least partly in the United Kingdom. In the case of a trade carried on partly in the United Kingdom, the charge is further restricted to the profits from the part of the trade carried on in the United Kingdom.

Section 7: Income charged

50. This section sets out the amount charged to tax. It is based on section 60(1) and (2) of ICTA (United Kingdom trades) and sections 65(3) and 68(1) of ICTA (foreign trades). See *Change 1* in Annex 1.

51. *Subsection (2)* makes the link to basis periods. Although the charge to tax under subsection (1) is on the profits of the tax year, traders calculate commercial profit by reference to their period of account. The basis period rules identify the profits that are taxed as the profits of the tax year.

52. In most cases the basis of assessment for the profits of a foreign trade is the same as that for a trade carried on wholly or partly in the United Kingdom. So the charge is on the full amount of the profits of the tax year (subsection (1)).

53. In the case of Irish income, section 68 of ICTA has two special rules.

54. First, section 68(3)(b) of ICTA allows the inspector to direct that the income should be assessed on the basis of an average of a period. And the subsection allows the Commissioners to review the inspector's decision. This rule is a relic of the tax system before Self Assessment. It is not rewritten.

55. Second, section 68(3) of ICTA provides that the income is computed as if it had arisen in the United Kingdom. In practice this rule puts Irish trading income on the same basis as other foreign trading income. So this second special rule for Irish income is not rewritten.

Section 8: Person liable

56. This section states who is liable for any tax charged. It is based on section 59(1) of ICTA.

57. This Act does not rewrite section 59(2) of ICTA. Section 59(2) of ICTA provides that income tax charged "in respect of any of the concerns mentioned in section 55 [of ICTA] shall be assessed and charged on the person carrying on the concern, or on the agents

or other officers who have the direction or management of the concern or receive the profits thereof".

58. Section 55 of ICTA provides that the profits arising from certain concerns such as mines and quarries shall be taxed under Schedule D Case I. Section 55 of ICTA is rewritten as section 12 of this Act.

59. The origins of section 59(1) and (2) of ICTA can be traced back to the Income Tax Act 1842. There is no longer any reason to maintain the distinction between the two subsections.

60. Section 59(2) of ICTA identifies two classes of person on whom the profits of a section 55 concern should be taxed. These are:

- the person carrying on the concern; and
- the agents or other officers who have the direction or management of the concern, or receive the profits.

61. Both these classes of person are likely to be covered by the section 59(1) test that they are "receiving or entitled to the profits". But if they are not, there is no reason why a wider category of persons should be liable in respect of section 55 concerns than are liable in respect of any other trades.

62. Also, applying the "person receiving or entitled" test to the profits of a section 55 concern would not include persons who would not be chargeable through the application of section 59(2) of ICTA.

Section 9: Farming and market gardening

63. This section has two functions. First, it treats all farming or market gardening carried on in the United Kingdom as a trade. Second, it treats all farming carried on in the United Kingdom by a particular person as a single trade. It is based on section 53(1) and (2) of ICTA.

64. *Subsection (1)* deals with the first function. In most cases there will be no doubt that farming is a trade on first principles. Like section 10 of this Act this section can trace its origins back to the time when there was a charge to income tax under Schedule B on the occupation of land. Farming was originally charged under Schedule B. The purpose of section 53 of ICTA and its predecessor provisions was to take the charge on farming out of Schedule B and into Schedule D. With the abolition of Schedule B that function is now spent.

65. But section 53 of ICTA does make clear that even uncommercial farming is treated as a trade. This section preserves that effect.

66. *Subsection (2)* deals with the second function of the section. It provides that all farming carried on by a person in the United Kingdom is treated as a single trade. Farming carried on as part of another trade is not included in the single trade of farming.

67. The restriction of subsection (2) to farming in the United Kingdom is derived from the definition of "farming" in section 832(1) of ICTA.

68. Section 53(2) of ICTA uses the expression "particular person or partnership or body of persons" to make clear that the single trade rule applies also to a firm and to a body of trustees. It follows that farming carried on by a person as a member of a firm or a body of trustees is separate from any farming carried on by that person alone.

69. This section does not rewrite this rule as it applies to firms. That is dealt with in section 859 of this Act.

70. Nor does this section rewrite the reference to "body of persons" in section 53(2) of ICTA. It is generally understood that a body of persons acting as trustee, or in some

other representative or fiduciary capacity, is not the same entity for tax purposes as one of those persons acting on their own behalf. So, for instance, section 15(1)1(3) of ICTA refers only to "a particular person or partnership"; there is no need to refer to a "body of persons". Retaining a reference to a "body of persons" in this section would cast doubt on the meaning of sections where the phrase is not used.

71. The definition of "farming" and "market gardening" is in section 876 of this Act.

Section 10: Commercial occupation of land other than woodlands

72. This section deals with the commercial occupation of land for purposes other than farming or woodlands. It is based on section 53(3) and (4) of ICTA.

73. The section treats the commercial occupation of land in the United Kingdom as the carrying on of a trade. It provides certainty of treatment if land is occupied on a commercial basis in circumstances that do not amount to the carrying on of a trade on first principles.

74. The origins of section 53 of ICTA go back to the time when there was a charge to income tax under Schedule B on the occupation of land. The purpose of the Schedule B charge was to tax the profit that an occupier of the land could earn from the land itself, for example, by farming it. The tax was charged whether or not the occupier actually exploited the land.

75. The Schedule B charge was calculated by reference to the annual value of the land. This amount could be considerably less than the amount of profit an occupier could in fact derive from the land. For this reason the basis of charge was switched from Schedule B to Schedule D Case I if the land was farmed or otherwise managed on a commercial basis.

76. The last remnant of Schedule B was repealed by FA 1988. Schedule 6 to FA 1988 exempted any profits and losses from the occupation of commercial woodlands from income tax.

77. The provisions of section 53 of ICTA relating to farming are rewritten as section 9 of this Act. The provisions relating to the occupation of commercial woodlands are rewritten as section 11 of this Act.

Section 11: Commercial occupation of woodlands

78. This section provides that the commercial occupation of woodlands is not treated as a trade for any income tax purpose. It is based on section 53(4) of ICTA and paragraph 3(2) of Schedule 6 to FA 1988.

79. *Subsection (3)* makes clear that when this section is read together with related sections any profits and losses arising from the commercial occupation of woodlands are wholly outside the income tax system.

80. This section prevents any charge to tax as trading income and denies any claim for relief for a trade loss. Section 267(b) of this Act performs a similar function in relation to property income. Section 768 of this Act prevents there being any charge to tax under Part 5 of this Act as miscellaneous income. Section 392(1)(b) of ICTA prevents any claim for a loss against miscellaneous income because it requires that for a loss to be allowed any profit on the same transaction should be taxable.

Section 12: Profits of mines, quarries and other concerns

81. This section treats the profits and losses of certain concerns as if they were the profits and losses of a trade. It is based on section 55 of ICTA.

82. The feature most of the concerns have in common is that they exploit land for its natural resources. The section applies only if the activity carried on by the concern does not

amount to a trade on first principles. If the activity is a trade on first principles the profits and losses will be taxed in accordance with section 5 of this Act.

83. *Subsection (1)* provides the profits and losses of the concern are calculated as if the concern were a trade. See *part (A) Change 2* in Annex 1.

84. The section does not deem the concern to be carrying on a trade. This means the profits will not be liable to Class 4 national insurance contributions as they are not immediately derived from the carrying on or exercise of a trade. Nor will the taxpayer qualify for capital gains tax roll-over relief under section 152 of TCGA. That section requires the taxpayer to be carrying on a trade as defined in section 158(2) of TCGA.

85. *Subsection (2)* provides that the profits and losses of the concern are charged to tax as if the concern were a trade carried on in the United Kingdom. See *part (B) Change 2* in Annex 1.

86. This rule applies even if the activity is carried on outside the United Kingdom. But subsection (2) makes clear that this territorial extension applies only to UK residents.

87. *Subsection (3)* provides that the normal loss rules apply. See *part (C) Change 2* in Annex 1.

88. *Subsection (4)* lists the concerns to which the section applies. It updates the reference to “fishings” to “rights of fishing”.

89. *Subsection (5)* makes clear that section 10 of this Act has priority over section 12. This is because section 10 treats the activity as if it were a trade. This contrasts with the approach of this section, which is to the treat the profits and losses as trade profits and losses. Section 10 may be more beneficial for the taxpayer. For example, the activity would qualify as a trade for capital gains tax purposes. See section 158(2) of TCGA.

Section 13: Visiting performers

90. This section has two functions. It treats certain activities as trades and it treats those trades as carried on in the United Kingdom. It is based on sections 555 to 558 of ICTA.

91. Section 555 of ICTA requires deduction of tax from certain payments to entertainers and sportsmen. The rules about deduction of tax are not rewritten in this Act. But there is a cross-reference in the definition of “payment” in subsection (8) to the rule about deduction of tax to identify the sort of payment with which the section is concerned.

92. A visiting performer may not be in the United Kingdom long enough to become resident for tax purposes. And any relevant activities may not be part of a trade, profession or vocation carried on in the United Kingdom. So, without this section, there would be no liability to tax on the activities in the United Kingdom.

93. *Subsection (1)* sets out the circumstances in which the section applies. A non-resident person performs “a relevant activity” in the United Kingdom. In accordance with subsection (8), that expression means activities prescribed by regulations. The regulations are those (currently SI 1987/530) made under sections 555 to 558 of ICTA or under section 14.

94. *Subsection (2)* creates a United Kingdom trade that includes the “relevant activity”.

95. *Subsection (4)* makes clear that this section creates a trade carried on in the United Kingdom only to the extent that such a trade would not otherwise exist. If a visiting performer’s activities in the United Kingdom amount to a trade on first principles, this section does not create a trade because one already exists. But a trade is not created if the activities are part of an employment. In that case, tax is charged on the payments as employment income (see section 7 of ITEPA).

96. *Subsection (5)* deals with the case where payments for the relevant activity are made to a person other than the performer - typically, a company controlled by the performer. As in subsection (2), the "relevant activity" is treated as part of a United Kingdom trade. In addition, the payments are treated as made to the performer (instead of to the "other person").

97. *Subsection (7)* treats the performer's deemed trade as separate from any other trade actually carried on by the performer.

Section 14: Visiting performers: supplementary

98. This section sets out the regulation-making powers that are needed for the operation of section 13. It is based on sections 556 and 557 of ICTA.

99. *Subsection (1)* is a regulation-making power to deal with the consequences of including in the performer's profits payments made to another person. It may be appropriate to allow a deduction for expenses incurred by another person (typically, but not necessarily, the person to whom the payments are made). And, if the payments are treated as receipts of the performer's trade, they may be excluded from the calculation of the other person's profits.

100. Section 556(5) of ICTA apparently means that the regulation-making power in section 556(3) of ICTA is itself capable of being disapplied by a regulation. This is illogical. So the reference to section 556(3) in section 556(5) of ICTA is not rewritten in this Act.

101. *Subsection (2)* is a regulation-making power to deal with calculation of the performer's profits.

Section 15: Divers and diving supervisors

102. This section deals with activities which are strictly the duties of an employment but which, if certain conditions are met, are taxed as if they were the carrying on of a trade. It is based on section 314 of ICTA.

Section 16: Oil extraction and related activities

103. This section provides that certain oil-related activities are treated as a single, separate trade. It is based on section 492(1) of ICTA.

104. Section 492 is in Chapter 5 of Part 12 of ICTA. Most of that Chapter is concerned with corporation tax and is not rewritten in this Act. The section deals with oil (and gas) exploration and extraction activities in the United Kingdom and in the United Kingdom sector of the continental shelf.

105. The main consequence of treating these oil-related activities as a separate trade is that losses from other trading activities cannot be set against oil profits. That consequence is set out in section 492(2) of ICTA.

Section 17: Effect of becoming or ceasing to be a UK resident

106. This section deals with the consequence of an individual trader moving to or from the United Kingdom. It is based on section 110A of ICTA.

107. *Subsection (1)* sets out the circumstances in which the section applies. In accordance with section 6 of this Act a non-resident individual who carries on a trade at least partly outside the United Kingdom is charged to tax only on the profits of any part of the trade carried on in the United Kingdom. Without this section it would be possible for a taxpayer to be charged to tax on profits which accrue in part of a basis period when the taxpayer is not resident in the United Kingdom.

108. If the trade is carried on in partnership and one of the partners changes residence, the rule in this section does not apply. But there is a special rule that applies only to the partner. See sections 852(6) and 854(5) of this Act.

109. *Subsection (2)* sets out the consequences of a change of residence. The trade is treated as ceasing and, if appropriate, a new one is treated as starting. There is no explicit rule in section 110A of ICTA to say when the trade is treated as ceasing or starting. The only sensible inference is that it is the date of the change of residence. The section makes this clear.

110. *Subsection (3)* ensures that losses are still available to be carried forward.

Section 18: Effect of company starting or ceasing to be within charge to income tax

111. This section applies only to companies and deems a trade commencement or cessation to take place in particular circumstances. It is based on section 337 of ICTA.

112. Section 337 of ICTA is primarily a corporation tax rule: it applies only to companies and originates from the introduction of corporation tax. However it can be relevant to income tax.

113. That is because non-resident companies are within the charge to income tax in respect of United Kingdom trade profits (when the trade is not carried on through a permanent establishment in the United Kingdom) and UK property business income. Section 337 of ICTA applies in cases of either inward or outward company migration. Where that involves a continuing trade or UK property business there will be a change of taxing regime from income tax to corporation tax or vice versa.

114. Section 18 says what happens when a company enters or leaves the income tax regime: then its trade profits are calculated as though it had commenced or discontinued the trade. The obverse case of the company exiting or entering the corporation tax regime is proper to the rewrite of section 337 of ICTA in the corporation tax provisions.

Section 19: Tied premises

115. This section treats rent received by a trader for premises let to persons to whom the trader supplies goods sold or used on those premises as a receipt of the trade rather than a receipt of a property business. It is based on section 98 of ICTA.

116. Section 98 of ICTA is expressed in general terms. But it most commonly applies to rent received by a brewer who lets premises to tied tenants.

Section 20: Caravan sites where trade carried on

117. This section allows a person who carries on a trade associated with the operation of a caravan site to include in the receipts of that trade income from letting pitches or caravans where the letting does not itself constitute a trade. It is based on ESC B29. See *Change 3* in Annex 1.

118. See section 875 and *Change 148* in Annex 1 for the definition of “caravan”.

Section 21: Surplus business accommodation

119. This section allows income from letting surplus business accommodation to be treated as a trade receipt instead of as rent. It is based on the practice known as “Revenue Decision 9” set out in Inland Revenue publication *Tax Bulletin* of 15 February 1994. See *Change 4* in Annex 1.

Section 22: Payments for wayleaves

120. This section applies if a trader receives rent from a wayleave granted in respect of land on which a trade is carried on. It is based on section 120 of ICTA.

121. Rent received in respect of a wayleave is normally taxed as property income either by Chapter 2 of Part 3 of this Act (property businesses) or by section 344 (charge to tax on rent receivable for a UK electric-line wayleave). But if the rent is received in respect of land on which a trader carries on a trade and the trader receives no other rent in respect of the same land the rent, and any associated expenses, can be included in the calculation of the trade profits. See *Change 5* in Annex 1.

122. *Subsection (2)* applies if the rent is received in respect of a UK electric-line wayleave. A taxpayer is not required to include the rent and expenses in the calculation of the trade profits.

123. *Subsection (3)* applies if the rent is received in respect of any other type of wayleave. A taxpayer is not required to include the rent and expenses in the calculation of the trade profits.

124. *Subsection (4)* defines "rent". Section 120 of ICTA uses the definition of "rent" in section 119(3) of ICTA (rent etc. payable in connection with mines, quarries and similar concerns). Section 119 of ICTA is rewritten as Chapter 8 of Part 3 of this Act. The definition of rent in that Chapter and in this section must be the same. See the commentary on section 336 of this Act for a fuller description of the rewrite of the word "rent" in Chapter 8 of Part 3 of this Act.

125. *Subsection (5)* defines "wayleave". Section 120 of ICTA uses the word "easement" as defined in section 119(3) of ICTA to describe the nature of the right for which the rent is paid. This section uses "wayleave" as that is how most of the payments covered by this section are usually described in practice. The definition of "easement" in section 119(3) of ICTA gives that word a meaning that is much wider than its usual legal meaning. See the comments of Uthwatt J at pages 329 and 330 of Mosley v George Wimpey Ltd (1945), 27 TC 314 CA.

126. The definition of "wayleave" preserves the generality of the words in section 119(3) of ICTA and includes a reference to the Scottish equivalent, "servitude".

127. The definition has no territorial limitation. So the section covers services other than UK electric-line wayleaves.

Section 23: Rent-a-room and foster-care relief

128. This section modifies the normal calculation rules when an individual is eligible for rent-a-room or foster-care relief under Part 7 of this Act. It is new.

129. When rent-a-room relief or foster-care relief applies the income may, depending on the total amount, be either exempt from tax or subject to a special calculation rule. This section ensures that, when appropriate, the rent-a-room and foster-care rules take priority over the usual trading profit calculation rules.

Chapter 3: Trade profits: basic rules

Section 24: Professions and vocations

130. This section makes it unnecessary to specify repeatedly that the rules in this Chapter (apart from section 30) apply to a profession or vocation as well as to a trade. It is new.

Section 25: Generally accepted accounting practice

131. This section sets out the starting point for the calculation of trade profits. It is based on section 42 of FA 1998, as amended by section 103(5) of FA 2002.

132. *Subsection (1)* is the general rule that requires profits to be calculated "in accordance with generally accepted accounting practice", an expression defined in section 50 of FA 2004. In particular, such practice generally requires account to be taken of debtors

and creditors and of the value of stock and work in progress. The general rule is subject to any special rule of law whether expressed in statute or explained by the courts.

133. The relevant statutory laws are mainly those that are rewritten in this Part. But there are also provisions not included in Part 2 of this Act which may affect the calculation of profits: for example, the pension contributions deductions provisions in FA 2004 and certain anti-avoidance provisions in ICTA that apply to all income types.

134. *Subsection (2)* makes it clear that subsection (1) does not bring with it any of the other accounting requirements, such as a formal audit.

135. *Subsections (3)* and *(4)* set out two exceptions to the general rule in subsection (1). Some barristers may use the "cash basis" of accounting (see section 160). And Lloyd's underwriters have their own special rules (mostly in Chapter 3 of Part 2 of FA 1993).

136. The Inland Revenue does not believe that there are currently any non-resident companies liable to income tax in respect of insurance business or that there will be any in the future as the law stands at present. So this section does not reproduce the reference to companies carrying on life assurance mentioned in section 42(5) of FA 1998.

137. There are no other exceptions to the general rule. So this section does not reproduce the reference to "particular description of business" in section 42(5) of FA 1998.

Section 26: Losses calculated on same basis as profits

138. This section ensures that profits and losses are calculated on a consistent basis. It is based on section 46(2) of FA 1998.

Section 27: Receipts and expenses

139. This section is based on section 46(1) of FA 1998.

Section 28: Items treated under CAA 2001 as receipts and expenses

140. This section signposts the CAA rules. It is new.

141. In particular the CAA rules override the rules against the inclusion of capital items in sections 33 and 96 of this Act.

Section 29: Interest

142. This section sets out the basic rule that interest is of a revenue nature. It is based on section 74(1) of ICTA.

143. Section 74(1)(f) of ICTA provides that in computing the profits of a trade:

- no deduction is allowed in respect of any capital withdrawn from or employed, or intended to be employed, as capital in the trade; but
- the prohibition of any deduction in respect of capital should not be construed as disallowing the deduction of interest.

144. This section rewrites the second of these propositions by providing that for the purpose of calculating the profits of a trade, all interest is of a revenue nature.

145. The question of whether interest is deductible in arriving at the trade profits falls to be determined according to whether the interest meets the general criteria for the deduction of an expense of a revenue nature in calculating the profits of a trade.

Section 30: Animals kept for trade purposes

146. This section contains the basic rule for the income tax treatment of animals. It is based on paragraphs 1, 7(1) and 9(5) Schedule 5 to ICTA. The animals are treated as trading stock unless a herd basis election is made under Chapter 8 of Part 2 of this Act.

Section 31: Relationship between rules prohibiting and allowing deductions

147. This section makes clear the interaction between those provisions that allow a deduction and those provisions that prohibit a deduction. It is new. See *Change 6* in Annex 1.

148. The general principle is that a rule allowing a deduction takes priority over a rule prohibiting a deduction. But this is subject to a number of exceptions.

Chapter 4: Trade profits: rules restricting deductions

Overview

149. This Chapter contains provisions prohibiting various deductions in calculating the profits of a trade or restricting the extent to which such deductions can be made.

Section 32: Professions and vocations

150. This section makes it unnecessary to specify in each section in this Chapter that the section applies to a profession or vocation as well as to a trade. The section is new.

Section 33: Capital expenditure

151. This section is based on section 74(1) of ICTA.

152. Section 74(1) of ICTA prohibits various deductions in computing a trader's profits including:

> (f) "any capital withdrawn from, or any sum employed or intended to be employed as capital in the trade, profession or vocation, …
>
> (g) any capital employed in improvements of premises occupied for the purposes of the trade, profession or vocation.

153. It is a long-established and generally accepted principle that capital items are ignored in calculating the profits of a trade.

154. Section 42(1) of FA 1998 requires that the profits of a trade:

> "must be computed in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in computing profits for those purposes.

155. But the question of whether a sum is income or capital is ultimately a question of law, not accountancy. For judicial authority for this proposition, see, for example the words of Brightman J on page 173 of ECC Quarries Ltd v Watkis (1975), 51 TC 153 CD[1]:

> "…unchallenged evidence, or a finding, that a sum falls to be treated as capital or income on principles of correct accountancy practice is not decisive of the question whether in law the expenditure is of a capital or income nature.

156. A sum which is of a capital nature may however be allowed as a deduction in computing the profits of a trade because of a statutory exception to the general rule on the deduction of such items in this section. See, for example, section 89 (expenses connected with patents).

1 STC [1975] 578

157. Section 74(1)(g) of ICTA is not rewritten as the deduction of capital employed in the improvement of premises is covered by the general prohibition on the deduction of "items of a capital nature". In the absence of general agreement on what constitutes capital expenditure "items of a capital nature" is not defined.

Section 34: Expenses not wholly and exclusively for trade and unconnected losses

158. This section contains rules for the deduction of expenses and losses in calculating the profits of a trade. It is based on section 74(1)(a) (expenses) and (e) (losses) of ICTA.

159. Section 74(1)(a) of ICTA provides that in calculating the profits of a trade no deduction is allowed for expenditure which is not incurred "wholly and exclusively" for the purposes of that trade. This could be construed to mean that if expenditure is incurred partly for trade purposes and partly for some other purposes, no part of that expenditure can be deducted in arriving at the trade profits.

160. But section 74(1)(c) of ICTA, which prohibits any deduction in respect of the rent of premises used for residential or "domestic" purposes, provides for the *apportionment* of rent paid for premises used partly as residential accommodation and partly for the purposes of a trade. And in practice, a deduction is allowed for any expenditure which can be apportioned between trade and non-trade expenditure – for example, expenditure on a car used partly for trade and partly for private purposes.

161. There is judicial support for allowing a deduction where expenditure incurred for more than one purpose can reasonably be apportioned between expenditure incurred for the purpose of the trade and non-trade expenditure. See, for example, Lochgelly Iron and Coal Company Ltd v Crawford (1913), 6 TC 267 CS, in which a deduction was allowed for part of a subscription to a trade association and Copeman v Flood (1941), 24 TC 53 KB, in which the High Court remitted the case to the Commissioners to find as a fact whether the remuneration paid to certain directors who were also shareholders in the family company was wholly and exclusively expended for the purpose of the Company's trade, and if not, how much of the remuneration was so expended.

162. Conversely, the courts have held that if it is not possible to identify any part of the expenditure which is incurred wholly and exclusively for the purposes of the trade, no apportionment is possible. See, for example, Mallalieu v Drummond (1983), 57 TC 330 HL[2] in which no deduction was allowable for professional clothing worn for warmth and decency as well as being required by the taxpayer's profession.

163. So *subsection (2)* of this section provides for the deduction of any part or proportion of expenses incurred partly for the purposes of the trade and partly for some other purpose which can be *identified* as incurred wholly and exclusively for the purposes of the trade. And because rent on dual purpose accommodation can be apportioned under subsection (2) of this section, it is not necessary to rewrite section 74(1)(c) of ICTA.

Section 35: Bad and doubtful debts

164. This section is based on the relief for bad and doubtful debts in section 74(1)(j) of ICTA. It also subsumes the relief in section 89 of ICTA for debts proved irrecoverable after a trade, profession or vocation is deemed to have ceased. See *Change 7* in Annex 1.

165. See section 259 for the meaning of "statutory insolvency arrangement" in *subsection (1)(c)* of this section.

Section 36: Unpaid remuneration

166. This section prevents a deduction for employees' (or an office-holder's) pay until it is paid. It is based on section 43 of FA 1989.

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2 STC [1983] 665

167. Section 43 of FA 1989 was introduced when the assessment of employment income was put on a receipts basis. No deduction is given to the employer for employees' pay until that pay is treated as received by the employees.

168. *Subsection (1)(b)* makes clear that the rule in this section is in addition to any other rules that determine whether or not a deduction is allowable.

Section 37: Unpaid remuneration: supplementary

169. This section provides definitions and further explanation of the main rule in section 36. It is based on section 43 of FA 1989.

170. *Subsection (1)* applies section 36 to provisions made in the accounts in respect of amounts that may become employees' remuneration. An example of such a provision would be an incentive payment that is payable only if the employee remains with the employer for a number of years.

171. *Subsection (3)* deals with the case in which the employer submits his or her tax return before the end of the nine month limit in section 36(2) and all or any of the remuneration is unpaid. The employer must assume the remuneration will remain unpaid. If, subsequently, the remuneration is paid within the time limit the calculation can be adjusted and the return amended. See *Change 8* in Annex 1.

Employee benefit contributions

Overview

172. The next seven sections deal with the deduction allowed in respect of an employer's contribution to an employee benefit scheme. They are based on Schedule 24 to FA 2003.

173. The sections give a comprehensive set of rules for determining when deductions can be made for payments made by an employer to a third party to hold or use to provide benefits for the employer's employees. The rules apply in particular to contributions made to the trustees of an employee benefit trust but are not confined to such contributions. They do not apply to contributions made to certain pension schemes.

Section 38: Restriction of deductions

174. This section sets out the conditions under which a deduction may be allowed. It is based on paragraphs 1 and 8 of Schedule 24 to FA 2003.

175. *Subsection (1)* identifies the conditions for the section to apply. It applies only to deductions that would otherwise be allowed under normal principles. It applies both to contributions made and to provisions in respect of contributions.

176. *Subsections (2)(b)* and *(3)(b)* apply if the benefit is provided by the making of the contribution itself. This may be the case if the employer sets up a trust to meet employees' medical expenses.

177. *Subsection (4)* identifies a number of cases in which employer contributions are not subject to the rules in this Chapter. Significant amendments have been made to this list by section 245(5) of FA 2004. That section is part of the regime for dealing with the taxation of pension schemes. The changes take effect from 6 April 2006.

178. This Act deals with this by including the new rules in this subsection. The commencement issue is then dealt with as a transitional measure in paragraphs 13 to 15 of Schedule 2 to this Act. The old rules apply until 5 April 2006.

Section 39: Making of "employee benefit contributions"

179. This section is based on paragraphs 1 and 9 of Schedule 24 to FA 2003.

Section 40: Provision of qualifying benefits

180. This section sets out what is meant by the provision of qualifying benefits. It is based on paragraph 2 of Schedule 24 to FA 2003. One of four conditions must be met.

181. *Subsection (2)* identifies the general rule, condition A. Subsections (3), (4) and (5) deal with less common cases, conditions B, C and D.

182. *Subsection (3)* applies if the employment income and national insurance contribution charges do not arise because the benefits are provided to an employee who works outside the United Kingdom.

183. *Subsection (4)* applies if the employment income and national insurance contribution charges do not arise because the benefits are provided in connection with the termination of the recipient's employment.

184. *Subsection (5)* applies if the benefit is provided under an employer-financed retirement benefits scheme. This condition will apply with effect from 6 April 2006. See the transitional measure in paragraph 15 of Schedule 2 to this Act. An employer-financed retirement benefits scheme is an arrangement under which the employer will pay pensions outside registered pension schemes introduced by FA 2004. The policy is to tax these benefits in the same way as other employee benefits. The definition of "employer-financed retirement benefits scheme" is given in section 44 of this Act.

Section 41: Timing and amount of certain qualifying benefits

185. This section sets out:

- when benefits in the form of money are treated as provided; and
- how to calculate the value of benefits provided by the transfer of an asset.

186. It is based on paragraphs 2 and 5 of Schedule 24 to FA 2003.

187. Section 245(4) of FA 2004 provides (with effect from 6 April 2006) that these rules do not apply to payments under an "employer-financed retirement benefits scheme".

188. *Subsection (2)* describes how to calculate the value of a qualifying benefit provided by the transfer of an asset. The amount of the benefit is the expenditure incurred on the asset by the third party including both the cost of acquiring the asset and any subsequent expenditure. If the asset was acquired by the employer and transferred to the third party the amount of the benefit is the trading deduction that would otherwise have been allowed to the employer plus any subsequent expenditure incurred by the third party.

189. *Subsection (3)* sets out an exception to the general rule in subsection (2). If the employment income charge is lower than the charge calculated in accordance with subsection (2) the value of the benefit is restricted to the lower amount.

Section 42: Provision or payment out of employee benefit contributions

190. This section sets out the rules for allocating the provision of qualifying benefits, or payment of qualifying expenses, by the third party against the employee benefit contributions received. It is based on paragraph 4 of Schedule 24 to FA 2003.

191. Other receipts and expenses of the third party are ignored. Qualifying benefits and qualifying expenses are treated as paid out of employee benefit contributions in priority to other expenditure and amounts received by the third party.

Section 43: Profits calculated before end of 9 month period

192. This section applies if the taxpayer makes his or her income tax return before the end of the nine month period. It is based on paragraph 6 of Schedule 24 to FA 2003.

193. A deduction is not allowed if the conditions in section 38 are not met at the time the return is made. The normal Self Assessment rules allow the return to be amended if the conditions are met before the end of the nine month period.

Section 44: Interpretation of sections 38 to 44

194. This section is based on paragraphs 3 and 9 of Schedule 24 to FA 2003 and section 245(7) of FA 2004.

195. An "employer-financed retirement benefits scheme" means:

> "a scheme for the provision of benefits consisting of or including relevant benefits to or in respect of employees or former employees of the employer
>
> But neither
>
> a registered pension scheme, nor
>
> a section 615(3) [of ICTA] scheme,
>
> is an employer-financed retirement benefits scheme.

Section 45: Business entertainment and gifts: general rule

196. This section and the following two sections deal with expenditure on business entertainment or gifts. This section is based on section 577(1),(5),(7) and (8) of ICTA.

197. *Subsection (1)* sets out the general rule that in calculating the profits of a trade no deduction is allowed for expenditure on providing entertainment or gifts.

198. *Subsection (2)* says that the general rule applies to sums paid to or on behalf of, or put at the disposal of, an employee (commonly known as an "expense allowance") only if those sums are *exclusively* for meeting expenses in providing business entertainment or gifts.

199. The general rule in subsection (1) does not apply to an allowance made to an employee for meeting expenses which include – but are not restricted to – expenses incurred in the provision of business entertainment or gifts. But section 356 of ITEPA provides that no deduction from the employee's earnings is allowed for expenses incurred in providing entertainment or gifts in connection with the trade, business, profession or vocation of his or her employer.

200. The definition of "employee" in *subsection (4)* of this section covers the application of this section and sections 46 and 47 to a non-resident company liable to income tax in the UK.

Section 46: Business entertainment: exceptions

201. This section is based on section 577(3),(5),(7) and (10) of ICTA.

Section 47: Business gifts: exceptions

202. This section is based on section 577(3),(5),(8),(9) and (10) of ICTA. See *Change 9* in Annex 1 regarding the provision in *subsection (3)* for the monetary limit on the exception in respect of certain gifts to be increased by Treasury order.

Section 48: Car or motor cycle hire

203. This section restricts the amount which a trader can deduct in respect of the cost of hiring certain cars or motor cycles with a retail price (when new) of more than £12,000. The restriction is in inverse proportion to the retail price. The section is based on sections 578A and 578B of ICTA.

204. Section 578B(1) of ICTA says that for the purposes of section 578A of ICTA "car" includes a motor cycle. So this section and section 49 refer to a "car or motor cycle" throughout.

205. Section 578A(4) of ICTA provides for amounts in respect of hire charges brought into account as a receipt of the trade under section 94 of ICTA (debts deducted and subsequently released) to be reduced in the same proportion as the deduction in respect of those charges is reduced under section 578A(3) of ICTA. *Subsection (4)* of this section extends the same treatment to amounts in respect of hire charges taxed as a post-cessation receipt under section 103(4) of ICTA (debts released after cessation). See *Change 10* in Annex 1.

206. Sections 94 and 103(4) of ICTA are rewritten in sections 97 and 249 respectively.

Section 49: Car or motor cycle hire: supplementary

207. This section is based on section 578B of ICTA.

208. Section 578B(2) of ICTA defines "qualifying hire car" for the purposes of section 578A of ICTA as a car hired under a hire-purchase agreement subject to an option to purchase which is exercisable for a nominal amount.

209. Not all hire purchase agreements require the hirer to exercise an option at the end of the hire period. Under some types of agreement, ownership of the vehicle passes automatically to the hirer at the end of the hire period. So *subsection (2)(a)* of this section extends the definition of "qualifying hire car or motor cycle" to include a car or motor cycle where ownership passes without the exercise of an option to purchase. See *Change 11* in Annex 1.

210. *Subsection (2)(c)* defines "qualifying hire car or motor cycle" by reference to the definition of "qualifying hire car" in section 82 of CAA.

211. Section 82 of CAA defines a "qualifying hire car" as follows:

"(1) For the purposes of this Part a car is a qualifying hire car if—

(a) it is provided wholly or mainly for hire to, or the carriage of, members of the public in the ordinary course of a trade, and

(b) the case is within subsection (2), (3) or (4).

(2) The first case is where the following conditions are met—

(a) the number of consecutive days for which the car is on hire to, or used for the carriage of, the same person will normally be less than 30, and

(b) the total number of days for which it is on hire to, or used for the carriage of, the same person in any period of 12 months will normally be less than 90.

(3) The second case is where the car is provided for hire to a person who will himself use it—

(a) wholly or mainly for hire to, or for the carriage of, members of the public in the ordinary course of a trade, and

(b) in a way that meets the conditions in subsection (2).

(4) The third case is where the car is provided wholly or mainly for the use of a person in receipt of -

(a) a disability living allowance under—

(i) the Social Security Contributions and Benefits Act 1992, or

(ii) the Social Security Contributions and Benefits (Northern Ireland) Act 1992,

because of entitlement to the mobility component,

(b) a mobility supplement under a scheme made under the Personal Injuries (Emergency Provisions) Act 1939,

(c) a mobility supplement under an Order in Council made under section 12 of the Social Security (Miscellaneous Provisions) Act 1977, or

(d) any payment appearing to the Treasury to be of a similar kind and specified by them by order.

(5) For the purposes of subsection (2) persons who are connected with each other are to be treated as the same person.

Section 50: Hiring cars (but not motor cycles) with low carbon dioxide emissions

212. This section excludes cars with low CO2 emissions and electrically propelled cars from the restriction in section 48. It is based on section 578A(2A) and (2B) of ICTA and section 60 of FA 2002.

213. Expenditure incurred on hiring a car first registered before 17 April 2002 does not qualify for relief under this section. See paragraph 17 of Schedule 2 to this Act.

214. *Subsection (2)* defines "car with low CO2 emissions" and "electrically propelled car" by reference to section 45D of CAA.

215. Section 45D(2) to (6) of CAA defines a car with low CO2 emissions as follows:

"(2) For the purposes of this section a car with low CO2 emissions is a car which satisfies the conditions in subsections (3) and (4).

(3) The first condition is that, when the car is first registered, it is so registered on the basis of an EC certificate of conformity, or a UK approval certificate, that specifies—

(a) in the case of a car other than a bi-fuel car, a CO2 emissions figure in terms of grams per kilometre driven, or

(b) in the case of a bi-fuel car, separate CO2 emissions figures in terms of grams per kilometre driven for different fuels.

(4) The second condition is that the applicable CO2 emissions figure in the case of the car does not exceed 120 grams per kilometre driven.

(5) For the purposes of subsection (4) the applicable CO2 emissions figure in the case of a car other than a bi-fuel car is—

(a) where the EC certificate of conformity or UK approval certificate specifies only one CO2 emissions figure, that figure, and

(b) where the certificate specifies more than one CO2 emissions figure, the figure specified as the CO2 emissions (combined) figure.

(6) For the purposes of subsection (4) the applicable CO2 emissions figure in the case of a bi-fuel car is—

(a) where the EC certificate of conformity or UK approval certificate specifies more than one CO2 emissions figure in relation to each fuel, the lowest CO2 emissions (combined) figure specified, and

(b) in any other case, the lowest CO2 figure specified by the certificate.

216. Section 45D(7) of CAA provides that the amount specified in section 45D(4) may be amended by Treasury order.

217. Section 45D(9) of CAA defines an electrically propelled car as a car which is:

"(a) …propelled solely by electrical power, and

(b) that power is derived from—

(i) a source external to the vehicle, or

(ii) an electrical storage battery which is not connected to any source of power when the vehicle is in motion.

Section 51: Patent royalties

218. This section is based on section 74(1)(p) of ICTA.

Section 52: Exclusion of double relief for interest

219. This section prevents a deduction for interest paid if the taxpayer claims relief under section 353 of ICTA. It is based on section 368(4) and (6) of ICTA.

220. The section will apply in the limited circumstances in which it is possible to claim relief for interest paid under section 353 of ICTA and as a deduction in calculating trade profits. This is likely only if the claim under section 353 of ICTA satisfies the qualifying conditions in section 359 of ICTA (loan to buy machinery or plant). Such relief is given in the tax year in which the interest is paid.

221. Alternatively, if the normal trade profit rules are met, the interest may qualify as a trading deduction. Such a deduction would be allowed on the normal accruals basis.

222. The section is mirrored by section 368(3) of ICTA which prevents a claim under section 353 of ICTA if the interest has been allowed as a trading deduction.

223. *Subsection (5)* gives the rule for deciding when relief under section 353 of ICTA has been given. It uses the definition of "finally determined" in section 43C(4) of TMA. See *Change 12* in Annex 1.

Section 53: Social security contributions

224. This section prevents a deduction for most social security contributions in calculating trade profits. It is based on section 617 of ICTA.

225. The rule is that there can be no deduction for the trader's own social security contributions. The section achieves this by prohibiting a deduction for any contributions and making an exception for contributions that an employer makes for the trade's employees.

226. The rule in section 617 of ICTA applies generally for tax purposes. This Act splits the rule.

- This section sets out the income tax trading income rule (applied also to property income by section 272).
- Section 868 sets out the income tax rule for non-trading income charged to tax by this Act (including rents from "concerns" charged to tax by Chapter 8 of Part 3 of the Act).
- A new section 360A of ITEPA is introduced by this Act (see paragraph 594 of Schedule 1 to this Act) to set out the rule for employment income.
- Section 617 of ICTA as consequentially amended (see paragraph 262 of Schedule 1 to this Act) continues to apply for corporation tax.

Section 54: Penalties, interest and VAT surcharges

227. This section contains the rule that most tax penalties and interest are not to be deducted for tax purposes. It is based on section 90 of TMA and section 827 of ICTA.

228. The section brings together all the rules prohibiting a trading deduction for penalties, interest and surcharges imposed by statute. So it deals with interest on unpaid income tax (imposed by TMA) as well as the penalties, interest, and surcharges relating to

the indirect taxes that are dealt with in section 827 of ICTA. The section is applied to property income by section 272.

229. There is a similar rule for non-trading income in section 869.

230. The table in *subsection (2)* sets out the specific statutory references because a general description of the penalties etc would not be precise enough. But the second column of the table is a description of the tax to indicate what is involved.

Section 55: Crime-related payments

231. This section prohibits any deduction for expenses incurred in making a payment:

- the making of which is a criminal offence, or which would be a criminal offence if the payment was made in the United Kingdom; or
- which is made in response to a demand, the making of which is a criminal offence.

232. The section is based on section 577A of ICTA.

233. It overrides any provision which otherwise allows a deduction to be made in calculating the profits of a trade. See section 31(1)(b) of this Act.

Chapter 5: Trade profits: rules allowing deductions

Overview

234. This Chapter contains provisions allowing various deductions in calculating the profits of a trade.

Section 56: Professions and vocations

235. This section makes it unnecessary to specify repeatedly that the rules in this Chapter (apart from sections 87 to 90) apply to a profession or vocation as well as to a trade. It is new.

Section 57: Pre-trading expenses

236. This section gives relief for expenses incurred before a trade starts. It is based on section 401(1) of ICTA.

237. Originally section 401 of ICTA gave relief by creating a loss for the tax year in which the expense was incurred. It was amended to allow the expense as a deduction on the first day of trading.

238. *Subsection (1)* sets the scene. Consistent with other rules in this Part, it refers to the "date" on which (instead of the "time" when) a person starts to trade.

239. *Subsection (2)* identifies the expenses that are allowed by the section. They are expenses that would be allowable if incurred after the start of the trade.

Section 58: Incidental costs of obtaining finance

240. This section gives relief for certain costs incurred in obtaining a loan, or an abortive loan. It is based on section 77(1),(2),(6) and (7) of ICTA.

241. Without this section, no deduction would be allowed for the incidental costs of raising a loan on capital account.

242. *Subsection (2)* defines "incidental costs of obtaining finance". Expenses incurred in the course of obtaining finance *other than* those listed in subsection (2) are subject to the rules restricting or allowing deductions in the usual way.

Section 59: Convertible loans and loan stock etc.

243. This section excludes from relief under section 58 costs relating to certain convertible securities. It is based on based on section 77(3),(4) and (5) of ICTA

Section 60: Tenants under taxed leases: introduction

244. This section and the following five sections entitle a tenant who uses land for the purposes of a trade to a deduction in calculating the profits of the trade for expenses which he or she is treated as incurring if the land is held under a lease which gives rise to an amount brought into account under Chapter 4 of Part 3 of this Act. Chapter 4 of Part 3 of this Act is based on sections 34 to 38 of ICTA. This section is based on section 87(1),(2) and (8) of ICTA.

245. Sections 277 to 286 treat certain amounts received by landlords as receipts of a property business. Sections 291 to 294 give a tenant carrying on a property business relief in the form of a deduction for expenses which the tenant is treated as having incurred. In rewriting section 87 of ICTA, sections 60 to 65 follow the same approach as sections 291 to 294 of this Act by giving relief in the form of a deduction for expenses which the tenant is treated as having incurred.

246. Section 87(2) of ICTA treats a person who occupies for the purposes of a trade land in relation to which any amount "falls to be treated as a receipt of a Schedule A business" by virtue of section 34 or 35 of ICTA as paying rent. In accordance with the policy of treating UK and overseas property businesses in the same way as far as possible, section 60(1) of this Act extends relief under section 87(2) of ICTA to a person who occupies for the purposes of a trade land outside the United Kingdom in relation to which any amount falls to be treated as a receipt of an overseas property business by virtue of section 34 or 35 of ICTA as applied by section 65A(5) of ICTA. See *Change 13* in Annex 1.

247. The amount which a tenant can deduct in respect of rent which he or she is treated as paying under section 87(2) of ICTA is qualified by:

- the general rules as to deductions not allowable in computing the profits of a trade in section 74(1) of ICTA; and
- rules prohibiting or restricting the deduction of specific expenditure elsewhere in ICTA.

248. In this Act, the rules restricting deductions are to be found in Chapter 4 of Part 2. Section 74(1)(a) of ICTA is rewritten in section 34 of this Act. Section 60(3) of this Act preserves the interaction of section 87(2) of ICTA and the general and specific rules restricting deductions in ICTA by providing that a deduction for an expense which a tenant is treated as incurring under section 61 of this Act is subject to the application of any provision of Chapter 4 of this Act.

Section 61: Tenants occupying land for purposes of trade treated as incurring expenses

249. This section treats a tenant under a lease in respect of which an amount is brought into account by the landlord under sections 277 to 282 (a "taxed lease") as incurring an expense for each day on which the property held under the lease is occupied for the purposes of his or her trade. It is based on section 87(2),(3) and (9) of ICTA.

250. Sections 277 to 282 rewrite sections 34 and 35 of ICTA. Sections 34 and 35 of ICTA treat premiums and certain other amounts in respect of leases as rent. In sections 277 to 282, a person who receives a premium, or an amount treated as a premium in section 34 or 35 of ICTA, is instead treated as entering into a transaction mentioned in section 264 (if the land to which the lease relates is in the United Kingdom) or in section 265 (if the land is outside the United Kingdom). This gives rise to a UK or overseas property

business (as defined in sections 264 and 265) if the recipient is not already carrying on such a business.

251. Sections 277 to 282 then require the recipient to bring an amount in respect of the premium or other amount payable under the lease into account as a receipt in calculating the profits of his or her property business.

252. Section 87(2) of ICTA treats a tenant who occupies land for the purposes of a trade as paying rent. This corresponds to the treatment in sections 34 and 35 of ICTA of a landlord who receives a premium, or an amount treated as a premium, as rent.

253. *Subsection (1)* instead treats the tenant as incurring an expense in respect of the land subject to the taxed lease. This corresponds to the treatment of the premium or other amount in respect of the land as a receipt in calculating the profits of the landlord's property business in sections 277 to 282 of this Act.

254. Section 87 of ICTA says that the tenant is treated as paying rent for the purposes of making deductions in calculating the profits of a trade. But the tenant is only entitled to a deduction if at least some of the property is used for the purposes of the trade. So *subsection (3)* defines a qualifying day as a day on which the tenant occupies all or a part of the land subject to the taxed lease for the purposes of carrying on a trade.

255. The formula in *subsection (4)* calculates the expense for each qualifying day by spreading the amount of the taxed receipt evenly over the receipt period of that receipt. Defining "A" in that formula as "the unreduced amount of the taxed receipt" makes clear that the amount of the expense which the tenant is treated as incurring for each qualifying day is calculated by reference to the amount of the taxed receipt *before* any reductions or deductions.

256. *Subsection (5)* modifies that formula for a qualifying day on which the tenant occupies only part of the land subject to the taxed lease for the purposes of a trade.

257. Section 87(3) of ICTA requires a "just apportionment" to be made where part only of the land subject to the lease is used for the purposes of the trade. Subsection (5) instead requires the fraction of the land which is occupied by the tenant for the purposes of the trade to be calculated "on a just and reasonable basis". See *Change 14* in Annex 1.

Section 62: Limit on deductions if tenant entitled to mineral extraction allowance

258. This section prevents a double deduction where a tenant is entitled under section 403 of CAA to an allowance in respect of qualifying expenditure on acquiring a mineral asset. It is based on section 87(7) of ICTA.

259. Section 87(7) of ICTA refers to an allowance for "any chargeable period". Section 832 of ICTA defines chargeable period (other than in the case of an accounting period of a company) as a year of assessment. So this section refers instead to an allowance for "a tax year".

Section 63: Tenants dealing with land as property employed for purposes of trade

260. This section applies to a tenant who, while not occupying a property, uses the property for the purposes of a trade – for example a trader who lets premises held under a taxed lease to a tenant who sells only goods supplied by that trader. It is based on section 87(4) and (6) of ICTA.

261. *Subsection (2)* treats the tenant as if he or she occupied the property for the purposes of relief under section 61 of this Act.

262. *Subsection (3)* is based on section 87(6) of ICTA which says that a tenant shall not be treated as paying rent under section 87(4) of ICTA for any chargeable period for which rent has, or will be, treated as paid under section 37(4) of ICTA. It prevents a tenant obtaining relief under section 61 to the extent that relief for the same day has been

allowed in calculating the profits of a property business under section 292. Section 292 rewrites section 37(4) of ICTA.

Section 64: Restrictions on section 61 expenses: lease premium receipts

263. This section is based on section 87(5) of ICTA. It restricts the expenses a tenant is treated as incurring under section 61 where a tenant under a taxed lease:

- grants a sublease in respect of a property which section 63 treats the tenant as occupying for the purposes of the trade; and
- receives in respect of the sublease, an amount which is brought into account as a receipt under Chapter 4 of Part 3 of this Act (a "lease premium receipt").

264. Section 87(5) of ICTA applies where there is a reduction in a receipt of a Schedule A business by virtue of section 34 or 35 of ICTA. This section also applies where there is a reduction in a receipt of an overseas property business by virtue of section 34 or 35 of ICTA as applied by section 65A(5) of ICTA. See *Change 13* in Annex 1.

265. Section 61 treats a tenant who occupies land under a taxed lease for the purposes of a trade as incurring an expense for each qualifying day in the receipt period of the taxed receipt relating to the taxed lease. The expense is calculated by reference to the amount of the taxed receipt.

266. If there is a reduction under section 288 in the amount which the tenant brings into account as a receipt under Chapter 4 of Part 3 of this Act in respect of the sublease, section 64 makes a corresponding reduction in the amount of the expense which section 61 treats the tenant as incurring for a qualifying day in the receipt period of the lease premium receipt.

267. It is not clear how the rule in section 37(5) of ICTA (as applied to section 87(4) of ICTA by section 87(5)) of ICTA is intended to apply where there is more than one "amount chargeable" by reference to which relief can be claimed for the same qualifying day.

268. *Subsections (3)* and *(4)* treat the tenant as incurring an expense for a qualifying day of the amount by which the "daily amount" of the taxed receipt exceeds:

- the "daily reduction" of the lease premium receipt; or
- if the qualifying day falls within the receipt period of more than one lease premium receipt, the *total* of the daily reductions of those lease premium receipts.

269. This corresponds to the treatment in section 293 of this Act of an expense under section 292 for a qualifying day which falls within the receipt period of more than one lease premium receipt. See *Change 15* in Annex 1.

270. The "daily amount" of a taxed receipt and the "daily reduction" of a lease premium receipt are calculated according to the formulas in *subsection (6)*:

- the formula for calculating the daily amount of the taxed receipt is the same formula used in section 61(4) to calculate the amount of the expense which the tenant is treated as incurring for each qualifying day in the receipt period of the taxed receipt; and
- the formula for the daily reduction of the lease premium receipt allocates equal amounts of the reduction by reference to the taxed receipt under section 288 to each day in the receipt period of the lease premium receipt.

Section 65: Restrictions on section 61 expenses: lease of part of premises

271. This section is based on section 87(5) of ICTA. It adapts section 61:

- where section 64 applies; and

- the sublease granted by the tenant does not extend to the whole of the premises subject to the taxed lease.

272. *Subsection (4)* deals with the case where the conditions for relief in sections 64 and 65 are met on the same qualifying day in respect of more than one lease. This corresponds to the treatment in section 294(4) of this Act of expenses under sections 292 and 293 where more than one taxed receipt falls to be reduced by reference to the same taxed receipt. See *Change 15* in Annex 1.

273. *Subsection (5)* adapts the formulas in sections 61(4) and 64(6) by multiplying the unreduced amount of the taxed receipt in those formulas ("A") by the fraction of the premises to which the sublease relates.

274. Section 87(3) of ICTA requires a "just apportionment" to be made where part only of the land to which section 87(2) of ICTA applies is occupied for the purposes of a trade. This section instead requires the fraction in subsection (5) to be calculated "on a just and reasonable basis". See *Change 14* in Annex 1.

Section 66: Corporation tax receipts treated as taxed receipts

275. This section and the following section ensure that a tenant is entitled to relief for an expense under section 61 by reference to an amount treated as a result of section 34 or 35 of ICTA as a receipt of a Schedule A business, or an overseas property business, of a landlord liable to corporation tax in the same way as if the landlord was liable to income tax on an equivalent amount as a receipt of his or her property business under sections 277 to 282 of this Act. This section is new.

276. Section 296 of this Act adapts certain terms used to give a tenant who is carrying on a property business relief under sections 287 to 290 by reference to an amount taken into account for income tax purposes under sections 277 to 282 so as to give relief instead by reference to an amount treated as a receipt under section 34 or 35 of ICTA for the purpose of corporation tax:

- subsection (1) of section 296 introduces the label "corporation tax receipt" for an amount treated as a receipt of a Schedule A business under section 34 or 35 of ICTA on the interest of a landlord liable to corporation tax for an accounting period ending after 5 April 2005, or which would be treated as such a receipt other than for relief under section 37(2) of ICTA;

- subsection (2) of section 296 provides that, for the purposes of Chapter 4 of Part 3 of this Act, a corporation tax receipt is treated as a taxed receipt and the lease in respect of which it arose is treated as a taxed lease. "Taxed lease" and "taxed receipt" are defined in section 287(4);

- subsection (3) of section 296 adapts the term "receipt period" (as defined in section 288(6)) to apply to a corporation tax receipt; and

- subsection (4) of section 296 adapts the term "unreduced amount" (as defined in section 290(2) and (5)) to apply to a corporation tax receipt.

277. In applying section 296 for the purposes of sections 60 to 67, this section performs the same function as section 296 in relation to a tenant who occupies or otherwise employs property subject to a taxed lease for the purposes of his or her trade.

Section 67: Restrictions on section 61 expenses: corporation tax receipts

278. This section is new. It ensures that any relief given for corporation tax purposes under section 37(2) or (3) of ICTA for an accounting period ending after 5 April 2005 by reference to:

- a receipt brought into account under Chapter 4 of Part 3 of this Act where the landlord is liable to income tax; or
- a receipt brought into account under section 34 or 35 of ICTA where the landlord is liable to corporation tax,

is taken into account in applying section 61 in the same way as any relief under section 288.

279. *Subsections (1), (2)* and *(3)* refer to a reduction under section 37(2) or (3) of ICTA by reference to "the amount chargeable on the superior interest".

280. Section 37(1) of ICTA defines "the amount chargeable on the superior interest" as an amount treated as a receipt of a Schedule A business under section 34 or 35 of ICTA, or which would be so treated other than for relief under section 37(2) or (3) of ICTA, The "superior interest" is the interest in the property held by the immediate landlord.

281. Paragraph 20 of Schedule 1 to this Act amends section 37(1) of ICTA by extending the definition of "the amount chargeable on the superior interest" to include any amount treated as a receipt of a property business under sections 277 to 282 of this Act, or which would be treated as such a receipt other than for relief under the additional calculation rule in section 288.

282. So in this section "the amount chargeable on the superior interest" is an amount:

- treated as a receipt under section 34 or 35 of ICTA for *any* tax year; or
- treated as a receipt under Chapter 4 of Part 3 of this Act for an accounting period ending after 5 April 2005 as a result of the amendments to section 37(1) of ICTA made under paragraph 20 of Schedule 1 to this Act.

Section 68: Replacement and alteration of trade tools

283. This section allows a deduction for the cost of replacing or altering trade tools if the *only* reason a deduction would not be allowed is that the expenditure is of a capital nature. It is based on that part of section 74(1)(d) of ICTA that relates to deductions in respect of the replacement ("supply") or alteration of implements, utensils and other articles employed for the purposes of the trade.

284. Expenditure on repairing trade premises or tools is revenue under the normal rules. And following the Special Commissioners decision in Jenners Princes Street Edinburgh Ltd v CIR (1998), SpC000166[3], it is generally accepted that the reference in section 74(1)(d) of ICTA to expenditure "beyond the sum actually expended" does not prohibit the deduction of a provision for repairs if the cost of the repairs would be allowable. So that part of section 74(1)(d) of ICTA which deals with repairs is not rewritten.

Section 69: Payments for restrictive undertakings

285. This section allows a trader to deduct certain amounts paid to employees for restrictive undertakings. Such amounts might not otherwise be deductible to the extent that they are capital in nature or fall foul of the "wholly and exclusively" rule. The section is based on section 73(2) of FA 1988.

286. Section 73(2) of FA 1988 applies only to amounts brought into charge on the employee as earnings under section 225 of ITEPA. The former cross-refers to the latter where the definition of the amounts concerned is set out.

287. *Subsection (1)* provides for the deduction. In so doing it focuses on the key element for the rule to apply: the fact of payment.

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288. *Subsection (2)* provides a timing rule. The deduction allowed by section 73 of FA 1998 is taken in the period of account in which the payment is made and no deduction is allowed in any other period. Similar words are used in section 77(6) and section 88(2) so the timing rules for deductions in Chapter 5 of Part 2 of this Act are explicit and consistent.

Section 70: Employees seconded to charities and educational establishments

289. This section allows a trader to deduct the cost of an employee seconded to a charity or educational establishment in calculating the trade profits. It is based on section 86(1), (2) and (3) of ICTA.

290. Section 86 of ICTA allows a trader who seconds an employee to a charity or educational establishment to deduct the cost of employing the seconded person *to the extent that* those costs would have been deductible if the employee continued to be employed for the purposes of the employer's trade. This section allows the employer to deduct *all* costs attributable to the seconded employee during the period of the secondment, regardless of whether those costs would have been allowed if the employee had not been seconded. See *Change 16* in Annex 1.

291. *Subsection (3)* defines "educational establishment" by reference to various bodies listed in section 71 and to any other educational body approved by "the Secretary of State or, in Northern Ireland, the Department of Education". For the purposes of section 86 of ICTA and of this section, "the Secretary of State" is the Secretary of State for the Department for Education and Skills.

Section 71: Educational establishments

292. This section defines "educational establishments" for the purposes of section 70. It is based on section 86(3),(4),(5) and (6) of ICTA.

293. Section 86(4)(c) of ICTA refers to an independent school registered under section 465 of the Education Act 1996. Section 465 of the Education Act 1996 was repealed by the Education Act 2002. So *subsection (1)(c)* refers instead to an independent school registered under section 161 of the 2002 Act.

Section 72: Payroll deduction schemes: contributions to agents' expenses

294. This section an allows an employer a deduction for expenses incurred in operating the payroll deduction scheme. It is based on section 86A of ICTA.

295. The main rules for payroll deduction schemes are found in Part 12 of ITEPA. Under such a scheme, an employer deducts charitable donations from employees' salaries and pays them to an agent, who distributes them to the employees' chosen charities.

296. The agent's administrative costs may be deducted from the donations. But many employers voluntarily pay the costs themselves so that the employees' full donations can go to the chosen charities.

297. Normally, payments made voluntarily to meet someone else's expenses are not made wholly and exclusively for the purposes of a trade and therefore would not be deductible. Employers might get relief for donations to charitable agencies under the Gift Aid scheme. But there are restrictions on the operation of that section and relief would not be available if the agent was not itself a charity.

298. This section gives relief for the expenses as a trading deduction.

299. *Subsection (3)* defines "approved scheme" and "approved agent" by reference to the definitions in section 714 of ITEPA.

300. Section 714(2) of ITEPA defines "approved scheme" as:

"a scheme which is approved (or is of a kind approved) by the Inland Revenue and under which—

(a) the payer is required to pay sums withheld to a body which is an approved agent at the time of the withholding, and

(b) the approved agent is required—

(i) to pay sums withheld to the specified charity or charities, or

(ii) in a case where the agent is itself a specified charity, to retain any sum due to itself …

301. Section 714(3) of ITEPA defines "approved agent":

"For the purposes of this section a body is an "approved agent" if it is approved by the Inland Revenue for the purpose of paying donations to one or more charities.

Section 73: Counselling and other outplacement services

302. This section provides a deduction for certain expenses of counselling provided for employees. It is based on sections 589A and 589B of ICTA, section 108 of FA 1993 and Schedule 6 to ITEPA.

303. *Subsection (3)* cross-refers to ITEPA for the conditions that need to be met for the deduction to be allowed (section 310 of ITEPA exempts the employee from tax in respect of counselling received).

Section 74: Retraining courses

304. This section gives a deduction for certain expenses of retraining provided for employees. It is based on section 588 of ICTA and Schedule 6 to ITEPA.

305. *Subsection (2)* cross-refers to ITEPA for the conditions that need to be met for the deduction to be allowed (section 311 of ITEPA exempts the employee from tax in respect of qualifying retraining courses).

306. The section does not rewrite section 588(3)(b) of ICTA. That provision makes a deduction in calculating the employer's trade profits conditional on the employee's exemption under section 311 of ITEPA in respect of the expenditure in question. This condition is not consistent with the similar provision rewritten in section 73 and does not serve any material purpose. See *Change 17* in Annex 1.

Section 75: Retraining courses: recovery of tax

307. This section allows the recovery of tax when a deduction under section 74 subsequently proves to have been wrongly allowed. It is based on section 588 of ICTA and Schedule 6 to ITEPA.

308. *Subsection (2)*, like section 74(2) cross-refers to the relevant provisions in ITEPA to refer to the conditions that have not been met.

309. *Subsections (4)* and *(5)* refer to the Inland Revenue rather than, as in the source legislation, to the inspector. See *Change 149* in Annex 1.

Sections 76 to 80: Redundancy payments etc

Overview

310. These five sections are based on the trading income rules relating to redundancy payments in sections 90, 579 and 580 of ICTA. The rules that deal with the employee's liability are in section 309 of ITEPA.

311. The trading income rules were introduced to reverse the decisions in CIR v Anglo Brewing Co Ltd (1925), 12 TC 803 and Godden v A Wilson's Stores (Holdings) Ltd (1962), 40 TC 161. In those cases the courts held that certain payments to employees on the closing down of a trade were not deductible in arriving at trading profits. In neither case was the payment made in accordance with a pre-existing obligation.

312. In 1999 the Inland Revenue announced (Tax Bulletin 39G, February 1999) that it will be guided by the decision in Commissioner of Inland Revenue v Cosmotron Manufacturing Co Ltd (1997), 70 TC 292[4].

313. In that Hong Kong case the Privy Council decided that redundancy payments made under a pre-existing obligation were deductible. Although that decision is merely persuasive in the United Kingdom, the Inland Revenue no longer argue that payments made under a pre-existing obligation (including a statutory obligation) are covered by the Anglo Brewing and Wilson's Stores decisions. The announcement in Tax Bulletin means that it may not be necessary to give the employer a statutory right to a deduction in calculating trading profits. But these sections put the matter beyond doubt.

Section 76: Redundancy payments and approved contractual payments

314. This section sets out the circumstances in which the following three sections apply and explains the terms used in the main provisions. It is based on section 579(2) of ICTA.

315. The sections retain the label "redundancy payment" and the expression "additional payment" from the source legislation. This section also introduces the label "approved contractual payment" to describe the payments that may replace redundancy payments in some cases.

Section 77: Payments in respect of employment wholly in employer's trade

316. This section sets out the main rule governing redundancy payments made by an employer. It is based on section 579(2) of ICTA.

317. If a payment is otherwise allowable (possibly as a result of the Cosmotron decision – see the overview for this group of sections), this section does not interfere with the accountancy treatment of the payment. In that case, the normal accruals basis applies.

318. *Subsection (5)* is based on section 113(2) of ICTA. The timing rule in section 579(2)(b) of ICTA refers to the "discontinuance" of a trade. That word has to be interpreted in the light of section 113 of ICTA: the trade is not treated as discontinued unless there is a complete change in the persons carrying it on.

319. The deduction allowed by section 579 of ICTA is for "a redundancy payment ... made". It is clear that a deduction is allowed only if a payment has been made. It follows that the deduction is to be taken in the period of account in which the payment is made and that no deduction is allowed in any other period.

320. *Subsection (6)* has a timing rule expressed in similar words to those used in sections 69 and 88 of this Act. So the timing rules for deductions in Chapter 5 of Part 2 are explicit and consistent. This special timing rule applies if the payment is allowable only as a result of this section.

Section 78: Payments in respect of employment in more than one capacity

321. This section deals with the case where the employee is employed in more than one capacity. It is based on section 579(5) of ICTA. The section covers the case where there is a private element in the employment and makes clear what part of the payment is allowed as a deduction in calculating trade profits.

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322. Section 579(5) of ICTA does not specify the basis on which to apportion the payment. This section adopts the "just and reasonable" apportionment that is used consistently in this Act. See *Change 14* in Annex 1.

Section 79: Additional payments

323. This section deals with any voluntary payments that an employer makes in addition to the statutory (or approved) payments dealt with in section 77 of this Act. It is based on section 90 of ICTA.

324. Unlike the payments in section 77, these additional payments are allowable only if the sole reason for their disallowance is the cessation of the trade.

325. The section applies to payments in connection with the cessation of *part* of a trade in the same way as it applies to payments in connection with the cessation of a whole trade. See *Change 18* in Annex 1.

326. *Subsection (2)* is based on section 113(2) of ICTA. Section 90(3) of ICTA refers to the "discontinuance" of a trade. That word has to be interpreted in the light of section 113 of ICTA: the trade is not treated as discontinued unless there is a complete change in the persons carrying it on.

327. A redundancy payment is not disallowable solely on account of a partial change of persons carrying on a trade. But this subsection puts it beyond doubt that a partial change of persons carrying on a trade does not count as a cessation.

Section 80: Payments made by the Government

328. This section sets out what happens if it is not the employer who makes the redundancy payment to the employee. It is based on section 579(6) of ICTA.

329. In some cases the Government makes the payment and is reimbursed by the employer. This section ensures that the employer is allowed a trading deduction.

330. *Subsection (1)(b)* reflects the effect of the devolution settlements. See *Change 19* in Annex 1.

Section 81: Personal security expenses

331. This section allows the deduction of certain expenditure, by individuals trading alone or in partnership, on their personal security. It is based on sections 112 and 113 of FA 1989.

332. Expenditure within this section normally falls foul of the "wholly and exclusively" rule in section 34 (based on section 74(1)(a) of ICTA). That is because it is incurred for an essentially non-business purpose.

333. The source legislation expressly overrides, where appropriate, both sections 74(1)(a) and (1)(b) of ICTA. Section 74(1)(b) of ICTA is not rewritten because it is not necessary (see the commentary on that provision in the explanatory notes on paragraph 45 of Schedule 1 to this Act). So the condition in *subsection (1)(e)* refers only to the rule in section 34.

334. The source legislation allows a deduction only for expenditure of a revenue nature. Section 81 can accordingly apply only to expenses of a revenue nature because section 33 is not overridden. There are parallel rules in section 33 of CAA which deal with similar expenditure of a capital nature.

335. Section 81 gives a narrowly targeted deduction which applies in particular and unusual circumstances. So it contains an extensive set of conditions which must be met for the deduction to succeed.

336. *Subsection (1)(b)* states the main condition: if there is no special threat there is no need to improve security and the rule cannot apply.

337. *Subsection (1)(e)* makes it clear that it is only the wholly and exclusively prohibitive rule that is overridden.

Section 82: Contributions to local enterprise organisations or urban regeneration companies

338. This is the first of five sections that allow deductions for contributions to local enterprise agencies, training and enterprise councils (TECs), local enterprise companies in Scotland, business links and urban regeneration companies. The sections are based on sections 79, 79A and 79B of ICTA.

339. Contributions to these bodies are generally donations and are likely to be made for benevolent reasons, rather than wholly and exclusively for the purposes of the trade (see section 34 of this Act).

340. *Subsection (3)* is an anti-avoidance rule. It prevents a trader using the section to obtain a deduction for private expenditure, such as funding the training of a family member, by passing funds through one of these bodies. The source legislation disallows any deduction if there is a benefit to the trader. This section merely restricts the deduction by the value of the benefit. See *Change 20* in Annex 1.

341. *Subsection (5)* sets out what happens if the trader receives a benefit in connection with the contribution. The rules in ICTA charge the benefit to tax for a "chargeable period", which, for income tax purposes, means a tax year. It is simpler to charge the benefit for a period of account. This is consistent with the similar charge on benefits in connection with gifts of trading stock (see section 108 of this Act). See *Change 21* in Annex 1.

342. The charge on the benefit applies if the benefit is received by a person "connected with" the trader. That expression is explained in section 878(5) of this Act.

343. *Subsection (6)(b)* deals with the case where the recipient's trade has ceased before the benefit is received. It treats the benefit explicitly as a post-cessation receipt. See *Change 22* in Annex 1.

344. *Subsection (7)* makes clear the extent of the disallowance under subsection (3) or charge under subsection (6).

345. The subsection limits the "disqualifying benefit" in accordance with the Inland Revenue practice. See *Change 20* in Annex 1.

Section 83: Meaning of "local enterprise organisation"

346. This section lists some of the organisations that qualify for deductions to be allowed under section 82. It combines the definitions in sections 79(4) and 79A(5) of ICTA.

347. *Subsection (2)* deals with local enterprise agencies. These agencies may take a number of forms and do not have an approval procedure for any other purpose. So the tax legislation specifies that they must be approved for this purpose.

348. The subsection introduces the expression "relevant national authority". The expression is used also in sections 84 and 85 of this Act.

349. The subsection reflects the effect of the devolution settlements. See *Change 19* in Annex 1. The National Assembly for Wales (Transfer of Functions) Order 1999 (SI 1999/672) devolves the functions of the Secretary of State under section 79 of ICTA to the National Assembly for Wales. So the "relevant national authority" may be the Assembly. But the Order does not refer to section 79A of ICTA. So the equivalent functions in subsections (3) and (5) of this section are still exercised only by the Secretary of State.

350. *Subsections (3)* to *(5)* deal with other bodies to which section 82 of this Act applies. These other bodies have to be set up in a particular way for other reasons and the tax legislation merely follows the existing procedures.

Section 84: Approval of local enterprise agencies

351. This section and section 85 set out the detailed rules that apply for the approval of local enterprise agencies and the withdrawal of such approval. They are based on section 79(4) to (7) of ICTA.

352. The section sets out the basic procedure for approving a local enterprise agency. The references to "relevant national authority" are explained in section 83(2) of this Act.

Section 85: Supplementary provisions with respect to approvals

353. This section and section 84 set out the detailed rules that apply for the approval of local enterprise agencies and the withdrawal of such approval. They are based on section 79(4) to (7) of ICTA.

354. The references to "relevant national authority" in this section are explained in section 83(2) of this Act.

Section 86: Meaning of "urban regeneration company"

355. This section sets out the detailed rules that apply for the designation of urban regeneration companies. It is based on section 79B(5) to (8) of ICTA.

Section 87: Expenses of research and development

356. This section gives relief for the cost of research and development undertaken by or on behalf of a trader. It is based on section 82A of ICTA.

Section 88: Payments to research associations, universities etc

357. This section gives relief for payments by a trader to various bodies engaged in scientific research. It is based on section 82B of ICTA.

358. Section 82B(1) of ICTA allows a deduction for "the sum paid". So *subsection (2)* allows a deduction for the period in which the payment is made.

359. Section 82B of ICTA provides that "the Board" shall refer any question as to whether, or to what extent, activities constitute scientific research for the purposes of section 82B to the Secretary of State. Section 832(1) of ICTA defines "the Board" as the Commissioners of Inland Revenue.

360. *Subsection (6)* instead says that any question as to what constitutes scientific research must be referred to the Secretary of State by "the Inland Revenue". "The Inland Revenue" is defined in section 878(1) of this Act as "any officer of the Board of Inland Revenue". See *Change 149* in Annex 1.

361. For the purposes of section 82B of ICTA and of this section, "the Secretary of State" is the Secretary of State for the Department of Trade and Industry.

Section 89: Expenses connected with patents

362. This section allows a deduction for expenses connected with patents. It is based on section 83 of ICTA.

363. *Subsection (1)* sets out the expenses that are allowable. The deduction is on the basis of expenses incurred. This relaxes any requirement in the source legislation that fees have to be paid before a deduction can be made. See *Change 23* in Annex 1.

364. *Subsection (2)* establishes that the rule in this section is an exception to the general rule in section 56.

Section 90: Expenses connected with designs or trade marks

365. This section allows a deduction for expenses connected with designs or trade marks. It is based on section 83 of ICTA.

366. *Subsection (1)* sets out the expenses that are allowable. The deduction is on the basis of expenses incurred. This relaxes any requirement in the source legislation that fees have to be paid before a deduction can be made. See *Change 23* in Annex 1.

367. *Subsection (2)* establishes that the rule in this section is an exception to the general rule in section 56 of this Act.

Section 91: Payments to Export Credits Guarantee Department

368. This section allows a trader to deduct the cost of certain payments to the Export Credits Guarantee Department ("ECGD"). It is based on section 88 of ICTA.

369. Section 88 of ICTA refers to payments made under arrangements made by the Secretary of State in pursuance of section 11 of the Export Guarantees and Overseas Investment Act 1978. This section refers instead to arrangements made under section 2 of the Export and Investment Guarantees Act 1991 which replaced the 1978 Act.

370. Section 13(1) of the Export and Investment Guarantees Act 1991 delegates the functions of the Secretary of State under section 2 of the 1991 Act to the ECGD. So the reference to the Secretary of State in section 88 of ICTA is not rewritten in this section.

371. Section 88 of ICTA allows a trader to deduct "sums paid" to the ECGD. This section instead allows a deduction for any "sum payable" by the trader. See *Change 24* in Annex 1.

Section 92: Expenses connected with foreign trades

372. This is the first of three sections that set out the special rules for expenses of a foreign trade. The sections are based on sections 80 and 81 of ICTA.

373. The expenses to be allowed are those of a business trip: the condition in sections 80(3) and 81(4) of ICTA is that the trader's absence from the United Kingdom should be wholly and exclusively for the purpose of a foreign trade (or for the purpose of a foreign trade and another trade).

374. The section sets out a single condition related to the purpose of the trader's absence from the United Kingdom. That condition applies for all the expenses set out in subsection (3).

375. In the case of family expenses, section 80(5) of ICTA requires the absence to be for the purpose of one or more *foreign* trades. The section relaxes this requirement. It allows the absence to be either for the purposes of the foreign trade or for the purposes of that trade and one or more other trades. The "other trades" may include one that is not carried on wholly outside the United Kingdom. So the treatment of family expenses is brought into line with the treatment of other expenses. See *Change 25* in Annex 1.

376. In the case of travelling expenses, section 81(3) of ICTA seems to impose a further condition requiring the performance of "functions" at the place of departure. This section does not include that further condition. See *Change 25* in Annex 1.

377. *Subsection (1)(d)* makes it clear that the section applies if it is only the "wholly and exclusively" rule that would otherwise disallow the expenses. The normal trading rule (based on the courts' explanation of the rule in section 34 of this Act) is that the cost of

home to work travel is not allowable for tax purposes. Other trading rules (such as the prohibition for capital expenditure in section 33) continue to apply.

378. *Subsection (2)* includes the rule that the special relief is not available if the income from the trade is assessable by reference to amounts received in the United Kingdom (the "remittance basis"). Section 80 of ICTA refers to section 65(4) of ICTA. This section refers directly to the remittance basis, which is explained in section 878(2) of this Act.

379. The section applies the special rules to the calculation of the profits of Irish trades (always assessed on the arising basis) even if the taxpayer's other foreign income is assessed on the remittance basis. See *Change 26* in Annex 1.

380. *Subsection (3)* sets out the expenses that qualify for relief under this section.

381. *Subsection (4)* defines the term "foreign trade". It replaces the reference in section 80 of ICTA to a trade carried on wholly abroad and the reference in section 81 of ICTA to a trade "in the case of which section 80 applies".

Section 93: Allocation of expenses

382. This section sets out the rules for allocating the expenses of the trades if the trader carries on more than one foreign trade. It is based on sections 80 and 81 of ICTA.

383. Those sections provide that the apportionment should be "reasonable". Other apportionments in this Act are made on a "just and reasonable" basis. This section uses "just and reasonable". See *Change 14* in Annex 1.

Section 94: Family expenses

384. This section sets out the family expenses that qualify for an allowance. It is based on section 80(6) and (9) of ICTA. The 60 day condition in section 80(5) of ICTA is in section 92(3)(c) of this Act.

385. Section 1 of the Family Law Reform Act 1987 (broadly) treats illegitimate children in the same way as legitimate children. Section 831(4) of ICTA disapplies that section. So section 80(9) of ICTA needs specially to bring illegitimate children within the scope of the relief in that section. Section 831(4) of ICTA does not apply to this Act. So the Family Law Reform Act ensures that illegitimate children are within this section.

Chapter 6: Trade Profits: Receipts

Overview

386. This Chapter contains provisions on how various receipts are to be treated in calculating the profits of a trade.

Section 95: Profession and vocations

387. This section makes it unnecessary to specify repeatedly that the rules in this Chapter (apart from section 105) apply to a profession or vocation as well as to a trade. The section is new.

Section 96: Capital receipts

388. This section corresponds to section 33 of this Act (capital expenditure) for capital receipts. It is new.

389. *Subsection (1)* sets out the general rule that items of a capital nature are not to be treated as receipts of a trade.

390. It is a long established principle that capital receipts are ignored in calculating the profits of a trade for income tax purposes. The principle that income tax applies only

to receipts of a revenue nature is set out by Lord MacNaghten in Attorney General v London County Council (1900), 4 TC 265 HL:

"Income Tax, if I may be pardoned for saying so, is a tax on income. It is not meant to be a tax on anything else.

391. Decisions in subsequent cases on whether a receipt is in the nature of income or capital have taken as their starting point Lord MacNaghten's principle that only receipts of a revenue nature fall to be included in the computation of the profits of a trade. See, for example, the comments of Lord Dundas and Lord Ormidale in Glenboig Union Fireclay Co, Ltd v CIR (1922), 12 TC 427 HL on whether a sum received as compensation for not working certain seams:

"…"the sum under consideration was surely of the nature of capital not revenue….the compensation was paid for the loss of a capital asset…the sum can surely not be described as profits arising from the Appellant's trade or business. (Lord Dundas)

…the sum received as compensation…falls to be dealt with as capital….it seems to me to be impossible to predicate of the £15,000 that they were profits arising or accruing from the trade or business of the company. (Lord Ormidale)

392. And, after recalling Lord MacNaghten's dictum in the London County Council case, Lord Moncreiff commented in Trustees of Earl Haig v CIR (1939), 22 TC 725 CS as follows:

"I accordingly proceed on the assumption, (which moreover appears to me to be a sound assumption) that all profits from trade, being the profits dealt with in Case I, are profits which have an "income" and not a "capital" quality.

393. More recently, the principle that capital receipts are not subject to income tax was restated by Lord Templeman in Beauchamp v F W Woolworth (1989), 61 TC 542 HL[5]:

"[Section 1 ICTA 1988] … directs … that income tax shall be charged in respect of profits described in Schedule D set out in [section 18 ICTA 1988]. That section directs … that tax shall be charged in respect of the annual profits arising or accruing to any person … from any trade. … The expression 'annual profits' confirms that income tax is to be charged on profits of an income nature as opposed to capital profits …

394. The question of whether a receipt is of a capital or a revenue nature falls to be determined by reference to the nature of the trade. This principle was set out by Lord MacMillan in Van den Berghs Ltd v Clark (1935), 19 TC 390 HL after reviewing the early authorities on distinguishing between income and capital receipts:

"…the nature of a receipt may vary according to the nature of the trade. The price of the sale of a factory is ordinarily a capital receipt, but it may be an income receipt in the case of a person whose business it is to buy or sell factories.

395. *Subsection (2)* disapplies the general rule in subsection (1) where there is statutory provision for a capital sum to be taken into account as a receipt in calculating the profits of a trade. See, for example, section 106 of this Act (sums recovered under insurance policies etc.).

Section 97: Debts incurred and later released

396. If an amount owed by a trader is released, this section treats the amount released as a trading receipt. The section is based on section 94 of ICTA.

397. *Subsection (1)(c)* sets out the exception that applies if the debt is released as part of a "statutory insolvency arrangement" (defined in section 259 of this Act). This rule reflects the change to section 94 of ICTA made by section 144 of FA 1994.

5 STC [1987] 510

398. If the trader is no longer carrying on the trade when the debt is released, the amount released is charged to tax as a post-cessation receipt (see section 249 of this Act).

Section 98: Acquisition of trade: receipts from transferor's trade

399. This section sets out what happens if a successor to a trade receives a sum that arose from the trade when it was carried on by the predecessor. It is based on section 106(2) of ICTA.

400. If a sum arises from a trade that has ceased, the usual rule is that the sum is a post-cessation receipt (see Chapter 18 of Part 2 of this Act). But, if the right to receive the sum is transferred with the trade to a person who takes over the trade, this section applies instead.

401. *Subsection (2)* treats the sum as a receipt of the successor's trade. It is not charged on the predecessor. The source legislation applies "for all purposes". This section applies for income tax purposes. Section 106(2) of ICTA (as amended by paragraph 85 of Schedule 1 to this Act) applies for corporation tax purposes. Section 37(1) of TCGA ensures that any sums received as a result of the transfer are not charged to capital gains tax.

402. *Subsection (3)* makes it clear that the sum is not treated as a post-cessation receipt.

403. Different rules apply if the right to receive sums is transferred to a person who does not take over the trade (see section 251 of this Act).

Section 99: Reverse premiums

404. This is the first of a group of five sections based on section 54 of and Schedule 6 to FA 1999. This legislation was introduced following the decision of the Privy Council in Commissioner of Inland Revenue v Wattie [1998], STC 1160. An inducement (a "reverse premium") paid to a tenant to take a lease of land is taxed as income in the hands of the tenant.

405. *Subsection (2)* introduces the term "the recipient", which is used throughout this group of sections.

406. *Subsection (3)* identifies the transaction which gives rise to a reverse premium.

407. *Subsection (4)* refers to an interest in land being "granted". This distinguishes such a transaction from one in which an interest is assigned. The general rule is that a charge to tax on a reverse premium arises on the grant of an interest in land but not on its assignment. But assignment can give rise to a charge if the assignor is connected with the grantor.

408. The meaning of "reverse premium" in this section is applied for the purpose of section 311 by subsection (6) of that section.

409. Paragraph 28 of Schedule 2 rewrites the transitional provision in section 54(2) of FA 1999. These sections do not apply to pre-1999 reverse premiums.

Section 100: Excluded cases

410. This section brings together the various exclusions from the charge on reverse premiums. It is based on paragraphs 5, 6 and 7 of Schedule 6 to FA 1999.

Section 101: Tax treatment of reverse premiums

411. This section treats a reverse premium as is a revenue receipt, rather than a capital item. It is based on paragraph 2 of Schedule 6 to FA 1999.

412. *Subsection (2)* is the rule for a trader. The reverse premium is treated as a receipt of the trade.

413. *Subsection (3)* is the rule for a non-trader. The reverse premium is treated as a receipt of a property business in accordance with section 311 of this Act.

414. If the transaction giving rise to the reverse premium is at arm's length there is no statutory timing rule; the normal accountancy treatment applies. If the transaction is not at arm's length, there is a timing rule in section 102.

Section 102: Arrangements not at arm's length

415. If a property transaction is not at arm's length there is a special timing rule. This section provides that the whole of the reverse premium is taxed when the property transaction is entered into. It is based on paragraph 3 of Schedule 6 to FA 1999.

416. *Subsection (1)* refers to "connected persons". That expression is defined for the purpose of this section in section 103.

417. *Subsection (5)* deals with the case where the recipient enters into a property transaction for the purpose of a trade but the trade has not yet started. In that case, the reverse premium is brought into account when the trade starts.

Section 103: Connected persons and property arrangements

418. This section contains the definition of "connected persons" that applies for the group of sections on reverse premiums. It includes a cross-reference to section 878(5) of this Act, which relies on the definition of "connected persons" in section 839 of ICTA. The section is based on paragraph 8 of Schedule 6 to FA 1999.

Section 104: Distribution of assets of mutual concerns

419. This section deals with the consequences for a trader of receiving a distribution from a mutual concern that is a corporate body. It is based on section 491 of ICTA.

420. *Subsection (1)* sets out the circumstances in which a distribution may give rise to a tax charge. It refers to a distribution out of assets that "represent profits" of the concern. This is not quite the same as "assets of a body corporate, other than assets representing capital", as identified in section 491(1) of ICTA. The difference is that the section excludes assets that represent capital gains of the concern. See *Change 27* in Annex 1.

421. *Subsection (2)* is the general rule: the distribution is treated as a receipt of the trade.

422. *Subsection (3)* deals with the case where the distribution is received after the trade has ceased. The section treats the distribution explicitly as a post-cessation receipt. See *Change 22* in Annex 1.

423. In the trading income Part the rules apply to the person carrying on a trade rather than to the trade itself. So section 113 of ICTA is not needed to treat a trade as ceasing when there is a change in the person carrying it on. That section is repealed (see paragraph 94 of Schedule 1 to this Act). Subsection (3) of this section reproduces the combined effect of section 491(3)(b) and (4) of ICTA.

424. *Subsection (4)* explains when money or money's worth "represents assets" in subsection (1). "Money's worth" includes consideration for the right to receive a distribution but excludes anything otherwise chargeable to tax.

425. *Subsection (5)* is a special rule that applies if the right to receive a distribution is transferred other than at arm's length. Market value is substituted for the actual amount received.

426. The section omits the references to mutual insurance and industrial and provident societies in section 491(9) and (11) of ICTA. Those examples were intended to help readers but there is no comprehensive definition of "mutual business". The subsections were intended to deal with particular doubts which were common when the provision was enacted in 1964. Those doubts do not exist today.

Section 105: Industrial development grants

427. This section deals with the treatment of certain grants under the Industrial Development Act 1982 or the corresponding provision in Northern Ireland. It is based on section 93 of ICTA.

428. This section does not rewrite the references in section 93(2) of ICTA to the Industry Act 1972, the Industries Development Act (Northern Ireland) 1966 and the Industries Development Act (Northern Ireland) 1971. These enactments were repealed or replaced in 1982 and there are no outstanding instalments under the old enactments.

429. Section 93(3) of ICTA disapplies section 93(1) of ICTA in the case of grants towards the payment of all or part of a corporation tax liability made under Article 7 of the Industrial Development (Northern Ireland) Order 1982. Persons liable to income tax do not, in general, receive grants for the payment of corporation tax. But such a grant could, in principle, be made under Article 7 of the 1982 Order to a partnership with an associated company.

430. Grants in respect of corporation tax liabilities can not be made under any of the enactments listed in *subsection (1)* of this section other than Article 7 of the Industrial Development (Northern Ireland) Order 1982. So *subsection (2)* of this section excludes *all* grants in respect of corporation tax liabilities.

Section 106: Sums recovered under insurance policies etc.

431. This section is based on section 74(1)(l) of ICTA.

432. Section 74(1)(l) of ICTA prohibits the deduction in computing a trader's profits of "any sum recoverable under an insurance or contract of indemnity". This is regardless of whether the sum is revenue or capital in nature.

433. Where a sum is recovered under an insurance policy or contract of indemnity in a year *other than* the year in which the event in respect of which it is received occurs, section 74(1)(l) of ICTA requires any deduction made in respect of that event to be adjusted to reflect the recovery.

434. This section provides instead that a capital sum recovered by a trader under an insurance policy or a contract of indemnity is brought into account as a receipt in calculating the profits of the trade to the extent that the loss or expense has been deducted in calculating those profits. This means the timing of the receipt will follow the accountancy treatment. See *Change 28* in Annex 1.

435. No special provision is needed for sums of a revenue nature.

Chapter 7: Trade profits: gifts to charities etc.

Section 107: Professions and vocations

436. This section makes it unnecessary to specify repeatedly that the rules in this Chapter apply to a profession or vocation as well as a trade. It is new.

Section 108: Gifts of trading stock to charities etc.

437. This section sets out the main rule for gifts of trading stock. It is based on sections 83A and 84 of ICTA, which give relief for gifts to charities and educational establishments respectively.

438. When a trader disposes of trading stock other than in the course of a trade the general rule is that the market value of the stock is taken into account in calculating the profits of the trade. That general rule is not explicit in the source legislation but it is explained in Sharkey v Wernher (1955), 36 TC 275 HL. This section sets out the exception to the general rule and applies if the trader disposes of trading stock by way of gift to a charity etc.

439. There is a test for gifts to educational establishments in section 84(2) of ICTA concerning the use to which the gift is put in the business of the educational establishment. There is no equivalent test in the rules for the relief for gifts to charities, in section 83A of ICTA. This section does not reproduce the condition in section 84(2) of ICTA. See *Change 29* in Annex 1.

440. The ICTA reliefs originally applied not only to gifts of trading stock but also to gifts of machinery and plant. That element of the reliefs is now in section 63 of CAA.

441. *Subsection (1)* combines the ICTA reliefs for gifts to charities and gifts to educational establishments. It includes the extension of the relief to registered clubs in Part 3 of Schedule 18 to FA 2002. The relief covers gifts "for the purposes of" charities etc. See *Change 30* in Annex 1.

442. *Subsection (2)* sets out the relief available under the section. It does not require a claim by the trader. In this respect, the section is different from section 84(3) of ICTA (but not from section 83A). See *Change 31* in Annex 1.

443. *Subsection (4)* lists the bodies (other than charities, registered clubs and educational establishments) to which a trader may make gifts that qualify for relief.

Section 109: Receipt by donor or connected person of benefit attributable to certain gifts

444. This section sets out what happens if a trader receives a benefit in connection with a gift of trading stock or plant and machinery. It is based on sections 83A and 84 of ICTA.

445. *Subsection (1)* applies the section if a benefit is received by the trader or a connected person. Section 82 of this Act (contributions to local enterprise organisations or urban regeneration companies) uses the same approach. The benefit must be in connection with a gift for which relief has been given under section 108 or under the corresponding capital allowances rule.

446. If the donor is still carrying on the trade when the benefit is received the value of the benefit is treated as a trading receipt. The ICTA rules impose a charge (under Schedule D Case I or II, but not explicitly as a trade receipt) for a chargeable period, which for an income tax payer is the tax year.

447. But the profits of a trade are calculated by reference to periods of account. (The basis period rules then determine the profits of the tax year.) *Subsection (2)* charges the benefit by reference to the period of account in which it is received. See *Change 21* in Annex 1.

448. If the donor has ceased to carry on the trade when the benefit is received the value of the benefit is treated as a post-cessation receipt. This treatment replaces the general charge under Schedule D Case VI. See *Change 22* in Annex 1.

Section 110: Meaning of "designated educational establishment"

449. This section defines "designated educational establishment" for the purpose of section 108. It is based on section 84(5) to (8) of ICTA.

450. The National Assembly for Wales (Transfer of Functions) Order 1999 (SI 1999/672) devolves the functions of the Secretary of State under section 84 of ICTA to the National Assembly for Wales. So this section refers to the Assembly.

451. The section reflects the effect of the devolution settlements. See *Change 19* in Annex 1. The section also uses the new name of the Northern Ireland department.

Chapter 8: Trade profits: Herd basis rules

Overview

452. This Chapter gives the rules for what is commonly known as the "herd basis". It is based on Schedule 5 to ICTA. The object of the herd basis is to treat a herd of animals in a similar fashion to a capital asset. Without the election the individual animals in the herd would be treated as separate items of trading stock. With the election:

- there is no tax allowance for the initial cost of, or any subsequent increase in the size of, the herd;
- the net cost of replacing animals in the herd is allowable;
- any profit or loss on the sale of a single animal or a small number of animals from the herd without replacement is included in the profits of the trade; and
- if the whole, or a substantial part of the herd, is sold and not replaced the resulting profit or loss is not included in the profits of the trade.

453. An election can be made only in respect of animals kept for their produce.

Section 111: Election for application of herd basis rules

454. This section allows a taxpayer to elect for the "herd basis rules" to apply and introduces some basic concepts. It is based on paragraphs 1(2), 1(3), 2(1), 3(1) and 9(1) of Schedule 5 to ICTA.

455. *Subsection (1)* allows a taxpayer to make a "herd basis election" if he or she keeps, or has kept, a "production herd". "Production herd" is defined in section 112(1)(c). The effect of a "herd basis election" is that the "herd basis rules" apply. These rules are set out in sections 114 to 123. The time limits for making the election are set out in sections 124 to 126. Section 878(3) and (4) of this Act sets out general rules for making claims and elections.

456. *Subsection (4)* makes clear that the Chapter has no application to a herd kept in circumstances that do not amount to the carrying on of a trade.

Section 112: Meaning of "animal", "herd", "production herd" etc.

457. This section provides various definitions used in the Chapter. It is based on paragraphs 8 and 9 of Schedule 5 to ICTA.

458. This section would be the natural home for the rule in paragraphs 7 and 9(5) of Schedule 5 to ICTA that prevents the herd basis rules applying to working animals. Paragraphs 7 and 9(5) of Schedule 5 to ICTA exclude certain animals from being part of a production herd. These are animals kept for the work they do in connection with the trade or those kept for public exhibition, or racing or other competitive purposes. In practice this rule is unnecessary since animals in a production herd must be kept wholly or mainly for the sake of their produce. So the exclusions are not rewritten.

459. *Subsection (1)(a)* rewrites the definition of animal in paragraph 9 of Schedule 5 to ICTA. Most of the definitions in paragraph 9 of Schedule 5 to ICTA refer to "animals and other living creatures". The main reason for the reference to "other living creatures" is to make clear that the Schedule applies to birds.

460. *Subsection (1)(c)* rewrites the definition of "production herd" in paragraph 8(5) of Schedule 5 to ICTA. Herd basis elections are made by reference to classes of production herd. See section 124. Section 113(2) identifies when different production herds are treated as being of the same class.

461. *Subsection (3)* gives the general rule that immature animals are not treated as part of the herd for tax purposes even if they are, in practice, kept in the herd; for example, calves kept with cows.

462. *Subsection (4)* sets out the exception to the general rule in subsection (3). It will usually apply only to certain flocks of sheep, commonly known as "hefted flocks", kept under particular natural conditions on mountain, hill or heath land.

463. *Subsection (6)* makes clear that an immature animal can be treated as added to the herd when it becomes mature. There is a definition of maturity for female animals in section 113(5).

Section 113: Other interpretative provisions

464. This section provides further definitions. It is based on paragraphs 3, 8 and 9 of Schedule 5 to ICTA.

465. *Subsection (2)(a)* applies if production herds of animals of different species are kept for the same product; for example, a herd of cows and a herd of goats both kept for milk production. Each herd satisfies the definition of production herd. Subsection (2)(a) prevents them being treated as of the same class.

466. *Subsection (2)(b)* prevents animals of the same species being treated as of the same class if they are kept for different products; for example, one herd of cows kept for milk production and another herd of cows kept for its calves.

467. *Subsection (6)* clarifies what is meant by "a substantial part of the herd". This is a question of fact depending on the circumstances. But 20% of the herd will always be regarded as substantial. See *Change 32* in Annex 1. The following sections refer to "a substantial part of the herd".

- Section 118(1) (sale of animals from the herd);
- Section 119(1) (sale of whole or substantial part of herd);
- Section 120(4) and (5) (acquisition of new herd begun within 5 years of sale);
- Section 122(1) (replacement of part sold within 5 years of sale); and
- Section 126(1) (slaughter under disease control order).

Section 114: Initial cost of herd and value of herd

468. This section sets out the treatment of the initial cost, and value, of the herd. It is based on paragraph 3(2) of Schedule 5 to ICTA.

469. No deduction is allowed for the initial cost of the herd. Neither is the value of the herd taken into account in calculating the profits of the trade.

Section 115: Addition of animals to herd

470. This section sets out the treatment of additions to the herd. It is based on paragraph 3(2) and (3) of Schedule 5 to ICTA.

471. *Subsection (1)* makes clear that there is a difference between additions, to which this section applies, and replacements dealt with in section 116.

472. *Subsection (2)* prevents a deduction for the cost of the additional animal. It is a similar rule to section 114(1) and is also based on paragraph 3(2) of Schedule 5 to ICTA.

473. *Subsections (3)* and *(4)* deal with the case in which the additional animal was part of the trading stock immediately before it became part of the herd. Subsection (3) requires the farmer to add an amount called "the balancing amount" to his or her trade receipts. The balancing amount is defined in subsection (4) and is intended to recover the costs that will already have been allowed as a trading expense.

Section 116: Replacement of animals in herd

474. This section sets out the treatment if an animal in the herd is replaced. It is based on paragraph 3(4) and (5) of Schedule 5 to ICTA.

475. *Subsection (1)* introduces the terms "old animal" to describe an animal leaving the herd and "new animal" to describe the animal that replaces it. The circumstances in which an animal is treated as sold and the meaning of "sale proceeds" are extended by the definitions in section 113(3) and (4).

476. *Subsection (2)* sets out the basic rule that any sale proceeds of the old animal are included in the farmer's trade receipts. This rule is subject to a number of exceptions:

- if the animal is slaughtered under a disease control order and the new animal is of a worse quality (see section 117);
- if the farmer acquires, or begins to acquire, a new herd within five years of the old herd being sold (see section 120); and
- if a substantial part of the herd is sold and the farmer acquires or begins to acquire replacement animals within five years (see section 122).

477. *Subsection (4)* deals with the deduction due for the replacement animal. The basic principle in paragraph 3(4)(b) of Schedule 5 to ICTA is that the cost of the second animal is deducted as a trading expense. But paragraph 3(4)(b) of Schedule 5 to ICTA provides for an exception - "in so far as that cost consists of such costs as are allowable apart from the provisions of this Schedule as deductions in computing profits of farming under Case I of Schedule D".

478. It is not clear from ICTA what these costs are. In fact the exception is aimed at the case where the replacement animal comes from trading stock. Here the costs of breeding or acquiring it and, if relevant, rearing it to maturity have already been allowed. The farmer is not allowed a double deduction for costs that have already been allowed.

479. This section does not reproduce that part of paragraph 3(4)(b) of Schedule 5 to ICTA which refers to the cost of the new animal being subject to paragraph 3(6) of Schedule 5 to ICTA. This reference appears to be an error made in the 1988 consolidation of ICTA. It is generally accepted that it is the rule in paragraph 3(4)(a), and not paragraph 3(4)(b), of Schedule 5 to ICTA which should be qualified by paragraph 3(6) of Schedule 5 to ICTA.

Section 117: Amount of receipt if old animal slaughtered under disease control order

480. This section limits the amount of the receipt taxed under section 116 if the old animal is slaughtered under a disease control order. It is based on paragraph 3(6) of Schedule 5 to ICTA.

481. Paragraph 3(6) of Schedule 5 to ICTA restricts the amount of the receipt to "the amount allowable as a deduction". It is not immediately clear what this amount is. This section

makes clear that it is the amount allowable as a deduction in respect of the new animal. This is called “the equivalent amount for the new animal”.

482. *Subsections (4)* and *(5)* define “the equivalent amount for the new animal”. Subsection (4) deals with the case in which the replacement animal comes from the farmer’s trading stock. Subsection (5) deals with all other cases.

Section 118: Sale of animals from herd

483. This section sets out the rules that apply if an animal is sold from the herd and not replaced. It is based on paragraph 3(10) of Schedule 5 to ICTA.

484. *Subsection (1)* identifies the scope of the section. References to the sale of an animal include references to its death or destruction. See section 113(3). An explanation of what is meant by “substantial part of the herd” is given in section 113(6).

485. *Subsections (2)* and *(3)* explain that profits are included as trade receipts and losses are allowed as trade deductions.

486. *Subsection (4)* sets out how to calculate the profit or loss. The definition of “deductible amount for the animal” is in *subsection (5).*

Section 119: Sale of whole or substantial part of herd

487. This is the first of three sections that set out the rules relating to the sale of all or a substantial part the herd within 12 months. It is based on paragraph 3(8) of Schedule 5 to ICTA.

488. The section merges the rules in paragraph 3(7) to (9) of Schedule 5 to ICTA. See *Change 33* in Annex 1. An explanation of what is meant by “substantial part of the herd” is given in section 113(6).

489. *Subsection (2)* sets out the general rule. If the herd, or a substantial part of the herd, is sold within a year no profit is taxed as a trade receipt and no loss is allowed as a trade deduction. This overrides the rule in section 118(2) and (3) (sale of animals from herd).

Section 120: Acquisition of new herd begun within 5 years of sale

490. This section sets out the rules that apply if, following the sale of the herd (either all at once or within 12 months), the farmer begins to acquire a new herd within five years. It is based on paragraph 3 of Schedule 5 to ICTA.

491. *Subsection (2)* sets out the general rule. The section treats what is really an acquisition as a replacement by applying section 116 (replacement of animals in herd) unless the sale was for reasons outside the farmer's control.

492. *Subsection (3)* identifies the time when the sale proceeds of the animal in the old herd are brought into account as a trade receipt.

493. *Subsection (4)* applies if the number of animals in the new herd is smaller than the number of animals in the old herd but the difference is not substantial. See *Change 33* in Annex 1.

494. *Subsection (5)* applies if the number of animals in the new herd is smaller than the number of animals in the old herd and the difference is substantial. The effect is that the difference between the number of animals in the old herd and the new herd is treated as the disposal of part of a herd. Section 119 will apply if there are no further replacements. Section 122 will apply if there are further replacements within five years.

495. *Subsection (6)* applies if the number of animals in the new herd is larger than the number of animals in the old herd. The effect is that the difference between the number

of animals in the old herd and the new herd is treated as an addition to the herd and section 115 applies.

496. *Subsection (7)* clarifies what is meant by a “substantial part of the herd”. See *Change 32* in Annex 1.

Section 121: Section 120: sale outside farmer's control

497. This section limits the amount taxed as a trade receipt under section 120 if the sale is for reasons outside the farmer's control and the replacement animal is of a worse quality. It is based on paragraph 3(9)(a) of Schedule 5 to ICTA.

498. The section is similar to section 117 although it is not limited, as that section is, to disposals under a disease control order. The source legislation for both sections refers to the amount of the trading receipt being restricted to “the amount allowable as a deduction”. It is not immediately clear what this amount is.

499. *Subsection (2)* makes clear that it is the amount allowable as a deduction in respect of the new animal. The section calls this “the equivalent amount for the new animal”.

500. *Subsections (3)* and *(4)* define “the equivalent amount for the new animal”. Subsection (3) deals with the case in which the replacement animal comes from the farmer’s trading stock. Subsection (4) deals with all other cases.

Section 122: Replacement of part sold begun within 5 years of sale

501. This section sets out the rules that apply if, following the sale of a substantial part of a herd (either all at once or within a year), the farmer begins to replace it within five years. It is based on paragraph 3(8) and (9) of Schedule 5 to ICTA.

502. *Subsection (1)* sets out the conditions for the section to apply. An explanation of what is meant by “substantial part of the herd” is given in section 113(6).

503. *Subsection (2)* applies section 116 (replacement of animals in herd). The sale proceeds of the old animal are brought into account as a trade receipt. This is subject to the exception given in section 123 if the sale was for a reason outside the farmer's control.

504. *Subsection (3)* provides the sale proceeds are not recognised until the new animal is acquired.

505. *Subsection (4)* deals with the case where not all the animals sold are replaced. No profit or loss arising from the sale is brought into account as a trade receipt.

Section 123: Section 122: sale outside farmer's control

506. This section limits the amount taxed as a trade receipt under section 122 if the sale is for reasons outside the farmer's control and the new animal is of a worse quality. It is based on paragraph 3(9)(a) of Schedule 5 to ICTA.

507. The section is similar to section 117 although it is not limited, as that section is, to disposals under a disease control order. The source legislation for both sections refers to the amount of the trading receipt being restricted to “the amount allowable as a deduction”. It is not immediately clear what this amount is.

508. *Subsection (2)* makes clear that it is the amount allowable as a deduction in respect of the new animal. The section calls this “the equivalent amount for the new animal”.

509. *Subsections (3)* and *(4)* define “the equivalent amount for the new animal”. Subsection (3) deals with the case in which the replacement animal comes from the farmer’s trading stock. Subsection (4) deals with all other cases.

Section 124: Herd basis elections

510. This section sets out the rules for the making of herd basis elections. It is based on paragraph 2 of Schedule 5 to ICTA.

511. The section does not specify that the election is to be made to "the inspector". Section 878(4) draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to "an officer of the Board".

512. *Subsection (2)* sets out the time limit for making the election. It merges the rules for partnerships and all other taxpayers with one exception. See *Change 34*. The exception is the extension to the time limit given to taxpayers other than partnerships by paragraph 2(5) of Schedule 5 to ICTA. This extension is preserved in subsection (2)(b).

513. *Subsection (3)* defines "the first relevant period of account". See *Change 34* in Annex 1.

514. *Subsection (4)* expands on subsection (1), which provides that an election must specify the class of production herd to which it relates. This means separate elections must be made for each class of production herd and that an election may not relate to more than one class of production herd. Separate elections may be made for different classes.

515. *Subsection (6)* identifies the production herds to which the election applies.

516. *Subsection (7)* identifies the periods of account to which the election applies. See *Change 35* in Annex 1. Section 129 allows earlier years to be re-opened to give effect to an election.

517. *Subsection (8)* deals with the case in which the farmer is a firm and there is a change in the partners in the firm. Paragraph 2 of Schedule 5 to ICTA refers to "the farmer making the election". If the farming trade is carried on in partnership, the "farmer" means the firm. If there is a change in the members of a firm, the question arises whether there is a new "farmer". Subsection (8) makes clear that there is.

Section 125: Five year gap in which no production herd kept

518. This section deals with the case where there is a period of at least five years when the farmer does not keep a production herd of the particular class for which he or she has made a herd basis election. It is based on paragraph 4 of Schedule 5 to ICTA.

519. *Subsection (2)* explains the consequences for the herd basis rules if the farmer starts to keep another production herd of the same class after the end of the five year period. See *Change 36* in Annex 1.

Section 126: Slaughter under disease control order

520. This section sets out the rules for making an election outside the normal time limits following slaughter under a disease control order. It is based on paragraph 6 of Schedule 5 to ICTA.

521. *Subsection (1)* sets out the conditions for the section to apply. An explanation of what is meant by "substantial part of the herd" is given in section 113(6).

522. *Subsection (2)* allows the farmer to make a herd basis election in respect of the class of production herd involved in the slaughter and identifies the relevant time limits.

523. In line with the approach adopted in the rewrite of the ordinary time limits in section 124 this section merges the rules for partnerships and all other taxpayers and applies the longer time limits given to partnerships. See *Change 37* in Annex 1.

524. *Subsection (3)* identifies the periods of account to which the election applies.

Section 127: Preventing abuse of the herd basis rules

525. This section provides anti-avoidance rules that may apply if a farmer transfers the whole or part of a production herd in a transaction that is not an open market sale. It is based on paragraph 5 of Schedule 5 to ICTA.

526. *Subsection (1)* sets out the conditions for the section to apply. If the transfer is not an open market sale the section will apply if either the "control condition" or the "herd basis benefit condition" are met.

527. *Subsection (2)* defines the relationship that must exist between the parties to the transfer for the "control condition" to apply.

528. *Subsection (4)* sets out the conditions for the "herd basis benefit condition" to apply.

529. *Subsection (6)* gives the counter-action that applies if either the "control condition" or the "herd basis benefit condition" are met. The animals are treated as sold at their open market value. Section 175(3) in Chapter 12 of Part 2 of this Act (trade profits: valuation of stock and work in progress) makes clear that this section takes priority over the provisions of that Chapter.

Section 128: Information if election made

530. This section gives the Inland Revenue power to obtain information about the animals kept for the purposes of the trade. It is based on paragraph 10 of Schedule 5 to ICTA.

531. Only the person carrying on the trade can be required to deliver a return. The reference to "inspector" has been changed to "Inland Revenue". See *Change 149* in Annex 1.

Section 129: Further assessment etc. if herd basis rules apply

532. This section enables effect to be given to a herd basis election made after an assessment has become final, either by amendment or by repayment of tax. It is based on paragraph 11 of Schedule 5 to ICTA.

Chapter 9: Trade profits: films and sound recordings

Overview

533. This Chapter rewrites the special rules for expenditure on the production and acquisition of films, tapes and discs in sections 40A to 43 of F(No 2)A 1992, section 48 of F(No 2)A 1997 and sections 99 to 101 of FA 2002 as they apply to persons trading in the exploitation of films, tapes and discs. Rules for non-trade businesses involving films or sound recordings are in sections 609 to 613 of this Act.

Section 130: Expenditure to which this Chapter applies

534. This section is based on sections 40A to 43 of F(No 2)A 1992.

535. Section 40A(1) of F(No 2)A 1992 refers to a "master version" of a film. Section 40A(5) defines a "master version" of a film as "a master negative, master tape or master audio disc" of the film. Section 43(1) of F(No 2)A 1992 defines "master negative", "master disc" and "master tape" in relation to a film.

536. *Subsections (1)* to *(4)* of this section refer instead to "the original master version of a film or sound recording". See *Change 38* in Annex 1.

537. *Subsection (5)* excludes interest and the incidental costs of obtaining finance from the definition of expenditure incurred in the production or acquisition of films and sound recordings. See *Change 39* in Annex 1.

538. Section 135 and sections 137 to 140 of this Act provide for a deduction in calculating the profits of the trade of the amount of preliminary, production or acquisition expenditure on the original master version of a film or sound recording allocated to a relevant period. In each case, the deduction is subject to the application of "any prohibitive rule". Section 130(7) defines "any prohibitive rule" for the purposes of such deductions.

Section 131: Meaning of "film" and related expressions

539. This section is based on section 43 of F(No 2)A 1992 and paragraph 1 of Schedule 1 to the Films Act 1985.

540. *Subsection (1)* reproduces the definition of "film" in paragraph 1(1) of Schedule 1 to the Films Act 1985. This is based on the requirement in section 43(2) of F(No 2)A 1992 that references to a film in sections 41 and 42 of F(No 2)A 1992 are to be construed in accordance with paragraph 1 of Schedule 1 to the Films Act 1985.

541. *Subsection (3)* provides that a series of films in respect of which the Secretary of State has given a direction under paragraph 1(4) of Schedule 1 to the Films Act 1985 is treated as a single film for the purposes of this Chapter. For the purposes of Schedule 1 to the Films Act 1985 and of this section, "the Secretary of State" is the Secretary of State for the Department for Culture, Media and Sport.

542. Paragraph 1(4) of Schedule 1 to the Films Act 1985 provides as follows:

"(4) The Secretary of State may direct that a number of films shall be treated as a single film for the purposes of this Schedule if—
   (a) they form a series with not more than twenty-six parts;
   (b) the combined playing time is not more than twenty-six hours; and
   (c) in the opinion of the Secretary of State the series constitutes a self-contained work or is a series of documentaries with a common theme.

Section 132: Meaning of "original master version" and "certified master version"

543. This section is based on sections 40A(5) and 43(1) of F(No 2)A 1992.

544. Section 40A(5) of F(No 2)A 1992 defines a "master version" of a film as "a master negative, master tape or master audio disc" of the film. Section 43(1) of F(No 2)A 1992 defines "master negative", "master disc" and "master tape" in relation to a film.

545. *Subsection (1)* defines "original master version" in relation to both a film and a sound recording. See *Change 38* in Annex 1.

546. *Subsection (3)* introduces the label "certified master version" for a film certified by the Secretary of State for Culture, Media and Sport as a qualifying film, tape or disc under paragraph 3 of Schedule 1 to the Films Act 1985. For the purposes of Schedule 1 to the Films Act 1985 and of this section, "the Secretary of State" is the Secretary of State for the Department for Culture, Media and Sport.

547. The criteria for certification under paragraph 3 of Schedule 1 to the Films Act 1985 are set out in paragraph 4 of that Schedule. Paragraph 4 of Schedule 1 to the Films Act 1985 requires the maker of the film to be ordinarily resident in a member State of the European Union and includes further requirements regarding the percentage of total expenditure on the production of the film to be incurred in the United Kingdom and on the fraction of the labour costs of the film to be paid to citizens of, or persons ordinarily resident in, a member State of the European Union.

548. The special rules for the treatment of certified master versions in sections 40D, 41 and 42 of F(No 2)A 1992, section 48 of F(No 2)A 1997 and sections 99 to 101 of FA 2002 are rewritten in sections 136 to 144 of this Act.

Section 133: Meaning of "relevant period"

549. This section is based on sections 40B, 40D and 43 of F(No 2)A 1992.

Section 134: Expenditure treated as revenue in nature

550. This section is based on section 40A of F(No 2)A 1992.

551. Expenditure on the production or acquisition of a film is in the nature of capital expenditure on the provision of a fixed asset and is eligible for capital allowances under the normal rules in CAA. This section provides for expenditure and receipts in respect of a film or sound recording to be treated instead as revenue for income tax purposes.

552. Section 143 allows the person carrying on the trade to elect for this section and sections 135 to 140 of this Act (which contain rules for allocating expenditure treated as revenue to relevant periods) not to apply.

Section 135: Films and sound recordings: production or acquisition expenditure

553. This section sets out the basic rules for allocation of expenditure to a relevant period. It is based on sections 40B and 40C of F(No 2)A 1992.

554. Section 40B of F(No 2)A 1992 refers to expenditure on the production or acquisition of a master version of a film. *Subsection (1)* refers instead to the original master versions of "films or sound recordings". See *Change 38* in Annex 1.

555. *Subsection (2)* provides that a deduction for production or acquisition expenditure allocated to the relevant period is subject to the application of "any prohibitive rule". "Any prohibitive rule" is defined in section 130(7) of this Act as any provision of the Income Tax Acts which prohibits, or restricts the extent of, a deduction in calculating the profits of a trade.

556. *Subsection (4)* provides for production and acquisition expenditure to be allocated to a relevant period in such a way that it will be written off over the period during which the value of the film or sound recording is expected to be realised. This is generally known as the "income matching" method of allocation.

557. *Subsection (5)* allows the amount allocated under subsection (4) to be increased to an amount equal to the value realised in the relevant period. This is generally known as the "cost recovery" method.

558. This section dispenses with the requirement in section 40B(5) of F(No 2)A 1992 for a claim to be made if the "cost recovery" method is to apply. See *Change 40* in Annex 1.

559. *Subsection (7)* provides that if any expenditure in respect of the original master version of a film or sound recording is allocated to the relevant period under the special rules for certified master versions in sections 137 to 140 of this Act (or under the corresponding rules in F(No 2)A 1992) no expenditure in respect of the same master version can be allocated under this section. This gives the person carrying on the trade a choice in any relevant period between allocating expenditure under the basic rules in this section or under the special rules for certified films in sections 137 to 140. See *Change 41* in Annex 1.

Section 136: Application of provisions about certified master versions

560. This section is based on sections 41 and 42 of F(No 2)A 1992.

Section 137: Certified master versions: preliminary expenditure

561. This section allows preliminary expenditure on a qualifying film "genuinely intended for theatrical release" to be written off in the relevant period in which it is incurred. It is based on section 41 of F(No 2)A 1992 and section 99(1) of FA 2002.

562. Preliminary expenditure is not defined. It consists of expenditure incurred in deciding whether to make the film (generally known in the industry as “development” or “pre-production” expenditure). “Genuinely intended for theatrical release” is defined in section 144 of this Act and refers to films intended for commercial release in cinemas.

563. This section dispenses with the requirement in section 41(1) of F(No 2)A 1992 for a claim to be made for preliminary expenditure to be allocated to a relevant period. See *Change 40* in Annex 1.

564. *Subsection (3)* provides that a deduction for preliminary expenditure allocated to the relevant period is subject to the application of “any prohibitive rule”. “Any prohibitive rule” is defined in section 130(7) of this Act as any provision of the Income Tax Acts which prohibits, or restricts the extent of, a deduction in calculating the profits of a trade.

565. *Subsection (7)* prevents preliminary expenditure being relieved both under this section and under the basic rules in section 135 in the same relevant period. See *Change 41* in Annex 1.

Section 138: Certified master versions: production or acquisition expenditure

566. This section allows production or acquisition expenditure on a qualifying film intended for commercial release in cinemas to be written off over three years. It is based on section 42 of F(No 2)A 1992, section 48(4) and (5) of F(No 2)A 1997 and section 99(1) of FA 2002.

567. *Subsection (2)* provides that a deduction for production or acquisition expenditure allocated to the relevant period is subject to the application of “any prohibitive rule”. “Any prohibitive rule” is defined in section 130(7) of this Act as any provision of the Income Tax Acts which prohibits, or restricts the extent of, a deduction in calculating the profits of a trade.

568. *Subsections (3)* to *(5)* allow up to one-third of production or acquisition expenditure not already allocated under sections 137, 139 or 140 of this Act (or under the corresponding rules in F(No 2)A 1992) to be allocated to a relevant period under this section.

569. This section dispenses with the requirement in section 42(1) of F(No 2)A 1992 for a claim to be made for production or acquisition expenditure to be allocated to a relevant period. See *Change 40* in Annex 1.

570. *Subsection (7)* provides that expenditure may not be allocated to a relevant period under this section if expenditure in respect of the same film has been allocated to that period under the basic rules in section 135 of this Act.

Section 139: Certified master versions: production expenditure on limited-budget films

571. This section allows production expenditure incurred before 2 July 2005 on a qualifying film with total production expenditure of £15 million or less and intended for commercial release in cinemas to be written off in full in the period in which it is incurred. It is based on section 42 of F(No 2)A 1992, section 48 of F(No 2)A 1997 and section 99(1) of FA 2002.

572. *Subsection (2)* provides that a deduction for production expenditure allocated to the relevant period is subject to the application of “any prohibitive rule”. “Any prohibitive rule” is defined in section 130(7) of this Act as any provision of the Income Tax Acts which prohibits, or restricts the extent of, a deduction in calculating the profits of a trade.

Section 140: Certified master versions: acquisition expenditure on limited-budget films

573. This section allows expenditure incurred before 2 July 2005 on the first acquisition of a qualifying film with total production expenditure of £15 million or less and intended for commercial release in cinemas to be written off in full in the period in which it is incurred. It is based on section 42 of F(No 2)A 1992, section 48 of F(No 2)A 1997 and sections 99(1) and 101 of FA 2002.

574. *Subsection (3)* provides that a deduction for acquisition expenditure allocated to the relevant period is subject to the application of "any prohibitive rule". "Any prohibitive rule" is defined in section 130(7) of this Act as any provision of the Income Tax Acts which prohibits, or restricts the extent of, a deduction in calculating the profits of a trade.

Section 141: Meaning of "total production expenditure"

575. This section defines "total production expenditure" for the rules on limited budget films in sections 139 and 140. It is based on section 48(6),(6A) and (7) of F(No 2)A 1997.

576. *Subsection (4)* substitutes an "arm's length" amount for any expenditure incurred as a result of a transaction between connected persons in arriving at the total production expenditure. "Connected person" is defined in section 839 of ICTA (see section 878(5) of this Act).

Section 142: When expenditure is incurred

577. This section is based on section 48(9) of F(No 2)A 1997 and section 5 of CAA.

Section 143: Election for sections 134 to 140 not to apply

578. This section allows for the person carrying on the trade to elect for sections 134 to 140 not to apply to expenditure on a certified film intended for commercial release in cinemas. It is based on section 40D of F(No 2)A 1992.

579. The effect of such an election is that expenditure on the film will be treated not as revenue expenditure but as capital expenditure. Capital allowances may then be available under the normal rules in CAA.

580. This section dispenses with the requirement in section 40D(3) of F(No 2)A 1992 for an election to be made "in such form as the Board of Inland Revenue may determine". This is because under section 42(2), (10) and (11) of TMA an election must be made either in a return under sections 8, 8A and 12AA of TMA (the form of which is determined by the Board) or "in such form as the Board may determine" in accordance with paragraph 2(3) of Schedule 1A to TMA .

Section 144: Meaning of "genuinely intended for theatrical release"

581. This section is based on section 99(2) of FA 2002.

582. Section 99(3) and (4) of FA 2002 contain transitional rules for qualifying films which do not meet the "genuinely intended for theatrical release" test but for which application for certification was received before 17 April 2002 or which were commissioned on or before 17 April 2002. See paragraph 35 of Schedule 2 to this Act.

Chapter 10: Trade profits: certain telecommunication rights

Overview

583. This Chapter applies to certain telecommunication licences and capacity on telecommunication cable systems known as indefeasible rights to use (IRUs). It is based on Schedule 23 to FA 2000.

584. The Chapter provides that the income tax treatment follows the treatment in the accounts provided the accounts are prepared in accordance with generally accepted accounting practice. This allows a taxpayer who acquires qualifying rights a deduction for expenditure that would otherwise be capital for tax purposes.

585. It applies to IRUs acquired on or after 21 March 2000. See the transitional rule in paragraph 39 of Schedule 2 to this Act.

Section 145: Professions and vocations

586. This section makes it unnecessary to specify repeatedly that the rules in this Chapter apply to a profession or vocation as well as a trade. It is new.

Section 146: Meaning of "relevant telecommunication right"

587. This section defines "relevant telecommunication right". It is based on paragraph 1 of Schedule 23 to FA 2000.

588. To date, the only licences to which paragraph (a) applies were granted in response to the government auction of third generation mobile telephone licences in April 2000.

Section 147: Expenditure and receipts treated as revenue in nature

589. This section sets out the general rule that the tax treatment follows the treatment in the accounts. It also identifies a number of circumstances that will be treated as the acquisition or disposal of a relevant telecommunications right. It is based on paragraph 2 of Schedule 23 to FA 2000.

590. *Subsection (1)* sets out the conditions for the section to apply. An amount in respect of the acquisition cost or disposal proceeds of the rights must be included in the calculation of profit or loss in accounts prepared in accordance with generally accepted accounting practice. In the case of acquisition costs this will usually be an amount of amortisation.

591. This section does not rewrite paragraph 4 of Schedule 23 to FA 2000 because it is likely to be of theoretical application only in the income tax field. Paragraph 4 of Schedule 23 to FA 2000 deals with the case in which the taxpayer is a member of a group of companies that prepares consolidated group accounts. It provides that in relation to paragraphs 2 and 3 of Schedule 23 to FA 2000 the accounting treatment in the taxpayer's accounts must be no more cautious than that adopted in the group accounts.

592. It is unlikely that a company liable to income tax would acquire a right to which the Schedule applies. Even if it did paragraph 4 of Schedule 23 to FA 2000 would be relevant only if it was a member of a group of companies which prepared consolidated accounts on a less cautious basis.

Section 148: Credits or debits arising from revaluation

593. This section sets out the rules that apply if the rights are revalued in the taxpayer's accounts. It is based on paragraph 3 of Schedule 23 to FA 2000.

594. The main purpose of this section is to prevent the taxpayer obtaining a cost-free increase in the amount on which amortisation will be allowed. If the value of the rights as shown in the accounts is increased in accordance with generally accepted accounting practice the amount on which amortisation is allowed is also increased. But the taxpayer has not borne any costs in respect of this increase. The effect of this section is to tax the amount of the revaluation.

595. The section applies even if the revaluation is not reflected in the profit and loss account. For example, generally accepted accounting practice may deal with the revaluation wholly as a balance sheet item.

596. The section does not apply to revaluations that are not made in accordance with generally accepted accounting practice. Amounts in respect of these revaluations would not meet the test in section 147(1).

Chapter 11: Trade Profits: Other specific trades

Overview

597. This Chapter contains special rules for the taxation of particular trades.

Section 149:Taxation of amounts taken to reserves

598. This section contains a special rule for the treatment of securities held by dealers on which the profits and losses are calculated by reference to the "fair value" of the securities rather than on a realisation basis. It is based on section 472A of ICTA.

599. Section 472A of ICTA applies to securities held by a person carrying on a banking or insurance business, or a business of dealing in securities, profits from the sale of which would "form part of the trading profits of that business".

600. The Inland Revenue does not believe that there are currently any individuals or non-resident companies liable to income tax in respect of a banking business. Similarly, the Inland Revenue does not believe that there are, or will be in the future as the law stands at present, any individuals (other than Lloyd's underwriters) or non-resident companies liable to income tax in respect of an insurance business.

601. So this section does not refer specifically to banking and insurance businesses. But such businesses (except for Lloyd's underwriters who come instead within the special rules in sections 171 and 176 of and Schedule 20 to FA 1993) are covered by the reference to a trade in which a profit on the sale of securities would be brought into account in calculating the profits.

602. Financial assets can be dealt with in a number of ways for accounting purposes.

603. Where a dealer in securities uses United Kingdom generally accepted accountancy practice ("UK GAAP"), profits and losses calculated by reference to the fair value of securities treated as trading assets are taken to profit and loss account. "Fair value" is an accounting term, the meaning of which is broadly equivalent to market value.

604. UK GAAP is defined in section 50(4) of FA 2004:

"In the Tax Acts "UK generally accepted accounting practice"—

(a) means generally accepted accounting practice with respect to accounts of UK companies (other than IAS accounts) that are intended to give a true and fair view, and

(b) has the same meaning in relation to—

(i) individuals,

(ii) entities other than companies, and

(iii) companies that are not UK companies,

as it has in relation to UK companies.

605. Section 50(4)(a) of FA 2004 refers to accounts "other than IAS Accounts". "IAS Accounts" is defined in section 50(1) of FA 2004 as "accounts prepared in accordance with international accounting standards".

606. "International accounting standards" is defined in section 50(2) of FA 2004 as:

"…international accounting standards, within the meaning of Regulation (EC) No. 1606/2002 of the European Parliament and the Council of 19 July 2002 on the application of international accounting standards, adopted from time to time by the European Commission in accordance with that Regulation.

607. Where a dealer in securities prepares accounts in accordance with international accounting standards, the securities would usually fall to be accounted for as at fair value, in accordance with paragraph 9 of International Accounting Standard 39, ("IAS 39") and any profits and losses calculated by reference to the fair value of securities taken to the profit and loss account. But a trader may instead account for certain securities as "available for sale" if they do not meet the conditions for being treated as at fair value through profit or loss. In such a case profits and losses calculated by reference to the fair value of securities are taken initially to a statement of changes in equity.

608. It is expected that from 2005 UK GAAP in this area will follow IAS 39. In UK terms the profits and losses on "available for sale" assets will be taken to the statement of total recognised gains and losses.

609. Section 42 of FA 1998 provides that the computation of profits or losses from a trade must be based on accounts drawn up in accordance with GAAP, subject to any adjustment authorised by law. Implicit in this rule is that the profits must appear in the profit and loss account. There is no tax law (apart from section 472A of ICTA) which allows profits on equity securities taken to any form of reserve to be treated as if they were taken to profit and loss account.

610. *Subsection (2)* provides that if changes in the fair value of the securities are taken either to the statement of recognised gains and losses (UK GAAP) or to the statement of changes in equity (IAS accounts), the profits or losses on those securities are taken into account in calculating the profits of the trade.

611. *Subsection (3)* disapplies subsection (2) where the profit or loss has been brought into account in an earlier accounting period. This prevents the same amount being taken into account twice.

612. Subsection (3)(b) provides that subsection (2) does not apply to "an amount recognised for accounting purposes by way of correction of a fundamental error". This refers to the requirement in International Accounting Standard 8 (Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies) that the correction of a fundamental error should be treated as a prior period adjustment. "For accounting purposes" is defined in section 832(1) of ICTA as "for the purposes of accounts drawn up in accordance with generally accepted accounting practice". See Schedule 4 to this Act.

613. The definition of "securities" in *subsection (4)* is based on section 472A(4) of ICTA. Section 472A(4)(a) defines "securities" to include rights, interests or options treated as shares for the purposes of sections 126 to 136 of TCGA by virtue of sections 135(5) or 136(5) of TCGA. Sections 135(5) and 136(5) of TCGA define "shares" in the case of a company with no share capital as "any interests in the company possessed by members of the company." So subsection (4)(c) of this section defines "securities" to include such interests.

Section 150: Conversion etc. of securities held as circulating capital

614. This section provides for relief on the conversion or exchange of securities held as part of the circulating capital of a trade of dealing in securities. The relief corresponds to the relief on the conversion or exchange of securities held as capital assets in sections 126 to 136 of TCGA. This section is based on sections 473 and 730C of ICTA.

615. Section 473(1) of ICTA applies to securities to which a person carrying on a banking or insurance business, or a business of dealing in securities, is beneficially entitled - the profits from the sale of which would "form part of the trading profits of that business". This section does not stipulate that the person must be beneficially entitled to the securities in question. See *Change 42* in Annex 1.

616. The Inland Revenue does not believe that there are currently any individuals or non-resident companies liable to income tax in respect of a banking business. Similarly, the Inland Revenue does not believe that there are, or will be in the future as the law stands at present, any individuals (other than Lloyd's underwriters) or non-resident companies liable to income tax in respect of an insurance business.

617. So this section does not refer specifically to banking and insurance businesses. But such businesses (except for Lloyd's underwriters who come instead within the special rules in sections 171 and 176 and Schedule 20 to FA 1993) are covered by the reference to a trade in which a profit on the sale of securities would be brought into account in calculating the profits.

618. *Subsection (3)* excludes securities brought into account at "fair value" in calculating the profits for the period in which the relevant transaction takes place. These are instead dealt with in section 149 of this Act.

619. *Subsection (7)* adapts the anti-avoidance rule in section 137(1) of TCGA to income tax in determining whether subsection (2)(a) of this section applies to treat a transaction as resulting in the original holding being equated with a new holding under sections 126 to 136 of TCGA. Section 137(1) of TCGA provides that sections 135 and 136 of TCGA do not apply to an exchange of shares unless the exchange is "effected for bona fide commercial reasons and does not form part of a scheme or arrangements of which the main purpose, or one of the main purposes, is avoidance of liability to capital gains tax or corporation tax".

620. The definition of "securities" in *subsection (8)* is based on section 473(6) of ICTA:

- section 473(6) of ICTA defines "securities" to include rights, interests or options treated as shares for the purposes of sections 126 to 136 of TCGA by virtue of sections 135(5) or 136(5) of TCGA. Sections 135(5) and 136(5) of TCGA define "shares" in the case of a company with no share capital as "any interests in the company possessed by members of the company." So subsection (8)(d) defines "securities" to include such interests;

- section 473(6) of ICTA defines "securities" by reference to the definition of "security" in section 132 of TCGA. Section 138A(3) of TCGA assumes that in certain circumstances earn-out rights are a security within section 132 of TCGA. So subsection (8)(f) includes such earn-out rights in the definition of "securities".

Section 151: Exchanges of gilts for gilts strips

621. This section sets out the trading income rules for the exchange of gilts for gilt strips. It is based on section 730C of ICTA. The rules for the consolidation of gilts are in section 152. The rules about regulations in connection with valuations are in section 154.

622. Section 151 ensures that a profit or loss on the exchange of a gilt for gilt strips is recognised for tax purposes even if it is not shown in the accounts of the trade. This is the opposite of the rule in section 150 that a conversion of a security is, in effect, ignored. Section 150(2) provides that the special rules for gilt strips override the general rule for securities.

Section 152: Consolidation of gilt strips

623. This section sets out the trading income rules for the consolidation of gilt strips. It is based on section 730C of ICTA.

624. This section ensures that a profit or loss on the consolidation of gilt strips is recognised for tax purposes even if it is not shown in the accounts of the trade. This is the opposite of the rule in section 150 that a conversion of a security is, in effect, ignored. Section

150(2) provides that the special rules for gilt strips overrides the general rule for securities.

Section 153: Meaning of "gilt-edged security" and "strip"

625. This section provides the definition of "gilt-edged security" for the purposes of this Act and the definition of "strip" for the purposes of sections 151 and 152. It is based on section 730C of ICTA and section 47 of FA 1942.

Section 154: Regulations for determining market value of securities or strips

626. This section contains the power for making regulations in connection with the valuation of gilts and gilt strips. It is based on section 730C(6) and (7) of ICTA.

Section 155: Levies and repayments under FISMA 2000

627. This section provides for the inclusion, in a calculation of trading profits, of certain payments arising from the Financial Services and Markets Act 2000 ("FISMA"). It is based on section 76A of ICTA.

628. Section 76A of ICTA applies to all persons who are "authorised persons" for the purposes of FISMA.

629. *Subsection (1)(b)* reflects section 76A(1) of ICTA and makes it clear that investment companies are not within the provision.

630. *Subsection (2)* provides for a deduction. Most FISMA levies would be allowable expenses under the basic trade profit calculation rules. The purpose of this provision is to deal with the exceptional case where deduction of a levy would otherwise be prevented by a prohibitive rule.

631. The expenses allowable and the receipts chargeable are determined by reference to FISMA. *Subsections (4)* and *(5)* provide the link with FISMA.

Section 156: Purchase or sale of woodlands

632. This section applies to a person carrying on a trade of dealing in land who buys and sells land on which trees are growing. It is based on section 99(1) of ICTA.

633. *Subsection (2)* provides that the cost of the trees or any saleable underwood is disregarded in calculating the profits of the trade. The section applies only to the disposal of the land as part of a trade of dealing in land. It has no application to the trader's use of the land before it is sold.

634. The cost of the land will include the value of the trees and underwood growing on it. Any profit on the sale of the trees and underwood is tax-free because of the exemption for the occupation of commercial woodlands. See section 11 of this Act. Subsection (2) prevents the dealer in land obtaining a trade deduction for that part of the cost of the land that is attributable to the cost of the trees.

635. *Subsection (3)* applies if the dealer sells the land with any of the trees and underwood still growing on it. The part of the sale price that relates to the trees and underwood is not treated as part of the sale proceeds.

636. The section applies only to woodlands purchased under a contract entered into on or after 1 May 1963. See paragraph 42 of Schedule 2 to this Act.

Section 157: Relief in respect of mineral royalties

637. This section gives relief if trade receipts include mineral royalties. It is based on section 122 of ICTA.

638. Most mineral royalties will be taxed under Chapter 8 of Part 3 of this Act. That Chapter rewrites the charge under Schedule D Case VI if rents are received from a concern listed in section 55 of ICTA. That list includes mines and quarries. The charge under Schedule D Case VI results from the operation of section 119 of ICTA. That section alters the normal priority rule between Schedules A and D. It applies to rents that would normally be taxed under Schedule A and provides that the rents are to be taxed under Schedule D. It does not say under what Case of Schedule D the charge is to be imposed.

639. In nearly all cases the rents will be taxed under Schedule D Case VI as they are not received in respect of a trade. But it is possible that the receipt of the rent will be incidental to a trade. In that case section 261 of this Act provides that the rent will be taxed under Part 2 of this Act. This is only likely to happen if the rent is received by a property developer in respect of land held as trading stock.

640. If the rent is a mineral royalty as defined in section 122(5) of ICTA the trader is entitled to the relief given by section 122(1) of ICTA. The mineral royalties are halved. The relief is rewritten in this section because dealers in land are the traders who are most likely to benefit from the relief. But the relief is not confined to dealers in land.

Section 158: Lease premiums etc.: reduction of receipts

641. This section prevents a person carrying on trade of dealing in land being taxed on all or part of a lease premium, or of certain other amounts received in respect of a lease, both as a receipt of the trade under Part 2 of this Act and as a receipt of a property business under Part 3 of this Act. It is based on section 99(2) and (3) of ICTA.

642. *Subsections (2)* and *(3)* provide for a receipt taken into account in calculating the profits of a trade of dealing in land to be reduced by the amount of that receipt taken into account under sections 277 to 285 of this Act.

643. *Subsections (4)* and *(5)* provide for a corresponding adjustment to be made in calculating the profits of the trade if tax paid as a result of section 284 or 285 is repaid under section 301 or 302 of this Act.

Section 159: Ministers of religion

644. This section sets out special rules for self-employed ministers of religion. It is based on section 332(3) of ICTA. The rest of that section was rewritten as sections 290 and 351 of ITEPA.

645. *Subsection (1)* provides that the section applies in calculating the profits of the profession or vocation of a minister of religion. This brings the wording of the rule into line with the other rules for permitting deductions. See *Change 43* in Annex 1.

646. Section 332 of ICTA was originally intended to give a comprehensive set of rules for the expenses of ministers of religion. In practice, the Inland Revenue apply the usual trading rules if they are more generous. Anything within section 332(3)(a) of ICTA would not be disallowed by section 74(1)(a) of ICTA. But there may be items not within section 332(3)(a) of ICTA which are allowed in practice as being within the usual rules.

647. A self-employed minister can in practice make deductions for revenue expenses that are wholly and exclusively for the purposes of the profession or vocation. For such a minister the rule in paragraph (a) of section 332(3) of ICTA, which provides for a deduction where expenses are incurred wholly, exclusively and necessarily in the performance of the duties, imposes a harsher test.

648. So section 332(3)(a) of ICTA is not rewritten, leaving the more generous rule in section 34 of this Act to apply. See *Change 44* in Annex 1.

649. *Subsection (2)(b)* introduces a "just and reasonable apportionment" which does not have a special appeal mechanism. See *Change 45* in Annex 1.

650. *Subsection (3)* uses the term “incurs” in preference to “borne”. See *Change 43* in Annex 1.

651. *Subsection (4)* sets out how to calculate the deduction under subsection (3). If the expenses of maintenance, repair, insurance or management incurred wholly and exclusively for the purposes of the profession or vocation exceed one quarter of the expenses within subsection (3) no further deduction is due but the deduction is not restricted to one quarter. If the expenses of maintenance etc do not exceed one quarter, a further deduction is due. So the total deduction for expenses within subsection (3) varies according to the extent to which they are expenses incurred wholly and exclusively for the purposes of the profession or vocation.

Section 160: Alternative basis of calculation in early years of practice

652. This section preserves the “cash basis” for some barristers. It is based on section 43 of FA 1998. It sets out the single exception to the general rule in section 25 of this Act that profits must be calculated in accordance with generally accepted accounting practice. It applies to barristers in the early years of practice. They are allowed to draw up accounts on a cash basis or a “fees billed” basis.

653. The section uses the phrase “independent practice” in line with the current Codes of Conduct of the English Bar and the Bar of Northern Ireland. The same expression correctly identifies practising advocates in Scotland.

Section 161: Mineral exploration and access

654. This section deals with intangible drilling costs of production wells in the oil and gas industry. It is based on section 91C of ICTA. Intangible costs are those which do not result in the acquisition or creation of machinery or plant. An example would be the cost of hiring a drilling rig. Production wells are wells that are drilled after the presence of oil in an area has been established and which are used to extract the oil.

655. Before the enactment of section 91C of ICTA in 1997, a deduction was allowed for the intangible drilling costs of the second and subsequent production wells in any area. This reflected a Special Commissioners’ decision in 1920 that this expenditure is of a revenue nature. Section 91C of ICTA disallows a deduction for such costs. It does this by denying a deduction for expenditure which, if it had been carried out while exploring for oil, would not have been allowed as a deduction.

656. *Subsection (1)* sets out the circumstances in which the section applies. It identifies the expenditure as being on “mineral exploration and access”, an expression defined in subsection (3).

657. *Subsection (2)* is the main rule. It ensures that any expenditure on drilling a production well that is deductible on normal principles can continue to be deducted. But no deduction is allowed for intangible drilling costs which were previously deductible only as a result of the earlier Special Commissioners’ decision. These costs are capital expenditure and qualify for mineral extraction capital allowances (see Part 5 of CAA).

Section 162: Payments by persons liable to pool betting duty

658. This section gives a special deduction to traders who pay pool betting duty. It is based on those parts of section 126 of FA 1990 and section 121 of FA 1991 which relate to the calculation of the profits of traders.

659. The majority of pool betting duty is paid by large companies operating football pools. But an individual or firm may carry on a trade as a pools promoter.

660. In 1990, following the Hillsborough disaster, pool betting duty was reduced on condition that the money saved be paid to the Football Trust 1990 to implement Lord Justice Taylor’s recommendations on safety and comfort at football grounds. In 1991

the duty was reduced again, this time on condition that the money be paid to the Foundation for Sport and the Arts, a charitable trust which supports athletic sports and games and promotes the arts. The reductions were initially for a limited period, but have so far been maintained.

661. *Subsection (1)* sets out the circumstances in which the section applies. It introduces the expression "qualifying payment".

662. *Subsection (2)* defines a "qualifying payment" to which the section applies. It does not specify that payments in consequence of the 1990 reduction in pool betting duty must be paid for football safety and comfort, and that payments in consequence of the 1991 reduction must be paid to the Foundation for Sport and the Arts. Instead the section applies to a payment for either purpose in consequence of any reduction in pool betting duty. See *Change 46* in Annex 1.

663. The section retains a general description of the payments, without identifying the bodies which were the targets of the original legislation. It is clear that payments made as a consequence of a reduction in pool betting duty to either body would qualify for relief under the section.

664. The source legislation is restricted to the 1990 and 1991 reductions in pool betting duty. This section applies to payments made in consequence of any reduction in the duty. See *Change 47* in Annex 1.

665. *Subsection (3)* is the rule that allows the payments as a trading deduction. Without this rule the payments might be disallowed because they are annual payments or because they are not made wholly and exclusively for the purposes of the payer's trade.

Section 163: Deduction for deemed employment payment

666. This section sets out the trading income rules that were originally part of the "IR35" scheme for the taxation of workers supplied by an intermediary. It is based on paragraph 17 of Schedule 12 to FA 2000. The worker is treated as receiving a "deemed employment payment" and is taxed accordingly (see Chapter 8 of Part 2 of ITEPA). This section ensures that an equivalent amount (and no more) is allowed as a trading deduction in calculating the profits of the intermediary.

667. *Subsection (1)* sets the scene, using expressions that are defined in *subsection (5)* by cross-reference to the employment income rules in ITEPA.

668. *Subsection (2)* identifies the amounts that are allowed as trading deductions.

669. *Subsection (3)* is a timing rule. Generally, the deemed employment payment is treated as made at the end of the tax year (see section 50(3) of ITEPA). In some circumstances the payment is treated as made earlier (see section 57 of ITEPA). In either case, the trading deduction is given for the period in which the payment is treated as made.

670. *Subsection (4)* is the rule that prevents any double deduction. It caters for the possibility that the payments may qualify as trading deductions on first principles and for the possibility that the payments may also qualify as trading deductions in a period of account different from that specified in subsection (3).

Section 164: Special rules for partnerships

671. This section sets out two additional rules that apply if a deduction under section 163 is to be given in calculating the trading profits of a firm. It is based on paragraph 18 of Schedule 12 to FA 2000.

672. Section 847 of this Act explains that "firm" is used in this Act to refer to persons carrying on a trade in partnership. It includes a limited liability partnership (see section 863).

673. *Subsection (1)* introduces the circumstances in which the section applies.

674. *Subsection (2)* is the rule that a deduction under section 163 of this Act cannot be used to create a loss in a firm. It is based on paragraph 18(2) of Schedule 12 to FA 2000.

675. *Subsection (3)* is the rule that limits the trading deduction to the amount that would have been deductible if the worker had been an employee of the intermediary, plus a margin to cover the expenses of the firm.

676. In accordance with paragraph 244 of Schedule 6 to ITEPA, "deemed Schedule E payment" in paragraph 18 of Schedule 12 to FA 2000 is replaced by "deemed employment payment". Similarly, in the same paragraph, "Schedule E" is replaced by "the employment income Parts of the Income Tax (Earnings and Pensions) Act 2003".

677. But the specific statutory references, such as those to "paragraph 7" (of Schedule 12 to FA 2000), are covered by the general rule in paragraph 5 of Schedule 7 to ITEPA. That general rule is that any reference to a repealed provision is to be read as a reference to the rewritten provision.

678. Paragraph 7 of Schedule 12 to FA 2000 has been repealed and rewritten as section 54(1) of ITEPA. So the reference to that paragraph in paragraph 18 of Schedule 12 is to be read as a reference to section 54(1) of ITEPA. This section updates the references to paragraph 7.

Section 165: Deduction for site preparation expenditure

679. This section sets out the rules for expenditure on preparing a site so that it can be used for waste disposal. It is the first of four sections that deal with waste disposal. They are based on sections 91A, 91B and 91BA of ICTA.

680. This section covers expenditure which is not deductible because it is capital and which is not eligible for capital allowances; in other words, expenditure that would otherwise go unrelieved for income tax purposes.

681. *Subsection (1)* introduces the concept of waste materials being deposited on a "waste disposal site", an expression defined in section 167. It makes it clear that a deduction is allowed only for a period of account in which waste is deposited on the site.

682. The reference to a "predecessor" was inserted into ICTA by FA 2000 to ensure that the relief continues even if the trade is no longer carried on by the person who originally incurred the site preparation expenditure. The term is defined in subsection (3).

683. *Subsection (2)* is the link to section 166, which calculates the amount of expenditure that is allowed as deduction.

684. A deduction under section 91B of ICTA is allowed only if the trader makes a claim (in such form as the Board may direct) and submits such plans and other documents (if any) as the Board may require. This section drops the requirement for a claim. See *Change 48* in Annex.

685. Paragraph 44 of Schedule 2 to this Act rewrites the transitional provision in section 91BA(1) of ICTA. Expenditure cannot be "inherited" if the site changed hands before March 2000.

Section 166: Allocation of site preparation expenditure

686. This section spreads site preparation expenditure over the useful life of the site. It is based on section 91B of ICTA.

687. *Subsection (1)* calculates the allowable expenditure for a period of account by means of a formula.

688. *Subsection (2)* explains how to arrive at the “residual expenditure”, part of which is allowed as a trading deduction by subsection (1).

689. It is necessary to exclude amounts for which capital allowances have been given. In the case of expenditure incurred before 1989, it is also necessary to exclude part of the “unrelieved old expenditure”, an expression defined in subsection (4).

690. Most waste disposal sites have a life of only four or five years. But some, notably in the nuclear waste industry, have preparation expenditure dating from before 6 April 1989. So this section preserves the rules for the pre-1989 expenditure.

691. *Subsection (3)* uses a formula to arrive at the amount of the unrelieved old expenditure that is to be excluded from the calculation in subsection (1).

Section 167: Site preparation expenditure: supplementary

692. This section contains the definitions of the expressions used in the waste disposal sections. Although the definitions are expressed to apply “for the purposes of sections 165 and 166”, the definition of “waste disposal licence” is also used to define a “site restoration payment” in section 168(5).

693. The section also sets out the rules for pre-trading expenditure. The section is based on sections 91B and 91BA of ICTA.

694. *Subsection (1)(c)* reflects the effect of the devolution settlements. See *Change 19* in Annex 1.

Section 168: Site restoration payments

695. This section deals with payments for the restoration of a site after it has been used for waste disposal. It is based on section 91A of ICTA.

Section 169: Cemeteries and crematoria: introduction

696. This section, and the following three sections, contain special rules for persons carrying on a trade of operating a cemetery or crematorium. They are based on section 91 of ICTA.

697. Without special provisions, no allowance would be due for the cost of land sold for interments, memorial gardens attached to crematoria or the surrounding land and buildings because expenditure on such land and buildings is in the nature of capital. The provisions in sections 169 to 172 recognise that most land and buildings in a cemetery or memorial garden are of little value when the cemetery or memorial garden is full.

698. This section introduces the provisions in section 170 to 172 and defines some of the terms used in those sections. It is based on section 91(1),(2),(5),(7) and (8) of ICTA.

699. Section 91(7)(a) of ICTA adapts the rules for cemeteries in section 91 of ICTA to crematoria and treats “land which is devoted wholly to memorial garden plots” as a cemetery, or as land in a cemetery. *Subsection (1)* of this section instead includes the carrying on of a crematorium, and the maintenance of “memorial gardens plots” in the trades to which sections 169 to 172 apply.

700. *Subsection (4)* is based on the definition of “relevant capital expenditure” in section 91(2) of ICTA.

701. Section 91(5) of ICTA provides that a change of ownership is ignored in calculating the relief due to the person then carrying on the trade. So subsection (4) of this section includes expenditure incurred by “a predecessor” of the person carrying on the trade (“the trader”) in the definition of ancillary capital expenditure.

Section 170: Deduction for capital expenditure

702. This section provides for a deduction for certain capital expenditure incurred by the trader or a predecessor. It is based on section 91(1), (4) to (7) and (9) of ICTA.

703. Section 91 of ICTA refers to "land" in a cemetery or crematorium. *Subsection (1)* of this section refers instead to "an interest in" such land. This accommodates better the possibility that operators of cemeteries and crematoria might sometimes hold land in leasehold rather than in freehold form.

704. *Subsection (3)(a)* is based on section 91(6) of ICTA which prohibits deductions in respect of the same expenditure under both section 91(1)(a) and section 91(1)(b) of ICTA.

Section 171: Allocation of ancillary capital expenditure

705. This section contains special rules for allocating ancillary capital expenditure to a period of account. It is based on section 91(1) and (3) to (8) of ICTA.

706. See section 169(4) of this Act for the definition of "ancillary capital expenditure".

707. *Subsection (1)* calculates the ancillary capital expenditure attributable to a relevant period. It does this by allocating part of the total of all ancillary capital expenditure incurred before the end of the relevant period (the "residual expenditure") to that period in the same proportion that the number of grave-spaces or memorial garden plots sold in the period ("PSR") bears to the *total* of the number of spaces or plots sold in the period and the number of spaces or plots potentially available for sale at the end of that period ("PSR" + "PAR").

708. Section 91(3) of ICTA excludes from "relevant capital expenditure" expenditure on buildings or structures destroyed "before the beginning of the first period to which [section 91(1)] applies" and a proportion of other expenditure "incurred before that time".

709. Section 91(4) of ICTA excludes from the residue of any expenditure at the end of a period ("residual expenditure") insurance money or other compensation received "after the beginning of the first period to which [section 91(1)] applies" in respect of buildings or structures sold or destroyed before the end of the relevant period.

710. Section 91 of ICTA is ultimately derived from section 22 of FA 1954 and the first period to which section 91 of ICTA applies is 1954-55. So *subsection (2)* of this section defines "residual expenditure" so as to exclude:

- ancillary capital expenditure on buildings destroyed before "the beginning of the first sale period"; and
- the sale proceeds of, or any compensation received in respect of, the sale or destruction of any asset representing ancillary capital expenditure sold or destroyed "after the beginning of the first sale period".

711. The "first sale period" is defined in *subsection (4)* as the period in which land in the cemetery or memorial garden was first sold for the purposes of the trade or the basis period for 1954-55, if later.

712. Similarly, *subsection (3)* calculates "the excluded amount of any remaining old expenditure" to be deducted from residual expenditure under subsection (2)(b) by reference to the number of grave-spaces and plots sold before the beginning of the basis period for 1954-55 and the number potentially available for sale immediately before the beginning of that period.

Section 172: Exclusion of expenditure met by subsidies

713. This section is based on section 91(9) of ICTA which applies the provisions of section 532 of CAA for the purposes of section 91 of ICTA.

714. *Subsection (1)* is based on the general rule in section 532 of CAA. *Subsections (3)* to *(5)* are based on the exceptions to general rule in sections 534 to 536 of CAA.

715. *Subsection (3)* refers to a grant made under Northern Ireland legislation and declared by the Treasury to correspond to a grant under Part 2 of the Industrial Development Act 1982.

716. The term "Northern Ireland legislation" is defined by Schedule 1 to, and section 24(5) of, the Interpretation Act 1978. Paragraph 3 of Schedule 13 to the Northern Ireland Act 1998 provides an amendment which would cover Acts of the Northern Ireland Assembly.

717. The Capital Allowances (Corresponding Northern Ireland Grants) Order 2001 (SI 2001/810) lists various grants made in Northern Ireland declared by the Treasury to correspond to a grant under Part 2 of the Industrial Development Act 1982 in so far as they are made towards capital expenditure. The Industrial Development Act 1982 was repealed with effect from 22 July 2004. But a deduction under section 170 of this Act continues to be allowed for expenditure met by a grant corresponding to a grant under Part 2 of the 1982 Act incurred by the trader, or by a predecessor.

Chapter 12: Trade profits: valuation of stock and work in progress

Overview

718. This Chapter sets out the rules for valuing stock and work in progress when a person ceases to carry on a trade, profession or vocation. The rules for trading stock are in sections 173 to 181. The rules for work in progress are in sections 182 to 185.

Section 173: Valuation of trading stock on cessation

719. This section sets out two general propositions based on section 100(1) and (1ZA) of ICTA. First, a valuation has to be made. Second, that valuation has to be made in accordance with the rules set out.

720. *Subsection (1)* restricts the operation of the section (and the other valuation rules) to the calculation of the profits of a trade when a person ceases to carry it on. It includes a signpost to the detailed valuation rules in sections 175 to 178.

721. *Subsection (2)* makes it clear that any transfer-pricing adjustment takes precedence over the rules for trading stock in this Chapter.

722. *Subsection (3)* is the rule for trades carried on in partnership. The general rule in ICTA is that a change in the person carrying on a trade is treated as the cessation of the trade. But, in the case of a trade carried on in partnership, section 113(2) of ICTA provides that there is a cessation only if there is a complete change in the persons (the partners) carrying on the trade.

723. *Subsection (4)* ensures that the special rules for the valuation of stock in this Chapter do not apply when the trader dies.

Section 174: Meaning of "trading stock"

724. This section defines trading stock. The definition applies:

- in this Chapter;
- in sections 135 and 136 (films and sound recordings);

- in section 236 (adjustment income); and
- in section 252 (post-cessation receipts).

725. The section is based on sections 100(2) and 101(3) of ICTA.

726. Section 101(3) of ICTA is invoked by section 100(2) and is concerned with valuation of incomplete services at the time of "discontinuance". So the definition in this section refers to incomplete services at the "time of the cessation".

Section 175: Basis of valuation of trading stock

727. This section introduces the five sections that follow. It is based on section 100 of ICTA. The five sections (including section 179 which defines "connected persons") deal with valuation of stock that is transferred to another trader. Subsection (4) of this section deals with valuation in any other case.

Section 176: Sale basis of valuation: sale to unconnected person

728. This section sets out the rule for the common case where the trading stock is transferred to an unconnected trader. It is based on section 100(1A)(a) of ICTA. It leads directly to the use of the sale price of the stock as the basis of valuation. If the transfer is other than by sale, section 181 explains how the expressions used in this section are to be interpreted.

Section 177: Sale basis of valuation: sale to connected person

729. This section sets out the rule for the case where the stock is transferred to a connected person. It is based on section 100(1A)(b) of ICTA.

730. The section preserves the concept of an arm's length price. This will usually be the same as the open market value (see section 175(4)) but sometimes there will be a difference.

731. For example, in an inheritance tax case, IRC v Spencer-Nairn [1991], STC 60, the Court of Session considered the meaning of an arm's length price and distinguished it from open market value. This was on the basis that the seller in that case had imperfect information. A sale at arm's length by that seller would not assume that the seller had better information; a sale in the open market would assume perfect information on both sides of the bargain.

732. Furthermore, in the case of an actual sale to a connected trader, there is no need to *assume* there is a sale. It is enough to treat the sale as made at arm's length. This leaves open the possibility that the stock is worth something different from open market value to a person who intends to use the stock in the trade.

Section 178: Sale basis of valuation: election by connected persons

733. This section allows the seller and purchaser of stock that would otherwise be valued at arm's length under section 177 to elect to use instead the price paid for the stock. The section is based on section 100(1C), (1D) and (3) of ICTA.

734. The election cannot be made unless the arm's length value of the stock is greater than its "acquisition value" in the hands of the seller.

735. The "acquisition value" of the stock for the trader who ceases to trade is effectively book value, but the definition in subsection (5) is more complicated than this. In the case where the net realisable value of stock has fallen below cost in the period leading up to cessation, a new period is deemed to start just before the deemed sale. That allows the new, lower, net realisable value to be used. It may be possible to manipulate net realisable value by selling the stock at an undervalue after the accounting date. So paragraph (a) of the definition assumes that the sale is at an arm's length value.

736. The election substitutes the price paid for the arm's length value of the stock. But the price paid must be higher than the acquisition value. Otherwise, the election substitutes the acquisition value for the arm's length value.

737. The time limit for the election in section 100(1C) is two years from the end of the tax year in which the trade ceases. This is inconsistent with most other time limits for income tax payers. The time limit in subsection (4) of this section is the normal time limit for claims and elections in this Act. See *Change 49* in Annex 1.

738. This section does not specify that the election is to be made to "the inspector". Section 878(4) of this Act draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to "an officer of the Board".

Section 179: Connected persons

739. This section provides a definition of connected persons for the stock valuation sections. It is based on section 100(1F) of ICTA.

740. This section is one of the exceptions to the general rule in section 847 that a firm is not to be regarded for tax purposes as a separate entity. If a firm is connected with the seller or purchaser of its stock, section 177 (rather than section 176) applies but the firm may make an election under section 178.

741. The definition includes references to bodies corporate because the tax liability of a person charged to income tax may be affected by a transaction involving a company.

Section 180: Cost to buyer of stock valued on sale basis of valuation

742. This section sets out the rule for the buyer of the stock. It is based on section 100(1E) of ICTA. In a "sale basis" case, any value given to the trading stock of the taxpayer whose trade has ceased is also used to calculate the profits of the buyer of the stock.

743. Section 100(1A) to (1C) of ICTA continue to apply for corporation tax. So the reference to those subsections is retained to cater for the case where the stock is acquired from a person liable to corporation tax. In the reverse case, where the stock is transferred from a person liable to income tax to a person liable to corporation tax, the valuation is made in accordance with this Chapter. The consequential amendments to section 100 of ICTA produce the right result for corporation tax (see paragraph 79 of Schedule 1 to this Act).

Section 181: Meaning of "sale" and related expressions

744. The stock valuation sections refer to a sale of stock. This section explains how the sections are to be interpreted if the stock is transferred other than by way of sale. It is based on section 100 of ICTA.

Section 182:Valuation of work in progress on cessation

745. This is the first of four sections that deal with the valuation of work in progress on cessation. The sections are based on section 101 of ICTA.

746. *Subsection (1)* introduces the different bases of valuation in sections 184 and 185. Unlike the corresponding section 173, relating to the valuation of trading stock, this section does not require that work in progress is valued at cessation. But a valuation is usually ensured by the requirement to calculate profits in accordance with generally accepted accounting practice (see section 25 of this Act). The only exception to this rule concerns barristers and advocates (see section 160 of this Act).

747. *Subsection (2)* is the rule for professions carried on in partnership. The general rule in ICTA is that a change in the persons carrying on a profession is treated as the cessation of the profession. But, in the case of a profession carried on in partnership,

section 113(2) of ICTA provides that there is a cessation only if there is a complete change of partners.

748. *Subsection (3)* ensures that the special rules for the valuation of work in progress in this Chapter do not apply when the person carrying on the profession or vocation dies.

Section 183: Meaning of "work in progress"

749. This section provides the definition of work in progress. It is based on section 101(3) of ICTA. This definition has a reference to the time at which the valuation is made. This is appropriate because the definition is used only in this Chapter and in section 252 of this Act. In both cases, the statute is concerned with the cessation of a profession or vocation.

Section 184: Basis of valuation of work in progress

750. This section sets out the main rules for the valuation of work in progress. It is based on section 100(1) of ICTA.

751. *Subsection (1)* applies if the work in progress is transferred to a person carrying on a profession or vocation. In that case, it is valued at the sale price.

752. There are no alternatives to the sale price. So there is no need for a rule (such as that in section 180 for stock) about the tax cost to the purchaser of the work in progress. The cost is always the price paid.

753. *Subsection (2)* applies if the work in progress is not transferred to a person carrying on a profession or vocation. In that case, it is valued at an arm's length price. As explained in the commentary on section 177, this Chapter retains the distinction between this basis of valuation and open market value.

Section 185: Election for valuation at cost

754. This section allows an election for work in progress to be valued at cost. It is based on section 101(2) and (2A) of ICTA. If the election is made the profit element in closing work in progress is not assessed until payment is received. If the election is made, the later payment is treated as a post-cessation receipt.

755. This section does not specify that the election is to be made to "the inspector". Section 878(4) of this Act draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to "an officer of the Board".

Section 186: Determination of questions by Commissioners

756. This section assigns proceedings to Commissioners. It is based on section 102(1) of ICTA. The valuation of trading stock and work in progress on cessation will affect the tax liabilities both of the trader who ceases and of the trader (if any) who takes over the stock (or work in progress). This section gives the rule about which body of Commissioners should resolve any dispute about that valuation.

Chapter 13: Deductions from profits: unremittable amounts

Overview

757. This Chapter gives statutory effect to ESC B38. See *part (A) Change 50* in Annex 1. The extra-statutory concession provides relief for trade debts that cannot be remitted to the United Kingdom. It is similar in scope to section 584 of ICTA, which is rewritten as Chapter 4 in Part 8 of this Act.

758. Section 584 of ICTA provides relief for unremittable income arising outside the United Kingdom, including unremittable trade profits. But relief under section 584 of ICTA

does not extend to trade debts owed to, or paid to, the trader outside the United Kingdom if the profits of the trade arise in the United Kingdom. This Chapter provides relief for such debts and payments.

759. ESC B38 requires the relief to be claimed. Under this Chapter the relief is allowed as a deduction without the need for a formal claim. See *part (B) Change 50* in Annex 1.

760. The deduction is not mandatory if the qualifying conditions are met. A taxpayer can choose whether or not to include the deduction in his or her tax return. If a deduction is taken the recovery provisions in section 191 follow automatically.

Section 187: Professions and vocations

761. This section makes it unnecessary to specify repeatedly that the rules in this Chapter apply to a profession or vocation as well as a trade. It is new.

Section 188: Application of Chapter

762. This section defines the basic concepts. It is based on ESC B38.

763. The relief applies both to amounts owed to the trader and to amounts that have been paid to the trader. Relief is allowed if some, or all, of those amounts cannot be remitted to the United Kingdom because of foreign exchange restrictions. The different definitions of "unremittable" in *subsections (2)* and *(3)* reflect the differences between an amount that has been paid and an amount owed.

764. The relief is available to any trader, including a financial trader.

765. *Subsection (4)* provides a definition of "foreign exchange restrictions". Local foreign exchange restrictions are not defined in the extra-statutory concession but are clearly a key concept in the operation of the concession. This subsection introduces a definition based on section 584(1)(a) of ICTA, which is rewritten as section 841(3) of this Act. By basing the definition on section 584 of ICTA this Act brings the two reliefs into line.

766. Section 584(1)(a) of ICTA is almost identical to section 585(1)(b) of ICTA. Section 584(1)(a) of ICTA is rewritten as section 841(3) and section 585(1)(b) of ICTA as section 835(3) of this Act. This section and sections 841(3) and 835(3) clarify the scope of sections 584(1)(a) and 585(1)(b) of ICTA in two ways.

767. First, both sections 584(1)(a) and 585(1)(b) of ICTA refer to "the impossibility of obtaining foreign currency in that territory". It could be argued that this condition is not met if it is possible to obtain foreign currency in the overseas territory regardless of whether that currency may be transferred to the United Kingdom. The sections in this Act makes clear that it must not be possible to obtain foreign currency that could be transferred to the United Kingdom.

768. Second, the sections in this Act make clear that the reference to foreign currency in sections 584(1)(a) and 585(1)(b) of ICTA does not include currency of the overseas country or territory. In relation to sterling the currency of the overseas country or territory clearly is foreign but in this context "foreign" means foreign to the local territory.

769. Sections 584 and 585 of ICTA include a requirement that the inability to transfer the funds is not due to any lack of reasonable endeavours on the part of the taxpayer. That condition has not been repeated in this Act. See *Change 135* in Annex 1.

Section 189: Relief for unremittable amounts

770. This section sets out how the relief is given. It is based on ESC B38.

771. The section has more detail than the extra-statutory concession about the mechanics of the relief. This is necessary to give the certainty required for Self Assessment. Relief

can be given only against the profits of the trade that include the unremittable amount. It cannot be used to create or increase a loss. But any excess relief is not lost. It is carried forward and set against future profits of the trade.

772. *Subsection (1)* sets out the basic condition that relief is given as a deduction in calculating trade profits.

773. *Subsection (2)* deals with the case in which the trader has profits but the relief would create a loss. The excess of the unremittable amounts is carried forward to the next period of account in which the trader has sufficient profits to absorb the excess.

774. *Subsection (3)* deals with the case in which the trader has losses and the relief would increase those losses. The total of the unremittable amounts is carried forward to the next period of account in which the trader has sufficient profits to absorb the excess.

775. *Subsection (4)* allows a deduction for any amounts brought forward in the next period of account in which the trader has made profits.

776. *Subsection (5)* prevents the relief creating a loss but, as explained in the commentary on subsections (2) and (3) any excess is not lost but carried forward.

Section 190: Restrictions on relief

777. This section describes the various circumstances in which relief is not allowed. It is based on ESC B38.

778. *Subsection (1)* denies a deduction if the funds are applied outside the United Kingdom.

779. *Subsection (2)* denies a deduction if a deduction has been allowed under section 35 of this Act on the grounds that the debt has become bad or doubtful.

780. *Subsection (3)* denies a deduction if the trader has received an insurance recovery in respect of the debt. This differs from the approach in the extra-statutory concession. Paragraph 4 of the concession denies relief if any part of the debt is insured. This Act denies, or recovers, relief only if an insurance recovery is received. See *part (C) Change 50* in Annex 1.

781. *Subsection (4)* denies a deduction if the trader can make a claim under section 842 that the income is unremittable. This restriction will apply only if the profits of the trade that include the unremittable amounts arise outside the United Kingdom, for example, because the profits arise in an overseas branch.

Section 191: Withdrawal of relief

782. This section sets out the circumstances in which relief is withdrawn and the machinery by which it is withdrawn. It is based on ESC B38.

783. *Subsection (2)* lists the events that trigger a withdrawal of the relief. *Paragraphs (a)* and *(d)* deal with the straightforward cases in which the amount, or part of it, ceases to be unremittable or is exchanged for an amount that can be remitted. *Paragraphs (b), (c), (e)* and *(f)* deal with the events listed in section 190 that would have prevented relief being given if they had occurred before the deduction was allowed.

784. *Paragraph (f)* deals with the case of insurance recoveries. It differs from the approach in the extra-statutory concession, which denies any relief if the debt is insured. This Chapter denies or recovers relief only if an insurance recovery is received (see the commentary on section 190). This follows the approach in section 843 when a payment is received from the Exports Credit Guarantee Department. See *part (C) Change 50* in Annex 1.

785. *Subsection (3)* sets out the way the relief is recovered. The amount identified in subsection (2) is treated as a trade receipt for the period of account in which the event

occurs. It is possible more than one event will apply to the same amount. Subsection (3)(b) ensures the relief is withdrawn only once.

786. *Subsection (4)* applies if the amount of the insurance recovery is less than the amount that is unremittable. In that case the amount of the recovery is limited to the amount of the insurance recovery.

Chapter 14: Disposal and acquisition of know-how

Overview

787. This Chapter sets out the rules for calculating trade profits if a trader receives a payment for know-how. Payments to non-traders are dealt with by the rules in sections 583 to 586.

788. The Chapter refers to the "disposal" of know-how. As Walton J pointed out in John and E Sturges Ltd v Hessel (1975), 51 TC 183 ChD[6] (on page 206):

"the mere imparting of "know-how" cannot be equated with the disposal of a capital asset. Just like the schoolmaster's knowledge, it remains the property of the person imparting it as well after as before another is told.

789. This Act retains "disposal" because "disclosure" gives rise to difficulties in identifying the person to whom the disclosure is made (who may not be the person who buys the know-how).

Section 192: Meaning of "know-how" etc.

790. This section sets out the meaning of know-how and explains other concepts used in the Chapter. It is based on sections 531(8) and 533(7) of ICTA and section 572 of CAA.

791. The definition of "mineral deposits" in *subsection (2)* is restored to what it was before the enactment of CAA. See *Change 51* in Annex 1.

792. *Subsections (5)* and *(6)* extend the meaning of "sale" to include an exchange. This rule is based on section 572 of CAA, which applies to section 531 of ICTA in accordance with section 532 of ICTA.

Section 193: Disposal of know-how if trade continues to be carried on

793. This section sets out a general rule for the treatment of payments received for the disposal of know-how. It is based on section 531 of ICTA.

794. *Subsection (1)* includes a signpost to the main exceptions to the general rule:

- if the know-how is disposed of as part of the disposal of a trade; and
- if the seller and buyer are under common control.

795. *Subsection (2)* is the general rule that consideration for the disposal of know-how is treated as a trade receipt.

796. *Subsections (3) to (6)* deal with the case where know-how is disposed of with other assets. The rules are based on section 572 of CAA, which applies to section 531 of ICTA in accordance with section 532 of ICTA.

Section 194: Disposal of know-how as part of disposal of all or part of a trade

797. This section sets out the main exception to the general rule in section 193. It is based on section 531(2) and (3) of ICTA.

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6 STC [1975] 127

798. *Subsection (1)* establishes that the section applies if the know-how is disposed of as part of the disposal of a trade.

799. *Subsection (2)* provides that a payment for know-how as part of the disposal of a trade is generally treated as a capital receipt for goodwill. This rule applies only if the person making the disposal is liable to income tax. If that person is liable to corporation tax the rule in section 531 of ICTA continues to apply.

800. *Subsection (3)* deals with the person acquiring the know-how. Again, the payment for the know-how is generally treated as a capital payment for goodwill and the rule applies only if the person acquiring the know-how is liable to income tax.

801. The capital treatment in section 531(2) of ICTA also applies for capital gains tax purposes. That part of the rule is inserted as a new section 261A into TCGA (see paragraph 444 of Schedule 1 to this Act).

802. *Subsection (4)* is an exception to the capital treatment in subsections (2) and (3). It applies if the trade was carried on wholly abroad by the person disposing of the know-how.

803. *Subsection (5)* allows the parties to the transaction to elect for the payment not to be treated as one for goodwill. The effect of an election for the purchaser is that the payment may qualify for capital allowances under Part 7 of CAA. Or, exceptionally, the purchaser may be able to treat the payment as a trading expense. As such an election may affect both parties to the transaction the election has to be made by both.

804. The question whether the election is made under this section or under section 531(3) of ICTA is decided by reference to the position of the person disposing of the know-how. If that person is liable to income tax this section applies; if the person is liable to corporation tax, ICTA applies.

805. This section does not specify that the election is to be made to "the inspector". Section 878(4) of this Act draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to "an officer of the Board".

806. *Subsection (6)* gives the time limit for the election. Most elections in this Act have to be made on or before the "first anniversary of the normal self-assessment filing date". But in this case one of the persons making the election may be chargeable to corporation tax. So the time limit for an election is based on the date of the disposal.

807. *Subsection (7)* deals with a disposal by an income tax payer to a corporation tax payer. An election under section 531(3) of ICTA is treated as an election under this section. The corresponding rule for a disposal by a corporation tax payer to an income tax payer is in section 531(3A) of ICTA (inserted by paragraph 207 of Schedule 1 to this Act).

Section 195: Seller controlled by buyer etc.

808. This section ensures that if the seller and buyer are under common control:

- the general rule in section 192 does not apply; and
- the parties to the transaction may not elect for the payment for know-how to be treated as a capital payment for goodwill.

809. The section is based on section 531(7) of ICTA.

810. For the purposes of this section, "control" is defined (through section 878(6)) by reference to section 840 of ICTA. The ICTA definition of "control" is identical in effect to that in section 574 of CAA. But as the relevance of "control" in this Act goes wider than this Chapter, the ICTA definition is used here.

811. This section is one of the exceptions to the general rule in section 847 of this Act that a firm is not to be regarded for tax purposes as a separate entity. If a firm is connected

with the seller or purchaser of its know-how the payment for know-how is treated as one for goodwill.

Chapter 15: Basis periods

Overview

812. Profits for a tax year are taxed by reference to the amount of profit earned in the basis period for that tax year.

813. This Chapter gives the rules that identify the basis period for a particular tax year.

814. For established, on-going trades with a constant accounting date – the majority of cases –the rules operate very simply: the basis period for a tax year is the 12 month period ending on the accounting date in that year.

815. But special rules are needed when a trade begins or ends. And further rules have to deal with less common events such as a change of accounting date or if accounts are regularly prepared to a particular day (rather than a particular date) in the year.

816. The rules in this Chapter are ordered so that the rules dealing with the more unusual cases are located at the end of the Chapter: the simplest cases are fully dealt with by the first six sections.

Section 196: Professions and vocations

817. This section makes it clear to whom the basis period rules apply. It is new.

Section 197: Meaning of "accounting date"

818. The basis period rules operate by reference to the accounting date falling in the tax year. This section defines the key term "accounting date". It is based on sections 60(5) and 62(2) of ICTA.

819. *Subsection (1)* gives the main rule. Sub-paragraph (b) deals with the case where two periods of account end in the same tax year and so there are two accounting dates.

820. *Subsection (2)* deals with two particular cases outside the main rule.

821. *Subsection (2)(a)* refers to section 211. That provision applies if the accounts are made up to a particular day in the year rather than a particular date. See the commentary on section 211 and *Change 56* in Annex 1.

822. *Subsection (2)(b)* refers to section 214. That provision extends the definition of "accounting date" to include the date in the tax year to which accounts are treated as being prepared under the change of accounting date rules. That can arise when the period of account ending with the new date starts in, say, year six and ends in year eight: then an accounting date - the new date - is treated as falling in year seven.

Section 198: General rule

823. This section gives the general rule which will apply year on year to most taxpayers unless it is displaced by a special rule. It is based on section 60(3) of ICTA.

824. *Subsection (2)* lists the provisions that displace the general rule.

Section 199: First tax year

825. This section gives the rule that applies to the first year of trading. It is based on section 61(1) of ICTA.

826. *Subsection (2)* addresses the case where the trade both starts and ends in the same tax year and signposts the reader to the "final tax year" rule in section 202.

Section 200: Second tax year

827. This section gives the rules that apply to the second year of trading. It is based on sections 60(3)(a) and (b), 61(2) and 63 of ICTA.

828. It makes explicit what is merely implicit in the source legislation. It covers several possible cases and a separate subsection addresses each.

829. *Subsection (4)* applies only when there is no accounting date in the second year and the accounting dates in the first and third years are the same. When there is no accounting date in the second year and the accounting dates in the first and third years are not the same there is a change of accounting date and section 214(3*)* applies to give a notional accounting date for the second year. Under section 197 that is treated as an accounting date for the purpose of the Chapter 15 rules and section 200(2) or (3) then determines the basis period for the second year depending on when the notional accounting date falls.

Section 201: Tax year in which there is no accounting date

830. This section deals with the case where there is no accounting date in a tax year. It is based on section 60(3)(b) of ICTA.

831. This section does not apply if there is no accounting date in a tax year because there is a change of accounting date effected by a period of account which entirely spans the year in question. In that case section 214 applies and treats an accounting date as falling in the spanned year.

Section 202: Final tax year

832. This section gives the basis period for the final year of trading. It is based on sections 61(1) and 63 of ICTA.

833. *Subsection (1)* deals with the more usual case and *subsection (2)* the less usual case.

Section 203: Apportionment etc. of profits to basis periods

834. If the period of account does not coincide with the basis period, profits must be apportioned. This section gives the rules for the apportionment. It is based on section 72(1) and (2) of ICTA and the non-statutory practice described in paragraph 71025 of the Business Income Manual.

835. *Subsection (4)* legislates that non-statutory practice. It allows apportionment in ways other than the apportionment by reference to days permitted by section 72(2) of ICTA. See *Change 52* in Annex 1. The wording of subsection (4) makes it clear that the option to choose an alternative basis of apportionment is exercisable only by the taxpayer, not the Inland Revenue.

Section 204: Meaning of "overlap period" and "overlap profit"

836. The basis period rules are designed to ensure that, over the lifetime of a trade, the total profits assessed exactly equal the total profits earned. This section defines the key concepts of "overlap period" and "overlap profit" that are central to achieving that. It is based on section 63A(5) of ICTA.

Section 205: Deduction for overlap profit in final tax year

837. This section provides the authority for deducting overlap profit in what is probably the more common of the two cases where it may be deducted: in calculating the profits of the final year of trading. (The other, on certain changes of accounting date, is dealt with in section 220.) It is based on section 63A(3) of ICTA.

838. This adjustment is a key part of the rules which ensure that, over the lifetime of a trade, the total profits assessed exactly equal the total profits earned.

Section 206: Restriction on bringing losses into account twice

839. This section states a short but important rule which prevents an "overlap loss" from being used more than once in aggregation. It is based on section 63A(4) of ICTA.

Section 207: Treatment of business start-up payments received in an overlap period

840. This section provides a special rule for business start-up payments. It is based on section 127 of ICTA.

841. The charge in ICTA is under Schedule D Case VI. But logically the income is trade profits.

842. The policy is that business start-up payments should be taxed only once. This section achieves that result directly, instead of by taking the income out of the calculation of trade profits. See *Change 53* in Annex 1. There is a transitional rule in paragraph 49 of Schedule 2 to this Act to ensure that the new treatment applies only to payments received after 5 April 2005.

843. Paragraph 108 of Schedule 1 to this Act repeals section 127 of ICTA. Subsection (3) of that section treats business start-up payments as earned income and as relevant earnings. This Act preserves that treatment because the payments are brought into account as receipts of the trade.

844. *Subsection (3)* sets out in full what the "corresponding payments" are in Northern Ireland and reflects the effect of the devolution settlements. See *Change 19* in Annex 1.

Section 208: When the late accounting date rules apply

845. This is the first of three sections whose purpose is to simplify the normal operation of the basis period rules in particular circumstances. They avoid the creation of very short overlaps (less than six days) between basis periods - and therefore small amounts of overlap profit. They are based on the non-statutory practice described in paragraph 71170 of the Business Income Manual.

846. That practice benefits taxpayers who, at the start of trading, prepare accounts to 31 March - a popular accounting date. They allow the accounts for the opening years to be treated as though they were prepared to 5 April.

847. And because it would be illogical to exclude cases where the chosen accounting date would result in overlaps even shorter than those arising from an accounting date of 31 March, accounts prepared to 1 to 4 April are also included. See *Change 55* in Annex 1.

848. Despite the simple purpose of this provision it gives rise to some complex issues. As well as covering those cases involving accounts prepared to dates between 30 March and 5 April, it needs also to deal with cases where:

- trading begins late in the tax year (that is, after 31 March); or
- the first account is for a period longer than 12 months.

849. And it has to ensure that:

- the application of the rule remains optional (some taxpayers may, depending on their own particular circumstances, wish their opening profits to be dealt with under the normal rules); and
- no profits are assessed twice or slip out of account.

850. For these reasons the rules are set out in three sections. The first section (section 208) sets the scene and the two following sections (sections 209 and 210) state the rules depending on whether or not there is an actual accounting date in the tax year.

851. Section 208 sets the scene by stating the purpose of the rules and when they can apply.

852. *Subsection (2)* applies the relevant rules. Most taxpayers with a late accounting date will probably wish to take advantage of these rules. So the rules apply automatically unless the taxpayer "elects out". See *Change 54* in Annex 1.

853. *Subsection (3)(b)* refers to the intention of the taxpayer. This addresses practical difficulties that arise when the accounting date is only an intended accounting date at the time the return is made.

854. *Subsection (4)* states the time limit for an opt out election. It has been made as straightforward as possible by adopting the procedures and time limits of the Self Assessment cycle.

Section 209: Rule if there is an accounting date

855. This is the second of the three sections whose purpose is to simplify the normal operation of the basis period rules in particular circumstances. It deals with the case where there is an actual accounting date in the tax year.

Section 210: Rules if there is no accounting date

856. This is the third of the three sections whose purpose is to simplify the normal operation of the basis period rules in particular circumstances. It deals with the more complex case where there is no accounting date in the tax year.

857. That case is more complex because in those circumstances it is necessary:

- to bring a notional accounting date into the tax year, corresponding to the intended accounting date; and
- if the trade begins very near the end of the tax year, to charge the profits of the first tax year as part of the profits of the following tax year.

Section 211: Treating middle date as accounting date

858. This is the first of three sections that, together, prevent the complex change of accounting date rules (in sections 214 to 220) from applying in particular circumstances. They are based on the non-statutory practice described in paragraph 71175 of the Business Income Manual.

859. Some taxpayers prefer to prepare their accounts regularly to a particular day in the tax year (for example, the last Friday in September) rather than to a particular date. The chosen day can then fall on a range of (normally) seven dates. Because the chosen day will not, from year to year, fall on the same date this would trigger the change of accounting date rules every year.

860. These sections legislate the practice that enables those taxpayers to choose the middle date of the actual dates to which accounts may be prepared as the accounting date. They prevent the change of accounting date rules applying. See *Change 56* in Annex 1.

861. In these sections the date which is to be taken as the accounting date is referred to as the "middle date" rather than the "mean date" (the term used in paragraph 71175 of the Business Income Manual). "Middle date" better reflects common usage and the fact that the actual accounting date does not normally vary by more than four days from that middle date. The only exception is when the day to which accounts are prepared is at or near the end of February and the day can fall on 29 February. Then the spread of dates on which the chosen day can fall is extended from seven to eight. But the "middle date" is still the fourth of those dates.

862. These sections express a rule based on a simple idea. But there are surprisingly complex implications. It is, for example, necessary:

- to express concisely, yet clearly, the "four day" condition while allowing for the fact that accounts may be prepared to a particular day (such as the last Sunday in the year) or to a day in a particular week (such as the last day of a school term);
- to preserve the optional nature of the practice;
- to ensure that taxpayers can, if they wish, move in or out of the practice authorised by the sections without the same profits being assessed twice or dropping out of charge; and
- to ensure that no profits are assessed twice or drop out of charge when the trade ends.

863. Because of this complexity the rule is set out in three sections.

864. Section 211 is the first of the three sections and sets the scene by stating the purpose of the rule and the election requirements.

865. The bracketed words in *subsection (1)(b)* address the case of a chosen day that can fall on 29 February.

866. *Subsection (4)* make elections as straightforward as possible by adopting the procedures and time limits of the Self Assessment cycle. Unlike the opt out election for the late accounting date rules (see the commentary on section 208) the election for the middle date rules is "opt in". This is because it is less clear that taxpayers will want automatically to choose the middle date treatment than it is that they will want to choose the late accounting date treatment.

Section 212: Consequence of treating middle date as accounting date

867. This is the second of the three sections that, together, prevent the complex change of accounting date rules from applying in particular circumstances. It states the effect of electing for the middle date treatment.

868. The section can apply whether or not the previous year was treated in the same way: if it was not, *subsection (2)* applies, and if it was, *subsection (3)* applies. See *Change 56* in Annex 1.

Section 213: Circumstances in which middle date not treated as accounting date

869. This is the third of the three sections that, together, prevent the complex change of accounting date rules from applying in particular circumstances. It ensures that when the middle date treatment ceases to apply no profits are assessed twice and no profits drop out of charge.

870. The section does this by imposing continuity in profit counting between the two relevant basis periods. This is necessary because when a middle date is used to mark the end of the basis period for the earlier year, the actual date to which its profits are calculated may otherwise result in a gap preceding, or an overlap with, the actual date on which the basis period for the following year begins. This section ensures continuity between the two when the basis period for the second year is given by any of the provisions listed in *subsection (2)*.

Section 214: When a change of accounting date occurs

871. This is the first in a group of seven sections dealing with changes of accounting date. This is the most complex aspect of the basis period rules. By separating these "change" sections from the main sections the taxpayer who does not change accounting date is sheltered from most of that complexity.

872. Section 214 determines the basis period for the year in which a change of accounting date takes place. It is based on section 62(1)(a), (2) and (5) of ICTA.

873. *Subsection (1)* covers two cases. Normally the year in which the change takes place is the first year in which accounts are prepared to the new date. But sometimes the period of account ending on the new accounting date will straddle an entire tax year (because that period of account is longer than 12 months). In these circumstances the straddled year is the year in which the change is treated as having taken place.

874. *Subsection (2)* is necessary to "switch off" the middle date treatment and to allow the provisions of section 213 to operate if appropriate (see the commentary on section 213).

875. *Subsection (3)* attributes an accounting date to a year which is straddled by the period of account ending with the new accounting date. That is necessary to determine the correct basis period for the straddled year. For example, if the period of account effecting the change of accounting date runs for 15 months from 1 April 2006 to 30 June 2007 an accounting date is treated as falling on 30 June 2006 in the tax year 2006-07 although, in fact, there is no accounting date in that year.

Section 215: Change of accounting date in third tax year

876. This section is the first of two sections that deal with a change of accounting date in particular years and for which special rules are required. It is based on sections 62(1) and (2)(b) and 63 of ICTA.

877. The approach in the change of accounting date sections follows that adopted in the earlier sections: that the general rule in section 198 applies unless a specific rule applies. A specific rule will apply when the basis period must be different from that which would be given by the general rule or when additional conditions apply.

878. In a continuing trade, specific rules will always apply to years in which a change of accounting date occurs after the third year (see section 216). This is because conditions have to be met for changes of accounting date in those years to be effective for tax purposes (see the commentary on section 216 and section 217). But for changes in the second and third years there are no conditions and the general rule will often apply. Section 215 deals with the case where the general rule does not apply in the third year.

Section 216: Change of accounting date in later tax year

879. This section applies to changes of accounting date occurring at any time after the third year, other than in the final year. It is based on sections 62(1), (2) and (3) and 63 of ICTA.

880. Changes of accounting date are normally effective for tax purposes and the basis period then aligns with accounts prepared to the new accounting date. But exceptionally, changes of accounting date will not be effective for tax purposes and then the basis period becomes out of step with the period of account.

881. *Subsections (2)* and *(3)* give the main change of accounting date rule. When a change is effective for tax purposes the basis period simply aligns with the new accounting date in the year of change.

882. Both subsections refer to section 217 that sets out the conditions that a change must meet to be effective for tax purposes.

883. When subsection (3) applies, the basis period for the year of change will be longer than 12 months.

884. *Subsection (4)* preserves the old basis period, notwithstanding the change of accounting date, when, exceptionally the conditions in section 217 are not met. This means that apportionment of the profits of the periods of account to the basis period is required.

Section 217: Conditions for basis period to end with new accounting date

885. This section sets out the conditions which must be satisfied for a change of accounting date to be effective for tax purposes. It is based on section 62A(1), (2), (3), (4), and (5) of ICTA.

886. *Subsection (1)(c)* imposes a test which may be satisfied by meeting either of two conditions. The first, condition A in *subsection (4)*, is a "no recent change" condition and is of the same "mechanical" type as those in *subsections (1)(a)* and *(1)(b)*.

887. The second, in *subsection (6)*, is, in part, a condition of purpose. Unlike the others, it introduces a test which is qualitative in nature. But it becomes relevant only if condition A in *subsection (4)* is not met. It is therefore likely to apply in relatively few cases. For those reasons and to achieve a simpler rule for the more common cases, the associated Inland Revenue notice and taxpayer appeal rules are stated in a separate section (section 218).

Section 218: Commercial reasons for change of accounting date

888. This section deals with three aspects of the "commercial reason" condition in section 217(6)(a):

- the automatic assumption of commerciality;
- timely notice by the Inland Revenue to the contrary; and
- appeals to the Commissioners if the Inland Revenue's view is disputed.

It is based on section 62A(5), (6), (7), (8), and (9) of ICTA.

889. *Subsection (1)* makes the effect of section 62A(5)(b) of ICTA clear: that a change is treated as having been made for a commercial reason in the absence of a timely challenge by the Inland Revenue.

890. *Subsection (6)* prevents a wish to obtain a tax advantage from being a commercial reason for the change of accounting date rules.

Section 219: The year after an ineffective change of accounting date

891. This section sets out the rules that apply in the tax year following a year in which a change of accounting date takes place that does not result in a change of basis period. It is based on section 62(3) and (4) of ICTA.

892. When a change of accounting date takes place that does not result in a change of basis period, section 216(4) applies and the basis period for the year of change remains the 12 month period ending with the old accounting date. As a result, basis period and period of account fall out of alignment. Such cases may be relatively uncommon. But, where they do arise, specific rules are needed to ensure the proper working of the basis period rules in subsequent years. In those years, the taxpayer can revert to the old accounting date, maintain the new one, or change to a different date altogether.

893. *Subsection (2)* deals with the case where, in the year after the ineffective change, the new date is maintained. It allows the rules to operate as though the change takes place for the first time in that later year (rather than in the actual year of change). This allows the taxpayer to make a fresh attempt to change the basis period without, for example, falling foul of the "any recent change" rule in section 217(4).

894. *Subsection (3)* deals with the case where, in the later year, the taxpayer reverts to the old accounting date. This second change is not counted as a change for the purpose of the relevant rules.

Section 220: Deduction for overlap profit on change of accounting date

895. This section allows the deduction of overlap profit in a year in which there is a change of accounting date leading to a change of basis period and that basis period is longer than 12 months. It is based on section 63A(1) and (2) of ICTA and paragraphs 71140, 71155, and 71170 of the Inland Revenue Business Income Manual.

896. This adjustment for overlap profit is one of the two rules which help to ensure that, over the lifetime of a trade, the total profits assessed exactly equal the total profits earned. (The other, which authorises a deduction of overlap profit in the tax year in which the trade ceases, is in section 205). And it ensures that, in the year of change, no more than 12 months' profits are assessed.

897. Calculating the deduction can be quite complex, particularly, for example, if there have been other changes of accounting date and deductions for overlap profit in previous years. *Subsection (3)* uses a step-by-step method statement to aid calculation.

898. This section includes three aspects which have previously been dealt with on a non-statutory basis.

899. *Subsection (4)* deals with the first (described in paragraph 71140 of the Business Income Manual). Where profits must be apportioned, it allows the use of any reasonable basis of calculation instead of the measure by days referred to elsewhere in the section, provided its use is reasonable and consistent. See *Change 52* in Annex 1. The wording of subsection (4) makes it clear that the option to choose an alternative basis of apportionment is exercisable only by the taxpayer, not the Inland Revenue.

900. *Subsection (5)* deals with the second. It permits a change of accounting date to 31 March (or to 1, 2, 3, or 4 April) to be treated as though it were a change to 5 April (described in paragraph 71170 of the Business Income Manual). This avoids the need to make small restrictions to the deduction for overlap profit and will always work to the taxpayer's advantage. See *Change 55* in Annex 1.

901. Finally, *subsection (6)* provides the option (described in paragraph 71155 of the Business Income Manual) to disregard 29 February in calculating a deduction for overlap profit if the change of accounting date is to a date falling on 31 March to 5 April inclusive. This always works to the taxpayer's advantage. See *Change 57* in Annex 1.

Chapter 16: Averaging profits of farmers and creative artists

Overview

902. A person carrying on farming or market gardening or a creative artist may make an averaging claim. The claim is for the profits of two tax years to be adjusted. This is possible only if the profits of the two years differ to a material extent.

Section 221: Claim for averaging of fluctuating profits

903. This section sets out who may make an averaging claim. It is based on section 96 of ICTA (farmers) and Schedule 4A to ICTA (creative artists). In the case of creative artists a claim may be made in respect of the profits of a trade carried on wholly outside the United Kingdom. See *Change 58* in Annex 1.

904. In the case of a person assessed on the remittance basis, the assessment is on the amount of "sums received" rather than the profits. So a claim may not be made in respect of income assessed on the remittance basis.

905. *Subsection (2)* extends the meaning of farming to include market gardening and factory farming. See *Change 59* in Annex 1.

906. *Subsection (4)* makes it clear that "profits from a trade" means the amount before the deduction of losses. If a loss is sustained in the trade for the relevant tax year

subsection (5) ensures that it does not create a negative profit for the purposes of averaging; it results in a profit of nil.

907. The reference in section 96(7)(c) of ICTA to any deduction for stock relief under Schedule 9 to FA 1981 is spent. Schedule 9 was repealed by ICTA. So this Chapter omits the reference.

Section 222: Circumstances in which claim may be made

908. This section sets out the circumstances in which an averaging claim may be made. It is based on section 96 of and Schedule 4A to ICTA.

909. *Subsection (2)* makes explicit the fact that a claim may be made in relation to a tax year which was the later year on a previous averaging claim. This rule is merely implicit in the opening words of section 96(1) of ICTA.

910. *Subsection (4)* is based on the rules in section 96(4)(b) of and paragraph 4(2) of Schedule 4A to ICTA. The rule in section 96 of ICTA provides that no claim is to be made in respect of any tax year "in which the trade is (or by virtue of section 113(1) [of ICTA] is treated as) set up and commenced or permanently discontinued". The rule in this section follows the wording in Schedule 4A to ICTA.

911. There is some doubt whether "the trade" referred to in ICTA can mean a partner's "deemed trade" (see section 111(4) of ICTA). It is generally accepted that individual partners cannot make an averaging claim in relation to the year in which they start or permanently cease to carry on a qualifying trade in partnership. This subsection makes clear that the rule applies to a partner's deemed trade. See *Change 60* in Annex 1.

Section 223: Adjustment of profits

912. This section sets out the way in which the profits of each of the two tax years for which a claim is made are adjusted. It is based on section 96 of and Schedule 4A to ICTA. It also includes a signpost to Schedule 1B to TMA.

913. There are two methods for adjusting the profits.

914. *Subsection (3)* sets out the first method. The profits of the two years are added together and then averaged.

915. *Subsection (4)* sets out the second method. The subsection uses a method statement to show how a more complex calculation is made. The aim is to achieve a straight line taper from a full adjustment when the profits differ by 30% to no adjustment when they differ by 25%.

Section 224: Effect of adjustment

916. This section explains the effect of adjusting profits after a claim is made. It is based on section 96 of and Schedule 4A to ICTA.

917. *Subsection (4)* deals with the relationship between an averaging claim and claims for relief under any other provision of the Income Tax Acts.

918. Section 96(9)(a) of ICTA provides that the time limit for the making of these other claims is the last day of the period during which the averaging claim is capable of being revoked. This section describes the time limit as being the last date on which the averaging claim could have been made. The actual time limit remains unchanged.

Section 225: Effect of later adjustment of profits

919. This section explains the effect of adjusting profits after a claim is made. It is based on section 96(5) of and paragraph 10 of Schedule 4A to ICTA.

920. *Subsection (4)* sets out the rule for a further averaging claim. This section removes any doubt that the normal 22 month time limit applies. See *Change 61* in Annex 1.

Chapter 17: Adjustment income

Overview

921. This Chapter sets out the rules for dealing with two sorts of changes in the way profits of a trade are calculated.

922. The first sort of change is in the way the accounts are drawn up. The general rule is that profits must be calculated on the basis of accounts drawn up in accordance with generally accepted accounting practice (see section 50 of FA 2004 and section 25 of this Act). There is an exception to this general rule for some barristers and advocates (see section 160 of this Act), who may calculate their profits on a cash basis.

923. If there is a change from the cash basis to the earnings basis, some receipts and expenses may fall out of account. This sort of change was dealt with originally in the rules that became section 104(4) to (7) of ICTA. Those rules were replaced by the rules in section 44 of and Schedule 6 to FA 1998. The 1998 rules were replaced by section 64 of and Schedule 22 to FA 2002.

924. The second sort of change is in the way tax adjustments are made. These are the adjustments "required or authorised by law in calculating profits for tax purposes" (section 25). This sort of change was dealt with for the first time by the 2002 legislation.

925. Section 860 of this Act applies the rules to trades carried on in partnership.

Section 226: Professions and vocations

926. This section makes it unnecessary to specify repeatedly that the rules in this Chapter apply to a profession or vocation as well as a trade. It is new.

Section 227: Application of Chapter

927. This section sets out the circumstances in which an adjustment may arise. It is based on section 64 of FA 2002.

928. Section 64 of FA 2002 refers to a change of the basis on which profits are calculated. This might mean *any* change of basis. But paragraph 3(2) of Schedule 22 to FA 2002 makes clear that it does not include a change which occurs on a change of ownership of a trade.

929. The trading income rules in this Part are generally "person-based". So this section applies when *a person* changes the basis. That person must be the same before and after the change of basis. So this section reproduces the effect of paragraph 3(2) of Schedule 22 to FA 2002.

930. An adjustment has to be made if:

- the "old basis" accorded with the law *or* practice at the time; and
- the "new basis" accords with the current law *and* practice.

931. The difference in wording is to cater for a case in which a decision of the Courts makes it clear that a previously accepted view of the law was wrong. In that case, the old basis accorded with the practice but not the law. The 1998 rules did not cater for this. But the 2002 rules (and the rules in this Chapter) do.

932. Section 64(1)(a) of FA 2002 refers to "a change of basis in computing the profits for the purposes of Case I or II of Schedule D". So the change of basis rules are "rules

applicable to Cases I and II of Schedule D" (section 65(3) of ICTA) and apply to foreign trade profits assessed under Schedule D Case V.

933. This conclusion is reinforced by the fact that, if the adjustment is negative, any relief under paragraph 5 of Schedule 22 to FA 2002 is given by way of "a deduction in computing profits".

934. The section refers to "a trade". So the rules apply to trades carried on wholly outside the United Kingdom as they apply to trades carried on at least partly in the United Kingdom.

935. There is a transitional rule in paragraph 59 of Schedule 2 to this Act. An adjustment arising from a change of accounting basis before 6 April 1999 is not charged to tax if the recipient was born before 6 April 1917.

Section 228: Adjustment income and adjustment expense

936. This section sets out the treatment of the adjustment. It is based on paragraphs 4 and 5 of Schedule 22 to FA 2002.

937. If the adjustment is positive it is called adjustment income. Adjustment income is charged as trading income under section 229. Section 64 of and Schedule 22 to FA 2002 create a charge under Schedule D Case VI if there is a positive adjustment on a change of basis. This Act deals with the income where it logically belongs. In this case, the income is trading income.

938. In the case of foreign trades, a positive adjustment on a change of basis is charged to tax under Schedule D Case VI in the source legislation even though the profits of the trade are chargeable under Case V. This Chapter treats trades carried on wholly abroad in the same way as trades carried on wholly or partly within the United Kingdom (unless the income is assessable on the remittance basis).

939. The charge in the source legislation under Schedule D Case VI has consequences for loss relief and the charge to Class 4 national insurance contributions. This Chapter preserves the position for loss relief in section 232(3). This Act preserves the position for Class 4 national insurance contributions because the consequential amendments to the social security legislation ensure that those contributions are charged only on profits chargeable under Chapter 2 of Part 2 of this Act.

940. If the adjustment is negative it is called an adjustment expense. An adjustment expense is dealt with in sections 233 and 234.

Section 229: Income charged

941. This section sets out the amount charged to tax. It is based on section 69 of ICTA. Adjustment income is charged to tax separately from the profits of a trade (see section 5).

Section 230: Person liable

942. This section states who is liable for any tax charged. In FA 2002 the charge is under Schedule D Case VI. So section 59(1) of ICTA applies.

Section 231: Calculation of the adjustment

943. This section contains the main rules for calculating the adjustment. It is based on paragraph 2 of Schedule 22 to FA 2002. The section presents the rules as a method statement.

944. The 2002 legislation introduced three new rules.

945. The first new rule concerns a change in the basis of valuing stock. The rule is in item 3(b) of step 1 of the method statement. For instance, in Period 1 the accounts show closing

stock of £1200. That is reduced for tax purposes, in accordance with the practice then prevailing, to £1000. In Period 2 the opening stock in the accounts is £1200. So there is no adjustment within item 3(a). But if a new practice allows the opening stock value to stand for tax purposes there is an adjustment within item 3(b). There is a corresponding rule in item 3 of step 2.

946. The second new rule concerns a change in the way that depreciation is recognised. This rule is in item 4 of step 1. The expression "for accounting purposes" is defined in section 832(1) of ICTA – see Schedule 4 to this Act.

947. The third new rule restricts the circumstances that can give rise to a deduction in step 2 to those that are purely a matter of timing. For instance, in Period 1 the accepted view was that an item of expenditure was capital and it was "added back" in the tax computation. After a Court decision, that view changes and, if the expenditure had been incurred in Period 2, no tax adjustment would have been required. Without item 2(b) of step 2, item 2(a) would give a deduction.

Section 232: Treatment of adjustment income

948. This section sets out two special rules for the treatment of adjustment income. It is based on paragraph 4(2) of Schedule 22 to FA 2002.

949. *Subsection (1)* establishes when the adjustment income arises, so that it is charged to tax for the appropriate year under section 229.

950. *Subsection (3)* treats the income as trade profits for the purpose of loss relief. So, for example, any losses of the same trade brought forward can be set against the income.

951. *Subsection (4)* preserves the treatment of adjustment income as earned income.

952. It also makes clear that adjustment income is relevant UK earnings for the purpose of making pension contributions.

953. FA 2004 made significant changes to the taxation of pension schemes. The changes take effect from 6 April 2006. This Act deals with this by including the new rules in section 232. The commencement issue is then dealt with as a transitional measure in paragraph 57 of Schedule 2 of this Act. The old rules apply until 5 April 2006.

Section 233: Treatment of adjustment expense

954. This section treats an adjustment deduction as a trading expense. It is based on paragraph 5 of Schedule 22 to FA 2002.

Section 234: No adjustment for certain expenses previously brought into account

955. This section deals with the case where the old basis of calculation allowed a tax deduction but the new basis requires the deduction to be spread over several periods. It is based on paragraph 6 of Schedule 22 to FA 2002.

956. In the absence of this section there would be a positive adjustment within item 2 of step 1 of the calculation of the adjustment in section 231. That would produce the right result overall but the rule would take effect too early. Instead, no adjustment is calculated but no deduction is allowed in future for expenses that have already been taken into account.

Section 235: Cases where adjustment not required until assets realised or written off

957. This section is a timing rule for an adjustment which results from any of the three new rules in section 231. It is based on paragraph 7 of Schedule 22 to FA 2002.

958. These new rules are the ones mentioned in the commentary on section 231. The general timing rule is that any adjustment is made at the end of the first period of account on the

new basis (see section 232(1) and section 233(1)). But any adjustment income for stock, work in progress or depreciation is charged when the asset is realised or written off.

Section 236: Change from realisation basis to mark to market

959. This section is concerned with a change from the realisation basis to "mark to market" accounting. It is based on paragraph 8 of Schedule 22 to FA 2002.

960. "Mark to market" is a basis of accounting used by traders in financial assets. Instead of carrying the assets in the books at cost, financial traders draw up accounts to show the assets at a fair value at the accounting date. But for tax purposes the realisation basis may have been used.

961. In the first period in which mark to market is adopted for tax purposes, the opening stock may be valued at a higher (market) value than the closing stock of the previous period. Or a financial asset may have been carried in the accounts at cost but appear as a deduction in a later period at fair value. In either case, there is an adjustment within section 231.

962. As in section 235, the charge on adjustment income is postponed until the asset is realised.

Section 237: Election for spreading if section 236 applies

963. This section provides for an election to be made if there is a charge (following a change to mark to market) under section 236. It is based on paragraph 9 of Schedule 22 to FA 2002.

964. The election is to spread the adjustment charge over six periods of account beginning with the first one in which the new basis is adopted. As the charge is postponed under section 236 until the asset is realised, this first period is not necessarily the one in which the charge would be made without the election.

965. "Period of account" is defined in section 832(1) of ICTA.

966. *Subsection (2)* sets out the usual Self Assessment time limit for an election.

Section 238: Spreading on ending of exemption for barristers and advocates

967. This section sets out a special rule for spreading adjustment income in the case of barristers and advocates. It is based on paragraph 11 of Schedule 22 to FA 2002.

968. The income is spread over ten years, subject to a maximum charge in any one year.

969. In paragraph 4 of Schedule 6 to FA 1998 there was another rule for spreading adjustment income. Spreading was available to a person who changed accounting basis to comply with section 42 of FA 1998 (generally accepted accounting practice). Such a change would have taken effect by 5 April 2000.

970. In accordance with paragraph 17 of Schedule 22 to FA 2002 the repeal of Schedule 6 to FA 1998 takes effect only in relation to a change of basis on or after 1 August 2001. So the transitional rule in paragraph 4(2)(a) of Schedule 6 to FA 1998 may continue to affect current liabilities if they include part of a pre-2001 adjustment.

971. The rules in paragraph 13(3) and (4) of Schedule 22 to FA 2002 apply only if an election is made under paragraph 11 by a partner. As barristers and advocates do not carry on their professions in partnership, these rules are not needed.

Section 239: Election to accelerate charge under section 238

972. This section sets out the election that is available if adjustment income is spread under section 238. A taxpayer may choose to have any part of the outstanding adjustment

income taxed earlier than would otherwise be the case. The section is based on paragraph 12 of Schedule 22 to FA 2002.

973. *Subsection (2)* sets out the usual Self Assessment time limit for an election.

974. The effect of an election is set out in paragraph 12(4) of Schedule 22 to FA 2002. It is not clear what the "additional amount" referred to in the sub-paragraph is. In some cases more than the total adjustment income could be charged to tax within the period of ten years over which it is spread. *Subsection (4)* of this section sets out the effect of an election. See *Change 62* in Annex 1.

Section 240: Liability of personal representatives if person liable dies

975. This section makes it clear that a taxpayer's personal representatives take over from the taxpayer both the liability to tax on adjustment income and the right to make any election. It is based on paragraph 14 of Schedule 22 to FA 2002.

Chapter 18: Post-cessation receipts

Overview

976. This Chapter charges receipts which are derived from a trade but are not received until after the trade has ceased and have not been brought into the calculation of profits.

Section 241: Professions and vocations

977. This section makes it unnecessary to specify repeatedly that the rules in this Chapter apply to a profession or vocation as well as a trade. It is new.

Section 242: Charge to tax on post-cessation receipts

978. This section charges post-cessation receipts to tax. It is based on sections 103 and 104 of ICTA. Post-cessation receipts are charged separately from the profits of a trade (see section 5 of this Act).

Section 243: Extent of charge to tax

979. This section sets out the charge to tax. It is based on sections 103 and 104 of ICTA, which create a charge under Schedule D Case VI on post-cessation receipts. This Act deals with the income where it logically belongs. In this case the income is trading income.

980. The charge in the source legislation under Schedule D Case VI has consequences for loss relief and the charge to Class 4 national insurance contributions. This Chapter preserves the position for loss relief in section 254. This Act preserves the position for Class 4 national insurance contributions because the consequential amendments to the social security legislation ensure that those contributions are charged only on profits chargeable under Chapter 2 of Part 2 of this Act.

981. *Subsection (3)* deals with a trader who has become non-resident after the trade has ceased. A trade carried on at least partly in the United Kingdom (see section 6) may include income that arises abroad. When the trader was resident in the United Kingdom all the profits of the trade would have been within the charge under Part 2 of this Act. This subsection removes the charge on a non-resident if the receipt arises abroad.

982. There is a transitional rule in paragraph 61 of Schedule 2 to this Act. A post-cessation receipt arising from a cessation before 6 April 2000 is not charged to tax if the recipient was born before 6 April 1917.

Section 244: Income charged

983. This section sets out the amount charged to tax. It is based on section 69 of ICTA, which applies because the charge in ICTA is under Schedule D Case VI.

Section 245: Person liable

984. This section states who is liable for any tax charged. It is based on section 59(1) of ICTA, which applies because the charge in ICTA is under Schedule D Case VI.

Section 246: Basic meaning of "post-cessation receipt"

985. This section sets out the basic meaning of "post-cessation receipt". It is based on sections 103 and 104 of ICTA.

986. *Subsection (1)* is the general rule that a post-cessation is a sum received after a person has ceased to carry on trade.

987. *Subsection (2)* deals with the case of a non-resident company liable to income tax. If a company ceases to be liable to corporation tax it is treated as ceasing to carry on the corporation tax trade. A post-cessation from that trade may be charged to income tax.

988. *Subsections (3)* and *(4)* explain how the idea of a person ceasing to carry on a trade is applied if the trade is carried on in partnership. If a partner leaves a firm and receives a sum, that sum may be a post-cessation receipt. In ICTA this is because the end of the partner's "deemed trade or profession" is treated as a permanent discontinuance of a trade for the purposes of the post-cessation receipts rules.

Section 247: Other rules about what counts as post-cessation receipts

989. This section is new. It contains signposts to:

- the nine sections in this Act that treat other sums as post-cessation receipts; and
- the two sections in this Act that exclude certain sums from the charge on post-cessation receipts.

Section 248: Debts paid after cessation

990. This section sets out what happens when a trader is allowed a deduction for a bad or doubtful debt owed to the trade but then recovers the debt after the trade has ceased. It is based on sections 103(5) and 109A of ICTA.

991. In the straightforward case where a deduction for the debt has been given during the course of the trade section 103(5) of ICTA makes it clear that the recovery has not been "taken into account" in calculating the trade profits. The result is that the recovery is within the charge in section 103 of ICTA.

992. In the less common case where the entitlement to relief has arisen under section 109A of ICTA after the cessation, the recovery is dealt with in section 109A of ICTA itself.

993. This section deals with both these cases.

994. *Subsections (1) and (2)* deal with the straightforward case and treat the recovery of the debt as a post-cessation receipt. The references to corporation tax and section 74(1)(j) of ICTA cater for the possibility that a deduction for a bad debt is allowed to a company liable to corporation tax but the debt is paid to a person liable to income tax.

995. *Subsections (3) and (4)* deal with the less common case and treat the recovery of the debt as a post-cessation receipt.

Section 249: Debts released after cessation

996. This section sets out the rules that apply when a debt owed by the trader is released after the trade has ceased. It is based on section 103(4) of ICTA.

997. *Subsection (1)* sets out the four conditions to be met if the section is to apply. It is the equivalent of section 97 of this Act which applies in the case of a continuing trade. The references to corporation tax caters for the possibility that a deduction for an expense is allowed to a company liable to corporation tax but a person liable to income tax takes over the related trade debt and is released from it.

998. *Subsection (3)* deals with the case of a non-resident company liable to income tax. If the company becomes liable to corporation tax it is treated as ceasing to carry on the income tax trade.

Section 250: Receipts relating to post-cessation expenditure

999. This section sets out what happens if relief has been claimed for post-cessation expenditure and there is a recovery. It is based on section 109A(3) of ICTA.

1000. *Subsection (2)* sets out the sorts of expenditure for which relief may have been claimed and which sums are treated as post-cessation receipts.

Section 251: Transfer of rights if transferee does not carry on trade

1001. This section deals with the position of the transferor if the right to a post-cessation receipt is transferred for value to a non-trading transferee. It is based on section 106 of ICTA.

1002. The transferor is charged to tax on the amount received for the transfer if the transfer is at arm’s length. Otherwise the transferor is charged to tax on the arm’s length value of the transfer. There is no later charge to tax on the transferee when the post-cessation receipt is received.

1003. Section 98 of this Act sets out the position if the transfer is to a trading transferee.

Section 252: Transfer of trading stock or work in progress

1004. This section excludes from the charge on post-cessation receipts sums arising from the transfer of stock and work in progress. It is based on sections 103(3)(c), 104(6) and 110(6) of ICTA.

1005. *Subsection (1)* makes explicit the general rule that there is no tax charge on a post-cessation receipt arising from trading stock or work in progress.

1006. The policy is that stock and work in progress should be valued at cessation in accordance with the rules in Chapter 12 of this Part. Once that has been done there is no need to charge tax on any sums arising from the disposal or realisation of stock and work in progress.

1007. In the case of stock, section 173 of this Act requires a valuation on cessation in all cases. It follows that its value is taken into account in calculating the profits before the cessation. But the valuation rules apply to work in progress only “if … the work in progress is valued” (section 182 of this Act). Such a valuation is made only by businesses whose accounts are drawn up on the earnings basis.

1008. When the charge on post-cessation receipts was extended to non-earnings basis cases in 1968 the exclusion for work in progress often did not apply because in many of those cases closing work in progress was not valued. The policy was to tax post-cessation receipts arising from work in progress (under section 104 of ICTA). Nowadays non-earnings basis cases are much rarer.

1009. A valuation of work in progress is not required for barristers and advocates within section 160 of this Act. So, in these non-earnings basis cases, receipts from work in progress after the cessation are charged to tax.

1010. *Subsection (2)* is a signpost to the rule that allows a taxpayer to value work in progress at cost and to have the profit element of a sum received later for work in progress taxed as a post-cessation receipt.

Section 253: Lump sums paid to personal representatives for copyright etc.

1011. This section exempts certain lump sums from the charge on post-cessation receipts. It is based on section 103(3)(b) and (bb) of ICTA.

1012. A professional author or designer may receive lump sums from the sale of rights in artistic works in the course of the carrying on a profession. Such sums are brought into account in calculating the profits of the profession. But this section makes it clear that, in the case of sales after the death of the author or designer, the sums are not charged to tax.

1013. The section ensures that a lump sum received for the assignment of design right is not treated as a post-cessation receipt. See *Change 63* in Annex 1.

1014. The definition of "assignment" in section 879 of this Act applies so that the word means "assignation" in Scotland.

Section 254: Allowable deductions

1015. This section is the first of two that set out the rules for allowing deductions from sums charged as post-cessation receipts. It is based on section 105 of ICTA.

1016. *Subsection (3)* ensures that a deduction is not allowed for any expenses for which relief has already been allowed under section 109A of ICTA (relief for post-cessation expenditure). The reference to section 90(4) of FA 1995 (not part of the Tax Acts because it relates to capital gains tax) is retained because relief may be given under that section following a claim under section 109A of ICTA.

Section 255: Further rules about allowable deductions

1017. This section is the second of two that set out the rules for allowing deductions from sums charged as post-cessation receipts. It is based on section 105 of ICTA.

1018. *Subsection (2)* ensures that any loss unused at the date of cessation is set off against post-cessation receipts in the same order as it would have been set off against profits under section 385 of ICTA, that is, against an earlier year before a later year.

1019. *Subsection (4)* ensures that no expense or loss can be set against amounts treated as post-cessation receipts by section 248 (debts paid after cessation) or section 250 (receipts relating to post-cessation expenditure).

1020. The references to capital allowances in section 105(1)(b) and (3) of ICTA are no longer needed because any capital allowance is allowed as a trading expense.

Section 256: Treatment of post-cessation receipts

1021. This section treats most post-cessation receipts as earned income and relevant UK earnings. It is based on section 107 of ICTA. See *Change 64* in Annex 1.

1022. FA 2004 made significant changes to the taxation of pension schemes. The changes take effect from 6 April 2006.

1023. This Act deals with this by including the new rules in section 256 of this Act. The commencement issue is then dealt with as a transitional measure in paragraph 60 of Schedule 2 to this Act. The old rules apply until 5 April 2006.

Section 257: Election to carry back

1024. It may be beneficial for a taxpayer to have a post-cessation receipt assessed for the year of cessation instead of the year of receipt. This section, based on section 108 of ICTA, allows the taxpayer to elect for that treatment.

Chapter 19: Miscellaneous and supplementary

Section 258: Changes in trustees and personal representatives

1025. This section sets out what happens if there is a change in the trustees or personal representatives who are carrying on a trade. It is based on section 113(7) of ICTA.

1026. There is a similar rule for property income in section 361 of this Act.

Section 259: Meaning of "statutory insolvency arrangement"

1027. This section defines "statutory insolvency arrangement". It is based on section 74(2) of ICTA.

1028. Section 74(2)(a) of ICTA refers to a voluntary arrangement under the Insolvency Act 1986 (dealing with individual voluntary arrangements in England and Wales) and the Insolvency (Northern Ireland) Order 1989. This section refers also to the Bankruptcy (Scotland) Act 1985. See *Change 65* in Annex 1.

Part 3: Property income

Overview

1029. This Part charges "property income". That is, income from land.

1030. This Part taxes income that is taxed under different Schedules and Cases in the source legislation. So it covers, for example, income from land in the United Kingdom and abroad as well as post-cessation receipts and certain charges arising from changes in the basis on which a taxpayer calculates property business profits.

1031. This reflects the rewrite approach of grouping charges which are logically part of the same "family". In Part 3 the unifying factor is that all the charges are on amounts that are, ultimately, attributable to exploiting an interest in land.

1032. But although the charges that are, in the source legislation, distinct, are here grouped in one Part, they do not lose their identity for all purposes. Loss relief for example (not dealt with in this Act) requires them to be kept apart. For this reason the charge on "property income" has specific components (see the commentary on section 260).

1033. References to "profits or gains" in the source legislation which relate only to income are rewritten in this Part omitting the reference to "gains". This continues the tidying up of such references started in section 46(3) of and Schedule 7 to FA 1998.

Chapter 1: Introduction

Section 260: Overview of Part 3

1034. This section is introductory. It is new.

1035. *Subsection (1)* sets out the components of "property income".

1036. *Subsection (1)(a)* refers to the main component. That is income from land that is taxed in the source legislation under Schedule A if it is land in the United Kingdom and under Schedule D Case V if it is foreign land. Central to the charge is the concept of the "property business". That is discussed in more detail in the commentary on sections 264 and 265.

1037. *Subsection (1)(e)* refers to post-cessation receipts of a UK property business. In the source legislation they are charged under Schedule D Case VI. This Act deals with the income where it logically belongs. In this case, the income is property income.

Section 261: Provisions which must be given priority over Part 3

1038. This section provides the rules to determine which Part takes priority in the event of any overlap of the charge on the profits of a trade and the charge on the profits of an overseas property business or the charge under Chapters 8 and 9 of this Part.

1039. It is based on section 18 of ICTA and section 65A(1) of ICTA as regards overlap between an overseas property business and a foreign trade. It gives statutory effect to the Crown Option as regards overlap between an overseas property business and a UK trade. See *Change 66* in Annex 1.

1040. It is based on the definitions of Schedule D Cases I and VI in section 18 of ICTA as regards overlap between a trade and the profits of a UK concern or the profits of a UK electric line wayleave. Case VI charges income that is not charged under any other case. So it is correct to give trading income (Case I in the source legislation) priority.

Section 262: Priority between Chapters within Part 3

1041. This section gives an order of priority between Chapter 3 and Chapters 8 and 9 of this Part of this Act and between Chapters 8 and 9. It is based on sections 119(1) and 120(1) of ICTA.

1042. *Subsection (3)* deals with income that falls within both Chapter 8 and Chapter 9 of this Part of this Act. See *Change 5* in Annex 1.

Chapter 2: Property businesses

Section 263: Introduction

1043. This section introduces the Chapter and provides a "road map" to the key provisions. It is new.

1044. Chapter 2 sets out the key concepts underlying the main component of income within this Part of this Act by defining "property business" and "generating income from land".

Section 264: UK property business

1045. This section defines "UK property business" and introduces the concept of "generating income from land". It is based on section 15(1) of ICTA.

1046. It makes it clear that all the income from a person's UK land interests is treated as falling within a single UK property business.

1047. The term "property business" is not entirely straightforward. The term used in the source legislation – "Schedule A business" – was introduced as part of the 1995 reform of Schedule A. That concept was helpful in providing a vessel to contain all the income from land previously charged under Schedule A and to which the rules for calculating trade profits could be applied. But the concept of a Schedule A business – and a UK property business - is rather more complex than that of a trade. That is reflected in this and the other sections that, together, define the range of income that is assessed as income of a property business.

1048. First, the income has to be defined by reference to land law. There are only limited possibilities for simplifying terms which have to link directly with the concepts and language of current land law.

1049. Second, the concept of the "property business" is, to a certain extent, an artificial one. Unlike the term "trade" it may not always correspond to an activity organised in a way that the proprietor would necessarily describe as a business. As such, the term has to cover:

- "real" businesses where the lettings are organised in a professional way;
- lettings which are not so organised; and
- casual and one-off transactions which may have very little of the qualities normally associated with a business.

Then all of these lettings of different types must be treated as part of the same, single business.

1050. Although the Chapter builds on the concept of the "business", the approach to defining a "UK property business" differs from the approach in the source legislation. This Act uses the term "UK property business" rather than "Schedule A business". Although the terms "UK property business" and "Schedule A business" are defined differently they have the same tax effect.

1051. Paragraph 1(1) of Schedule A (see section 15(1) of ICTA) provides for tax to be charged on "the annual profits arising from a business carried on for the exploitation, as a source of rents or other receipts, of any estate, interest or rights in or over land in the United Kingdom". Under paragraph 1(2) of Schedule A, "to the extent that any transaction is entered into for [that purpose], it is taken to be entered into in the course of such a business". Paragraph 1(3) of Schedule A treats all businesses and transactions carried on or entered into by a particular person, so far as they are carried on or entered into for that purpose, as together forming a single business for the purposes of Schedule A.

1052. Section 832(1) of ICTA provides:

""Schedule A business" means any business the profits or gains of which are chargeable to income tax under Schedule A, including the business in the course of which any transaction is by virtue of paragraph 1(2) of that Schedule to be treated as entered into.

1053. Each of the individual businesses carried on (or, by virtue of paragraph 1(2) of Schedule A, notionally carried on) for the purpose mentioned in Schedule A is thus a "Schedule A business". Under paragraph 1(1) and (3) of Schedule A, the charge to tax is on the profits of the single notional business consisting of all the Schedule A businesses carried on by a single person. It is that notional business that is defined as the person's "UK property business" in section 264.

1054. Section 859 explains how the "one business per person" rule applies in the case of a business carried on (or a transaction entered into) in partnership.

Section 265: Overseas property business

1055. This section defines "overseas property business". It is based on section 65A of ICTA.

1056. The definition is identical to that of "UK property business" except that the land from which the income arises is outside the United Kingdom. That is the only difference between a UK and an overseas property business: income from land outside the United Kingdom can arise only in an overseas property business; income from land in the United Kingdom can arise only in a UK property business.

1057. For the purpose of deciding whether there is an overseas property business, overseas land law is interpreted in accordance with section 363.

1058. The priority rules in the trading income Part of this Act (section 4) make it clear that a charge under Part 3 of this Act as United Kingdom property income has priority over a charge under Part 2 as trading income. This reflects the rule in Schedule D Case I (section 18(3) of ICTA). The sort of receipt to which this rule might apply is rent received by a property developer from the temporary letting of land awaiting development. The rent is taxed as property income, even if it could properly be regarded as a trade receipt.

1059. In the case of a foreign trade and foreign property, the rule in section 65A(1)(b) of ICTA is the reverse of that in section 18(3) of ICTA. An overseas property business does not include "income to which section 65(3) of ICTA applies (income immediately derived from carrying on a trade …)". So the priority rule in section 261 preserves this position.

Section 266: Meaning of "generating income from land"

1060. This section defines "generating income from land". It is based on sections 15(1), 24 and 65A of ICTA.

1061. The section defines what may be described as the essence of the property business. That is, exploiting rights of land ownership for profit. But it is not intended to identify everything that must be taken into account in calculating the profits of such a business. The concept of the property business is wider than that. "Property business" includes, for example, amounts specifically charged under other provisions such as certain insurance recoveries (see section 106 applied by section 272(2)).

1062. *Subsection (1)* states the basic definition of "generating income from land".

1063. *Subsection (2)* extends the meaning of "rent" and is based on section 24(6)(b) of ICTA. It applies to payments by tenants, whether made to the landlord or to someone else, in respect of maintenance or repair of the leased premises that the tenant is not required by the lease to carry out. Including this extension in the main section (in the source legislation it is relegated to a "construction" section) keeps all the relevant definitions together.

1064. *Subsection (3)* explains "other receipts" in subsection (1). This list is not exhaustive but amounts that are not listed here would have to be of a similar nature to those that are listed to come within the definition.

1065. *Subsection (4)* extends the charge to particular types of receipt. The source legislation cross-refers to a definition of "caravan" in the Caravan Sites and Control of Development Act 1960. There is an Act-wide, uniform definition of "caravan": see the commentary on section 875 and *Change 148* in Annex 1.

1066. There is also a new Act-wide, uniform definition of "houseboat" which introduces changes in the law: see the commentary on section 878(1) and *Change 150* in Annex 1.

Section 267: Activities not for generating income from land

1067. This section excludes certain "land-related" income from property income and cross-refers to the trading income provisions under which that income is charged. It is based on sections 15(1) and 65A of ICTA.

Chapter 3: Profits of property businesses: basic rules

Section 268: Charge to tax on profits of a property business

1068. This section charges the profits of a property business to tax. It is based on sections 15 and 18 of ICTA.

Section 269: Territorial scope of charge to tax

1069. This section sets out the limitations on the charge to tax on a UK property business and an overseas property business. It is based on sections 18 and 65A of ICTA.

1070. *Subsection (1)* establishes that the profits of a UK property business are charged to tax whatever the residence status of the taxpayer.

1071. *Subsection (2)* establishes that the profits of an overseas property business are charged to tax only if the taxpayer is a UK resident.

1072. Income from an overseas property business is assessable under Schedule D Case V. So the charge to tax is subject to the territorial restriction in Schedule D. A non-resident person is taxable only on income from "property" in the United Kingdom (see paragraph (a)(iii) of Schedule D in section 18(1) of ICTA). So a non-resident is not charged to tax on the income from overseas property.

1073. *Subsection (3)* is the special rule for Irish income. It is based on section 68 of ICTA. Even if a person is entitled to the remittance basis for other foreign income Irish income is assessable on the basis of the income arising. But it is not clear how the rules in sections 65(4) and 68 of ICTA interact. This section makes it clear that the rules for an overseas property business are used in calculating the income from Irish property. See *Change 67* in Annex 1.

1074. *Subsection (4)* is a signpost to the special rule in Chapter 11 of Part 2 of this Act for the non-Irish foreign income of a person who is assessable on the remittance basis. The overseas property business rules in section 65A of ICTA are disapplied in the case of a remittance basis person by section 65(4) of ICTA.

Section 270: Income charged

1075. This section states the amount charged to tax. It is based on sections 21 and 65 of ICTA.

1076. The section refers simply to "profits" rather than "annual profits" used in the source legislation. Omitting "annual" is consistent with the approach adopted for trading and savings and investment income - the word adds nothing to the meaning of "profits".

Section 271: Person liable

1077. This section states who is liable for any tax charged. It is based on sections 21 and 59 of ICTA.

Section 272: Profits of a property business: application of trading income rules

1078. This is the main rule for calculating the profits of a property business. It is based on sections 21A and 65A of ICTA.

1079. The same basic rules apply to the calculation of both UK and overseas property businesses.

1080. From 1995, the profits of a Schedule A business charged to income tax are calculated by treating the business as similar to a trade and applying the calculation rules of Schedule D Case I.

1081. In the source legislation this is achieved by section 21A of ICTA. But, at the margins, the application of certain of the Case I rules to Schedule A is not altogether clear.

1082. First, the relationship of section 21A(2) of ICTA to section 21A(1) of ICTA is uncertain. Section 21A(2) of ICTA refers to provisions that apply "in accordance" with section 21A(1). It is open to debate whether section 21A(2) of ICTA merely contains examples of the Schedule D Case I provisions that apply in accordance with the general rule in section 21A(1) of ICTA or whether it contains an exhaustive list of those provisions. The former appears the better view and the one best reflecting the underlying policy.

1083. Second, some Schedule D Case I provisions that are applied to Schedule A are inherently incapable of applying to income from land. The "herd basis" provisions in section 97 of and Schedule 5 to ICTA (rewritten in Chapter 8 of Part 2 of this Act) are an example. They are among the provisions of Chapter V of Part 4 of ICTA that are applied to Schedule A specifically (subject to stated exceptions) by section 21A(2) of ICTA. But they are not among the exceptions referred to in section 21A(4) of ICTA.

1084. On the other hand, some Schedule D Case I provisions outside Chapter V of Part 4 of ICTA that seem potentially more relevant, such as the car hire provisions in sections 578A and 578B of ICTA, are not applied specifically.

1085. Section 272 clarifies these matters by listing all the sections in Part 2 of this Act that are relevant to property business profits.

1086. Some of the sections in Part 2 of this Act that are applied to a property business contain rewrite changes. Those changes are carried through to property income. Details of those changes are recorded in the Annex 1 notes on the particular sections in Part 2 of this Act.

1087. *Subsection (1)* states the general principle that the profits of a property business are calculated in the same way as the profits of a trade. This reflects the fact that there are provisions not included in Part 2 of this Act which may affect the calculation of profits. For example, the pension contributions deductions provisions in FA 2004 and certain anti-avoidance provisions in ICTA that apply to all income types.

1088. *Subsection (2)* lists all the sections in Part 2 of this Act that are relevant to property business income. It reflects the principle that section 21A(1) of ICTA applies all Schedule D Case I calculation provisions to Schedule A unless they are expressly disapplied elsewhere. Provisions that are expressly disapplied in the source legislation are excluded from the list.

1089. Also excluded are provisions which are attracted to Schedule A in the source legislation either expressly by section 21A(2) of ICTA or under the general principle expressed in section 21A(1) of ICTA, but which are incapable of applying once carried over to the context of the property business. Exclusion is achieved simply by omitting them from the list of provisions that do apply.

1090. The majority of the provisions in Part 2 of this Act that can apply to a property business are applied by subsection (2). But in some cases later sections set out the provisions specifically (Chapter 7 (adjustment income) and Chapter 10 (post-cessation receipts)).

1091. The following sections that are applied by subsection (2) merit specific mention. These are:

- sections 48 to 50: expenses of car hire;
- sections 188 to 191: deduction for unremittable amounts.

1092. Including these accurately reflects the effect of section 21A(1) of ICTA.

1093. Although the list in subsection (2) excludes sections in Part 2 of this Act that are inherently incapable of applying to a property business it does not exclude those that are merely unlikely to apply. This recognises the possibility of certain provisions applying in unusual circumstances. Examples are section 87 and section 88 (scientific research). Although their relevance to a property business is unlikely, it is not inconceivable and they are needed to cater for the possibility of a landlord funding an activity that would qualify as "scientific research". An example might be research on the decontamination of brown land with a view to building an investment property on it.

1094. *Subsection (3)* ensures that the trading income provisions cross-referred to in subsection (2) work properly in the context of the property business.

Section 273: Amounts not brought into account as part of a property business

1095. This section excludes from the profits of a property business certain income from land that, exceptionally, may be taxed as profits of a trade. It is based on sections 15 and 65A of ICTA.

1096. *Subsection (1)* signposts to the relevant provisions.

- See *Change 3* in Annex 1 in respect of caravans.
- See *Change 4* in Annex 1 in respect of surplus business accommodation.
- See *Change 5* in Annex 1 in respect of payments for wayleaves.

Section 274: Relationship between rules restricting and permitting deductions

1097. This section determines the interaction between those provisions that allow a deduction and those provisions that prohibit a deduction. It is new. See *Change 6* in Annex 1.

1098. This section does a similar job in the property income Part to that which section 31 does in the trading income Part. The general principle is that a rule allowing a deduction takes priority over a rule prohibiting a deduction. But that is subject to the exceptions the section mentions.

1099. *Subsection (4)* makes it clear that the effect of this priority rule extends to the large number of trading income rules that apply to property income indirectly through section 272.

Section 275: Apportionment of profits to tax year

1100. This section deals with cases where the period of account does not coincide with a tax year. It is based on sections 21A, 72 and 65A of ICTA.

1101. This section is necessary because the charge under section 270 is on the property business profits arising in the *tax year*.

1102. In the source legislation section 72 of ICTA is one of the provisions applied to Schedule A specifically by section 21A(2) of ICTA. Section 72 of ICTA is rewritten for trade profits in section 203. But simple cross-reference to that trading income section would not work very well for property income because that section is drafted in terms of basis periods and basis periods are not relevant to property income. So section 275 is a specific property income version.

1103. *Subsection (4)* adopts the approach of section 203(4) in permitting an alternative basis of apportionment if its use is reasonable and consistent. See *Change 52* in Annex 1. The wording of subsection (4) makes it clear that the option to choose an alternative basis of apportionment is exercisable only by the taxpayer, not the Inland Revenue.

Chapter 4: Profits of property businesses: lease premiums etc.

Overview

1104. This Chapter contains rules for the taxation of premiums, and certain other amounts paid in respect of leases, which would otherwise generally be amounts of a capital nature. It is based on sections 34 to 38 of ICTA.

1105. The effect of section 34 of ICTA is that premiums for leases with an effective duration of 50 years or less, and certain other amounts treated as premiums, are treated wholly or partly as income in the hands of the recipient. Premiums in respect of leases with a duration of one year or less are treated wholly as income. For premiums in respect of leases with a duration of between one and 50 years, the amount treated as income is calculated on a sliding scale according to the duration of the lease. Similar provision is made for amounts treated as premiums under section 34(4) and (5) of ICTA. See sections 277 to 281.

1106. Section 35 of ICTA applies when a lease for 50 years or less is granted for a premium less than market value and is then reassigned at a profit. The assignor is treated as receiving as income an amount calculated on a sliding scale according to the duration of the lease. See sections 282 and 283.

1107. Section 36(1) and (2) of ICTA apply when an estate or interest in land is sold with a condition that it may be required to be sold back to the vendor. The vendor is treated under section 36(4A) of ICTA as receiving as income an amount calculated on a sliding scale according to the earliest date on which the interest could fall to be reconveyed. Section 36(3) makes similar provision where the terms of the sale provide for the grant of a lease to the vendor. See sections 284 to 286.

1108. Section 37 of ICTA contains rules under which:

- there may, in certain circumstances, be a reduction in the amount of another receipt under section 34 or 35 of ICTA – see sections 287 to 290; and/or
- the tenant under the lease may be entitled to a deduction in calculating the profits of his or her property business – see sections 291 to 294.

1109. A tenant who uses land subject to a lease in respect of which there is a receipt under section 34 or 35 of ICTA in connection with a trade, profession or vocation may be entitled under section 87 of ICTA to a deduction in computing the profits of that trade, profession or vocation. Section 87 of ICTA is rewritten in sections 60 to 65 of this Act.

1110. Section 38 of ICTA contains rules for determining the duration of a lease for the purposes of sections 34 to 36 of ICTA. See sections 303 to 305.

Section 276: Introduction

1111. This section is new.

1112. *Subsection (3)* refers to "any lease" in the case of sums payable instead of rent or for the variation or waiver of the term of a lease. See commentary on sections 279 and 281 and *Change 68* in Annex 1.

1113. *Subsection (6)* defines a "short-term" lease as "a lease whose effective duration is 50 years or less". The "effective duration" of a lease is its duration for the purpose of the lease premium rules. This may not be the same as the contractual duration. See commentary on sections 303 and 304.

Section 277: Lease premiums

1114. This section contains the basic rule for the amount treated as a receipt if a premium is paid on the grant of a short-term lease. It is based on sections 34(1), (6) and (7A) and 37(2) of ICTA.

1115. Section 34(1) of ICTA treats a landlord who receives a premium as receiving an amount by way of rent. Section 34(6) of ICTA treats a person other than a landlord who receives a premium as receiving income as a result of entering into a transaction within paragraph 1(2) of Schedule A in section 15(1) of ICTA.

1116. This section instead treats both landlords and non-landlords as entering into a transaction mentioned in section 264 of this Act (if the land to which the lease relates is in the United Kingdom) or section 265 of this Act (if the land to which the lease relates is outside the United Kingdom).

1117. Section 264 in Chapter 2 of Part 3 of this Act provides that a person’s UK property business consists of:

“(a) every business which the person carries on for generating income from land in the United Kingdom, and

(b) every transaction which the person enters into for that purpose otherwise that in the course of such a business.

1118. Section 269(1) of this Act provides that the profits of a UK property business are charged to tax under Chapter 3 of Part 3 of this Act whether the business is carried on by a UK resident or a non- UK resident.

1119. Section 265 in Chapter 2 of Part 3 of this Act provides that a person’s overseas property business consists of:

“(a) every business which the person carries on for generating income from land outside the United Kingdom, and

(b) every transaction which the person enters into for that purpose otherwise that in the course of such a business.

1120. Section 269(2) and (3) provides that the profits of an overseas property business are charged to tax under Chapter 3 of Part 3 of this Act only if the business is carried on by a UK resident but in the case of a UK resident to whom the remittance basis applies, only in respect of land in the Republic of Ireland.

1121. The effect of sections 264 and section 265 is that the transaction which subsection (2) of this section treats the person as entering will be included in the person's UK or overseas property business, or will constitute the person's UK or overseas property business if that person is not already carrying on such a business.

1122. The approach adopted in subsections (2) to (4) of section 277 is also followed in rewriting the rules on:

- sums payable instead of rent in section 279;
- sums payable for the surrender of a lease in section 280;
- sums payable for the variation or waiver of the term of a lease in section 281;
- assignments for profit of lease granted at undervalue in section 282;
- sales with right to reconveyance in section 284; and
- sale and leaseback transactions in section 285.

1123. Section 34(1) of ICTA treats rent treated as received by a landlord as received when the lease is granted. Section 34(7A) of ICTA provides that an amount treated as received as rent must be taken into account for the chargeable period in which it is treated as received. There is no corresponding rule for non-landlords in section 34(6).

1124. *Subsection (3)* requires the person to whom the premium is due (both landlord and non-landlord) to bring an amount into account in calculating the profits of the property business for the tax year in which the lease is granted. See *Change 69* in Annex 1.

Section 278: Amount treated as lease premium where work required

1125. This section is based on section 34(2) and (3) of ICTA.

Section 279: Sums payable instead of rent

1126. This section deals with cases where a payment is made instead of rent for some or all of the duration of a lease. It is based on sections 34(1), (4), (6) and (7A) and 37(2) of ICTA.

1127. Section 34(1) of ICTA applies if the duration of the lease is not more than 50 years. But section 34(4)(a) of ICTA provides that any period other than that in relation to which the sum is payable in lieu of rent must be ignored in arriving at the duration of the lease. So for the purposes of section 34(4) of ICTA the duration of a lease cannot be longer than the period in respect of which the sum is payable instead of rent. *Subsection (1)* makes clear that –irrespective of the length of the lease – the payment of a sum instead of rent for a period of not more than 50 years is within the scope of this section. See *Change 68* in Annex 1.

1128. Subsections (2) to (4) of this section are drafted on the same basis as subsections (2) to (4) of section 277.

1129. *Subsection (2)* treats a person to whom a sum is due instead of rent as entering into a transaction mentioned in section 264 (if the land to which the lease relates is in the United Kingdom) or section 265 (if the land to which the lease relates is outside the United Kingdom). The effect of sections 264 and 265 is that the transaction will be included in, or will constitute, the person's UK or overseas property business.

1130. Section 34(1) of ICTA treats income in the hands of a landlord as received when the lease is granted. There is no corresponding rule for non-landlords in section 34(6) of ICTA. This section instead requires the person carrying on the property business (whether or not that person is the landlord) to bring an amount into account in calculating the profits of that business for the tax year in which the sum instead of rent is payable. See *Change 69* in Annex 1.

1131. The formula in section 34(1) of ICTA calculates the amount treated as received by way of rent by reference to the duration of the lease. Section 34(4)(a) of ICTA says that in computing the profits of the business any period other than that in respect of which the sum is paid instead of rent must be ignored. So in calculating the amount to be treated as rent in respect of a sum within section 34(4) of ICTA, the duration of the lease for the purposes of the formula in section 34(1) of ICTA must be adjusted in accordance with section 34(4)(a) of ICTA.

1132. *Subsection (6)* combines the requirements at sections 34(1) and (4)(a) of ICTA so that the period used in the formula in *subsection (5)* is the shorter of the period for which the payment is made and the period from the beginning of that period to the end of the effective duration of the lease.

Section 280: Sums payable for surrender of lease

1133. This section deals with cases where a sum is payable for the surrender of a lease. It is based on sections 34(1), (4), (6) and (7A) and 37(2) of ICTA.

1134. Subsections (2) to (4) of this section are drafted on the same basis as subsections (2) to (4) of section 277.

1135. *Subsection (2)* treats a person to whom a sum is due as consideration for the surrender of the lease as entering into a transaction mentioned in section 264 (if the land to which the lease relates is in the United Kingdom) or section 265 (if the land to which the lease relates is outside the United Kingdom). The effect of sections 264 and 265 is that the transaction will be included in, or will constitute, the person's UK or overseas property business.

1136. Section 34(1) of ICTA treats income in the hands of a landlord as received when the lease is granted. There is no corresponding rule for non-landlords in section 34(6) of ICTA. This section instead requires the person carrying on the property business (whether or not that person is the landlord) to bring an amount into account in calculating the profits of that business for the tax year in which the sum for the surrender of the lease is payable. See *Change 69* in Annex 1.

Section 281: Sums payable for variation or waiver of term of lease

1137. This section deals with the case where a payment is made for the variation or waiver of any of the terms of a lease. It is based on section 34(1), (5), (6), (7) and (7A) of ICTA.

1138. Section 34(1) of ICTA applies if the duration of the lease is not more than 50 years. Section 34(5)(a) of ICTA provides that any period before or after the period for which the variation or waiver has effect must be ignored in arriving at the duration of the lease. So for the purposes of section 34(4) of ICTA, the duration of a lease cannot be longer than the period for which the variation or waiver has effect. S*ubsection (1)* makes clear that – irrespective of the length of the lease – the payment of a sum as consideration for the variation or waiver of the terms of a lease for a period of not more than 50 years is within the scope of this section. See *Change 68* in Annex 1.

1139. Section 34(6) of ICTA says that sums due to a person other than a landlord under:

- section 34(1) of ICTA (premiums);
- section 34(4) of ICTA (sums payable instead of rent or for the surrender of a lease); and
- section 34(5) of ICTA (sums payable for the variation or waiver of the terms of a lease),

are charged on that person.

1140. Section 34(7) of ICTA disapplies section 34(6) of ICTA if the payment is due to a person not connected with the landlord. But section 34(7) of ICTA does not explicitly set aside the requirement in section 34(5) of ICTA to treat sums payable for the variation or waiver of the terms of a lease as the payment of a premium to the landlord if that payment is made to a person unconnected with the landlord. So it is not clear whether section 34(6) of ICTA catches a person unconnected with the landlord who receives a consideration in connection with the variation or waiver of the terms of a lease (eg a person living above a shop who receives a payment in consideration of the landlord waiving a term in the shop lease which restricts the hours during which the shop may open).

1141. *Subsection (1)* deals with this by providing that this section applies only if the sum is due to the landlord or a connected person. "Connected person" is defined in section 839 of ICTA (see section 878(5) of this Act). See *Change 70* in Annex 1.

1142. Subsections (2) to (4) of this section are drafted on the same basis as subsections (2) to (4) of section 277.

1143. *Subsection (2)* treats a person to whom a sum is due as consideration for the variation or waiver of the terms of a lease as entering into a transaction mentioned in section 264 (if the land to which the lease relates is in the United Kingdom) or section 265 (if the land to which the lease relates is outside the United Kingdom). The effect of sections 264 and 265 is that the transaction will be included in, or will constitute, the person's UK or overseas property business.

1144. Section 34(1) of ICTA treats income in the hands of a landlord as received when the lease is granted. There is no corresponding rule for non-landlords in section 34(6) of ICTA. This section instead requires a person carrying on the property business (whether or not that person is the landlord) to bring an amount into account in calculating the profits of that business for the tax year in which the sum is payable. See *Change 69* in Annex 1.

1145. Section 37(2) of ICTA provides for the reduction of amounts treated as rent under section 34 or 35 of ICTA which arise in respect of the "grant or disposition" of a lease. It is arguable that section 37(2) of ICTA does not apply to an amount treated as income under section 34(5) of ICTA in respect of a sum payable for the variation or waiver of the terms of a lease because the amount does not arise in respect of the grant or disposition of a lease.

1146. Section 287(1) extends relief under section 288 to receipts in respect of sums payable for variation or waiver. This is reflected in *subsection (5)* of this section. See *Change 71* in Annex 1.

1147. The formula in section 34(1) of ICTA calculates the amount treated as received by way of rent by reference to the duration of the lease. Section 34(5)(a) of ICTA says that in computing the profits of the business any period other than that in relation to which the variation or waiver has effect must be ignored. So in calculating the amount to be treated as rent in respect of a sum within section 34(5) of ICTA, the duration of the lease for the purposes of the formula in section 34(1) of ICTA must be adjusted in accordance with section 34(5)(a) of ICTA.

1148. *Subsection (6)* combines the requirements in section 34(1) and (5)(a) of ICTA so that the period used in the calculation is the shorter of the period for which the variation or waiver has effect and the period from the beginning of that period to the end of the effective duration of the lease.

Section 282: Assignments for profit of lease granted at undervalue

1149. This section treats a person who assigns, at a profit, a lease granted to him or her at less than its true value as receiving an amount calculated by reference to the smaller of the discount at which the lease was granted and the profit on the assignment. It is based on sections 35(1), (2) and (2A) and 37(2) of ICTA.

1150. Subsections (2) to (4) of this section are drafted on the same basis as subsections (2) to (4) of section 277.

1151. *Subsection (2)* treats a person who assigns the lease at undervalue as entering into a transaction mentioned in section 264 (if the land to which the lease relates is in the United Kingdom) or section 265 (if the land to which the lease relates is outside the United Kingdom). The effect of sections 264 and 265 is that the transaction will be included in, or will constitute, the person's UK or overseas property business.

1152. Section 35(2A) of ICTA treats income deemed to have been received under section 35 of ICTA as received when the consideration for the assignment of the lease becomes payable. This section instead brings an amount into account as a receipt in calculating the profits of the property business for the tax year in which the consideration for the assignment is payable. See *Change 69* in Annex 1.

1153. The formula in *subsection (4)* for calculating the deemed receipt if there is an assignment at a profit is based on section 35(2) of ICTA (which refers back to the formula in section 34(1) of ICTA).

Section 283: Provisions supplementary to section 282

1154. This section is based on section 35(1) and (2) of ICTA.

Section 284: Sales with right to reconveyance

1155. This section brings a deemed receipt into account if property is sold on terms which provide for the property to be reconveyed to the seller, or to a connected person, at less than the sale price. It is based on section 36(1) and (4A) of ICTA.

1156. "Connected person" is defined in section 839 of ICTA (see section 878(5) of this Act).

1157. Section 36(1) of ICTA does not specify any limit on the time between sale and reconveyance. But because section 36(1) of ICTA reduces the amount of the deemed income by 1/50th for each complete year between sale and reconveyance, no charge arises if the property is reconveyed more than 51 years after the sale. So this section applies only if the period between sale and reconveyance is not more than 50 years. See *Change 72* in Annex 1.

1158. Subsections (2) to (4) of this section are drafted on the same basis as subsections (2) to (4) of section 277.

1159. *Subsection (2)* treats the person who sells the land as entering into a transaction mentioned in section 264 (if the land to which the lease relates is in the United Kingdom) or section 265 (if the land to which the lease relates is outside the United Kingdom). The effect of sections 264 and 265 is that the transaction will be included in, or will constitute, the person's UK or overseas property business.

1160. Section 36(4A) of ICTA treats income deemed to have been received under section 36 of ICTA as received when the property is sold. This section instead brings an amount into account as a receipt in calculating the profits of the property business for the tax year in which the property is sold. See *Change 69* in Annex 1.

1161. The formula in *subsection (4)* is based on section 36(1) of ICTA. Section 36(1) of ICTA deems the person by whom the property is sold to receive an amount equal to the excess, if any, of the sale price over the price at which the property is to be reconveyed or, if the earliest date on which the property can be reconveyed is two or more years after the sale, the excess reduced by 1/50th for each complete year between the sale and that date.

1162. If a property is reconveyed within two years of sale, the amount given by the formula in subsection (4) is equal to the excess of the sale price over the price at which the property is reconveyed. So it is not necessary to prescribe different rules for properties reconveyed before and after the two year period.

Section 285: Sale and leaseback transactions

1163. This section brings a deemed receipt into account if property is sold on terms which provide for the grant of a lease to the seller, or to a connected person, at less than the sum of any premium for the lease and the value on the date of sale of the right to lease back the property. It is based on section 36(1), (3), (4) and (4A) of ICTA.

1164. "Connected person" is defined in section 839 of ICTA (see section 878(5) of this Act).

1165. Section 36(1) of ICTA does not specify any limit on the time between sale and leaseback. But because section 36(1) of ICTA reduces the amount of the deemed income by 1/50th for each complete year between sale and leaseback, no charge arises if the property is leased back more than 51 years after the sale. So this section applies only if the period between sale and leaseback is not more than 50 years. See *Change 72* in Annex 1.

1166. Subsections (3) to (5) of this section are drafted on the same basis as subsections (2) to (4) of section 277.

1167. *Subsection (3)* treats the person who sells the land as entering into a transaction mentioned in section 264 (if the land to which the lease relates is in the United Kingdom) or section 265 (if the land to which the lease relates is outside the United Kingdom). The effect of sections 264 and 265 is that the transaction will be included in, or will constitute, the person's UK or overseas property business.

1168. Section 36(4A) of ICTA treats income deemed to have been received under section 36 of ICTA as received when the property is sold. This section instead brings an amount into account as a receipt in calculating the profits of the property business for the tax year in which property is sold. See *Change 69* in Annex 1.

1169. The formula in *subsection (5)* is based on section 36(1) and (3) of ICTA. Section 36(1) of ICTA, as adapted by section 36(3) of ICTA, deems the person by whom the property is sold to receive an amount equal to the excess, if any, of the sale price over the sum of any premium for the lease and the value on the date of sale of the right to lease back the property or, if the earliest date on which the property can be leased back is two or more years after the sale, the excess reduced by 1/50th for each complete year between the sale and that date.

1170. If a property is leased back within two years of sale, the amount given by the formula in subsection (5) is equal to the excess of the sale price over the sum of any premium for the lease and the value on the date of sale of the right to lease back the property. So it is not necessary to prescribe different rules for calculating the amount of the receipt for properties leased back before and after the two year period.

Section 286: Provisions supplementary to sections 284 and 285

1171. This section is based on section 36(2)(a), (3) and (4B) of ICTA.

Section 287: Circumstances in which additional calculation rule applies

1172. This section and the next eight sections (all based on section 37 of ICTA) contain special rules giving a tenant relief by reference to the amount of a premium or other sum brought into account as a receipt in calculating the profits of a property business of his or her landlord under section 277 or sections 279 to 282:

- sections 287 to 290 provide for the amount of a premium or other sum brought into account as a receipt in the hands of a tenant *who is also a landlord* to be reduced if the tenant's own landlord has received a premium or other amount within section 277 or sections 279 to 282 in respect of the same property;
- sections 291 to 294 allow a tenant under a lease in respect of which the landlord has received a premium or other amount within section 277 or sections 279 to 282 a deduction in calculating the profits of any property business carried on by the tenant; and
- section 295 caps the total relief which can be given by reference to a premium or other sum brought into account in calculating the profits of a property business under section 277 or sections 279 to 282 to the amount of that receipt.

1173. Section 287 is based on section 37(1), (2), (3) and (9) of ICTA.

1174. Section 37(2) of ICTA provides for the reduction of amounts treated as rent under section 34 or 35 of ICTA which arise in respect of the "grant or disposition" of a lease. But section 37(2) does not provide for the reduction of an amount in respect of a sum paid under section 34(5) for the variation or waiver of the terms of a lease because a variation or waiver is not in respect of the grant or disposition of a lease. This section extends relief to payments for variation or waiver. See *Change 71* in Annex 1.

1175. The definitions of "taxed lease" and "taxed receipt" in *subsection (4)* are based on the definitions of "head lease" and "amount chargeable on the superior interest" in section 37(1) of ICTA.

1176. Section 37(9) of ICTA contains the following prohibition against excess relief:

"An amount or part of an amount shall not be deducted under this section more than once from any sum, or from more than one sum, and shall not in any case be so deducted if it has been otherwise allowed as a deduction in computing the income of any person for tax purposes.

1177. But section 37 of ICTA does not give rules for calculating deductions if there is more than one premium under section 34 of ICTA, or more than one amount treated as a premium under section 35 of ICTA, and gives taxpayers no guidance as to how deductions under section 37 of ICTA are to be calculated in order not to breach the limit in section 37(9) of ICTA.

1178. *Subsection (5)* stipulates that for section 288 to apply there must be at least one taxed receipt with an "unused amount". See *Change 73* in Annex 1.

1179. Amounts within section 278 (amount treated as lease premium where work required) are not specified separately in this section, or in section 288, because section 278(2) treats such amounts as premiums within section 277.

Section 288: The additional calculation rule

1180. This section provides for the amount of a receipt calculated under section 277 or sections 279 to 282 of this Act to be reduced if there is an earlier taxed receipt in relation to the same property. It is based on section 37(2), (3), (7) and (9) of ICTA.

1181. The amount to be reduced is referred to in this section, and in section 289, as "the receipt under calculation".

1182. Section 37(2) of ICTA provides for the reduction of amounts treated as rent under section 34 or 35 of ICTA which arise in respect of the "grant or disposition" of a lease. But section 37(2) of ICTA does not provide for the reduction of an amount in respect of a sum paid under section 34(5) of ICTA for the variation or waiver of the terms of a lease because a variation or waiver is not in respect of the grant or disposition of a lease.

1183. Section 287 extends relief to payments for variation or waiver. This is reflected in the reference to section 281 in *subsection (2)* of this section. See *Change 71* in Annex 1.

1184. This section introduces the label "basic relieving amount" for the amount by which the receipt under calculation is to be reduced.

1185. *Subsection (3)* requires the basic relieving amount to be restricted under section 289(5) so that it does not exceed the amount of the receipt under calculation. This means that if the basic relieving amount exceeds the amount of the later taxed receipt, the excess is not available to offset against other receipts. See *Change 73* in Annex 1.

1186. If there is more than one taxed receipt by reference to which the receipt under calculation may be reduced, it is for the person entitled to the relief to decide the order in which relief is to be taken by reference to those receipts. And where a basic relieving amount has been calculated by reference to more than one taxed receipt, subsection (3) provides for the *total* of the basic relieving amounts to be restricted under section 289(5) .

1187. The use of the "unreduced amount" of the taxed receipt (defined in section 290(2) of this Act) in the formula in *subsection (4)* makes clear that the basic relieving amount by reference to a taxed receipt is to be calculated according to the amount of that receipt *before* any reductions or deductions.

1188. The definition of "receipt period" in relation to a receipt under section 277 and sections 279 to 282 in *subsection (6)* is based on the definition of "the period in respect of which an amount arose" in section 37(7)(b) of ICTA.

Section 289: The additional calculation rule: special cases

1189. This section modifies the rule in section 288 for cases within sections 277 to 281 if a sub-lease is granted in respect of part only of the premises subject to the taxed lease. It is based on section 37(2), (3) and (9) of ICTA.

1190. Section 37(2) of ICTA provides for the reduction of amounts treated as rent under section 34 or 35 of ICTA which arise in respect of the "grant or disposition" of a lease. But section 37(2) of ICTA does not provide for the reduction of an amount in respect of a sum paid under section 34(5) of ICTA for the variation or waiver of the terms of a lease because a variation or waiver is not in respect of the grant or disposition of a lease.

1191. Section 287 extends relief to amounts brought into account in respect of sums payable for the variation or waiver of the terms of a lease. This is reflected in the reference in *subsection (2)* of this section to the receipt under calculation "under any of sections 277 to 281". See *Change 71* in Annex 1.

1192. But this section does not apply to receipts under section 282 (assignments for profit of lease granted at undervalue) because it is not possible for a lease to be assigned other than in respect of the whole of the premises subject to the lease.

1193. Section 37(3) of ICTA requires a "just apportionment" of the amount chargeable on the superior interest to be made if the whole of the premises are not subject to the lease. This section instead requires the basic relieving amount by reference to a taxed receipt to be calculated by reference to the fraction of the premises which is subject to the lease calculated on a "just and reasonable basis". See *Change 14* in Annex 1.

1194. *Subsection (4)* restricts the reduction calculated under section 288(4) or subsection (2) of this section to the "unused amount" of the taxed receipt by reference to which it is calculated. This is based on the general prohibition against excess relief in section 37(9) of ICTA. See *Change 73* in Annex 1.

Section 290: Meaning of "unused amount" and "unreduced amount"

1195. This section is based on section 37(1), (8) and (9) of ICTA.

1196. The "unused amount" of a taxed receipt is defined in *subsections (1)* and *(5)*. See *Change 73* in Annex 1.

Section 291: Deductions for expenses under section 292

1197. This section and the next three sections give a tenant relief in calculating the profits of his or her property business by reference to the amount of the premium or other sum brought into account by the landlord (the "taxed receipt") in respect of the same property. This section is based on section 37(4) and (9) of ICTA.

1198. Section 37(4) of ICTA treats a tenant under a lease in respect of which a chargeable amount arose under section 34 or 35 of ICTA as paying rent for the purpose of computing the profits of a Schedule A business.

1199. A deduction for rent which a tenant is treated as paying under section 37(4) of ICTA is allowed only in respect of premises used in the Schedule A business. So *subsection (2)* provides that a deduction for an expense which a tenant is treated as incurring under section 292 is allowed for each "qualifying day" on which all or part of the premises subject to the taxed lease is either occupied for the purposes of the tenant's property business or is sublet.

1200. A "qualifying day" is defined in section 292(3) as a day which falls within the receipt period of the taxed receipt.

1201. The amount which the tenant can deduct in respect of the rent which he or she is treated as paying under section 37(4) of ICTA is qualified by:

- the general rules as to deductions not allowable in computing the profits of a trade in section 74(1) of ICTA; and
- rules prohibiting or restricting the deduction of expenditure elsewhere in ICTA.

1202. In this Act, the rules restricting deductions are in Part 2 of Chapter 4. Section 74(1)(a) of ICTA is rewritten in section 34. *Subsection (3)* of this section preserves the interaction of section 37(4) of ICTA and the general and specific rules restricting deductions in ICTA by providing that a deduction for an expense which a tenant is treated as incurring under section 292 is subject to the application of any provisions of Chapter 4 of Part 2 of this Act.

1203. *Subsection (4)* provides that the deduction allowed in respect of an expense under section 292 may be restricted to prevent the cap in section 295 on the total relief which can be given by reference to a taxed receipt being exceeded. See *Change 73* in Annex 1.

Section 292: Tenants under taxed leases treated as incurring expenses

1204. This section sets out the method of calculating the expense for which a deduction may be allowed under section 291. It is based on section 37(4) of ICTA.

1205. Section 37(4) of ICTA treats a tenant as paying rent for the purposes of making deductions in respect of the expenses of his or her Schedule A business. In this section, the tenant is treated instead as incurring an expense for each qualifying day in the receipt period of the taxed receipt. This corresponds to the treatment of premiums and other sums payable in respect of leases in section 277 and sections 279 to 282 of this Act, and of amounts treated as receipts in sections 284 and 285 of this Act, as amounts to be brought into account in calculating the profits of a property business rather than as rent.

1206. The formula in *subsection (4)* calculates the expense for each qualifying day by spreading the amount of the taxed receipt evenly over the receipt period of that receipt. Defining “A” in that formula as “the unreduced amount of the taxed receipt” makes clear that the amount of the expense which the tenant is treated as incurring for each qualifying day is calculated by reference to the amount of the taxed receipt *before* any reductions or deductions.

Section 293: Restrictions on section 292 expenses: the additional calculation rule

1207. This section supplements section 292 where a tenant is entitled under section 288 to a reduction in a receipt within section 277 or sections 279 to 282. It is based on section 37(5) of ICTA.

1208. If an amount treated under section 34 or 35 of ICTA as income of a Schedule A business has been reduced under section 37(2) of ICTA, a tenant is entitled under section 37(5) of ICTA to a deduction in respect of deemed rent under section 37(4) of ICTA only if the appropriate fraction of the amount chargeable on the superior interest exceeds the later chargeable amount. The deduction is then allowed in the same proportion as the excess bears to the appropriate fraction of the amount chargeable on the superior interest.

1209. This section provides instead for a tenant to be treated as incurring an expense for a qualifying day under section 292 only to the extent that the “daily amount of the taxed receipt” exceeds the “daily reduction of the lease premium receipt”.

1210. The daily amount of the taxed receipt and the daily reduction of the lease premium receipt are calculated according to the formulas in *subsection (6)*:

- the formula for calculating the daily amount of the taxed receipt is the same formula used in section 292(4) to calculate the amount of the expense which the tenant is treated as incurring for each qualifying day; and
- the formula for calculating the daily reduction of the lease premium receipt spreads the reduction calculated under section 288 evenly over the receipt period of the lease premium receipt.

See *Change 15* in Annex 1.

1211. It is not clear how the rule in section 37(5) of ICTA governing the interaction of section 37(2) and (4) of ICTA is intended to apply if there is more than one later chargeable amount falling to be reduced under section 37(2) of ICTA by reference to an amount chargeable on the superior interest or a later chargeable amount falls to be reduced under section 37(2) of ICTA by reference to more than one amount chargeable on the superior interest.

1212. *Subsection (5)* provides that where there is more than one lease premium receipt by reference to which the tenant may be treated as incurring an expense for the same qualifying day, the tenant is treated as incurring an expense for that day only to the extent that the daily amount of the taxed receipt exceeds the *total* of the daily reductions of each of the lease premium receipts. See *Change 15* in Annex 1.

Section 294: Restrictions on section 292 expenses: lease of part of premises

1213. This section adapts sections 292 and 293 for cases where the tenant's lease does not extend to the whole of the property in respect of which the landlord received a premium. It is based on section 37(6) of ICTA.

1214. Section 287(1) extends relief under 288 to sums payable for variation or waiver brought into account under section 281. This is reflected in *subsection (1)(c)* of this section. See *Change 71* in Annex 1.

1215. Section 37(6) of ICTA says that where section 37(3) of ICTA applies (ie if the tenant's lease extends to part only of the premises subject to the landlord's lease) section 37(4) and (5) of ICTA are to be applied separately to that part of the premises subject to the tenant's lease and to the rest of the premises. But it is not clear how the rule in section 37(6) of ICTA is intended to apply if the premises subject to the landlord's lease are subject to more than one sublease in respect of different parts of those premises.

1216. *Subsection (3)* applies sections 292 and 293 separately to that part of the premises which is subject to the tenant's lease and to the remainder of the premises. And *subsection (4)* deals with the case where there is more than one sublease which does not extend to the whole of the landlord's premises. See *Change 15* in Annex 1.

1217. *Subsection (5)* adapts sections 292 and 293 where the lease does not extend to the whole of the premises by multiplying the unreduced amount of the taxed receipt ("A") by the fraction of the premises to which the sublease relates in the formulas for calculating:

- the expense for a qualifying day in section 292(4); and
- the daily amount of the taxed receipt in section 293(6).

1218. Section 37(6) of ICTA requires the amount chargeable on the superior interest to be "proportionately adjusted" where the tenant's lease does not extend to the whole of the premises. This section instead requires the fraction in subsection (5) to be calculated "on a just and reasonable basis". See *Change 14* in Annex 1.

Section 295: Limit on reductions and deductions

1219. This section is based on the general prohibition against excess relief in section 37(9) of ICTA. It restricts total relief allowed by reference to a taxed receipt by way of:

- reductions under the additional calculation rule in section 288 in the amount brought into account by a tenant who is also a landlord; and
- deductions in calculating the profits of a tenant's property business under section 292,

to the amount of the taxed receipt *after* any deductions calculated by reference to that receipt for expenses incurred under section 61 of this Act in calculating the profits of a tenant who uses the property subject to the lease for the purposes of his or her trade. See *Change 73* in Annex 1.

Section 296: Corporation tax receipts treated as taxed receipts

1220. This section and the next two sections ensure that a tenant is entitled to relief under sections 287 to 295 by reference to an amount treated under section 34 or 35 of ICTA as a receipt of a Schedule A business, or an overseas property business, of a landlord liable to corporation tax in the same way as if the landlord was liable to income tax on an equivalent amount as a receipt of his or her property business under sections 277 to 282.

1221. This section adapts certain concepts used in sections 287 to 290 to give relief by reference to an amount taken into account for income tax purposes under sections 277 to 282 to give relief by reference to amounts treated as receipts under section 34 or 35 of ICTA for the purposes of corporation tax. The section is new.

1222. Section 37(1) of ICTA refers to an amount treated as a receipt of a Schedule A business under section 34 or 35 of ICTA, or which would be so treated other than for relief under section 37(2) or (3) of ICTA, as "the amount chargeable on the superior interest". The "superior interest" is the interest in the property held by the tenant's immediate landlord.

1223. Paragraph 20 of Schedule 1 to this Act amends section 37(1) of ICTA by extending the definition of "the amount chargeable on the superior interest" to include any amount treated as a receipt of a property business under sections 277 to 282 of this Act, or which would be treated as such a receipt other than for relief under the additional calculation rule in section 288 of this Act.

Section 297: Taking account of reductions in corporation tax receipts

1224. This section is new. It ensures that any relief given for corporation tax purposes under section 37(2) or (3) of ICTA for an accounting period ending after 5 April 2005 to a tenant who is also a landlord by reference to:

- a receipt brought into account under this Chapter where the tenant's landlord is liable to income tax; or
- a receipt brought into account under section 34 or 35 of ICTA where the tenant's landlord is liable to corporation tax,

is taken into account in the same way as any relief under sections 287 to 290 of this Act.

1225. *Subsections (1)* and *(2)* refer to a reduction under section 37(2) or (3) of ICTA in "the amount chargeable on the superior interest". The amount chargeable on the superior interest here refers to an amount:

- treated as a receipt under section 34 or 35 of ICTA for any tax year; or
- treated as a receipt under this Chapter for an accounting period ending after 5 April 2005 as a result of the amendments to section 37(1) of ICTA made under paragraph 20 of Schedule 1 to this Act.

Section 298: Taking account of deductions for rent as a result of section 37(4) or 87(2) of ICTA

1226. This section is new. It ensures that any deduction for corporation tax purposes for rent which a tenant is deemed to pay under section 37(4) or 87(2) of ICTA for an accounting period ending after 5 April 2005 by reference to:

- a receipt brought into account by the landlord under this Chapter where the landlord is liable to income tax; or
- a receipt brought into account by the landlord under section 34 or 35 of ICTA where the landlord is liable to corporation tax,

is taken into account in the same way as any deduction for an expense incurred under sections 61 or 292 of this Act.

1227. *Subsections (3)* and *(4)* refer to amounts treated as rent under section 37(4) of ICTA by reference to "the amount chargeable on the superior interest". The amount chargeable on the superior interest here refers to an amount:

- treated as a receipt under section 34 or 35 of ICTA for any tax year; or

- treated as a receipt under this Chapter for an accounting period ending after 5 April 2005 as a result of the amendments to section 37(1) of ICTA made under paragraph 20 of Schedule 1 to this Act.

Section 299: Payment of tax by instalments

1228. This section is based on section 34(8) of ICTA.

1229. Section 34(8) of ICTA entitles a taxpayer who receives an amount chargeable to tax under section 34 of ICTA in instalments to pay the tax chargeable by reference to that amount "by such instalments as the Board may allow…". Section 832(1) of ICTA defines "the Board" as the Commissioners of Inland Revenue.

1230. This section instead attributes the power to determine the amount and timing of the instalments to "the Inland Revenue". "The Inland Revenue" is defined in section 878(1) of this Act as "any officer of the Board of Inland Revenue". See *Change 149* in Annex 1.

Section 300: Statement of accuracy for purposes of section 282

1231. This section is based on section 35(3) of ICTA.

1232. Section 35(3) of ICTA requires "the inspector" to certify the accuracy of a statement submitted to him or her showing the amount of a chargeable receipt (if any) on the assignment of a lease granted at undervalue if he or she is satisfied as to the statement's accuracy. "Inspector" is defined in section 832(1) of ICTA as "any inspector of taxes".

1233. This section provides instead for the statement to be submitted to, and certified by "the Inland Revenue". "Inland Revenue" is defined in section 878(1) of this Act as "any officer of the Board of Inland Revenue". See *Change 149* in Annex 1.

Section 301: Claim for repayment of tax payable by virtue of section 284

1234. This section provides that if a property is reconveyed on a date *other than* the date by reference to which tax was paid under section 284 of this Act, the seller must be repaid the difference between the tax paid and the tax which would have been due if the tax had been calculated on the basis of the actual date of reconveyance. It is based on section 36(2)(b) of ICTA.

Section 302: Claim for repayment of tax payable by virtue of section 285

1235. This section provides that if a lease is granted on a date *other than* the date by reference to which tax was paid under section 285 of this Act, the seller must be repaid the difference between the tax paid and the tax which would have been due if the tax had been calculated on the basis of the actual date on which the lease was granted. It is based on section 36(2)(b) and (3) of ICTA.

Section 303: Rules for determining effective duration of lease

1236. This section contains the rules for determining the effective duration of a lease. It is based on section 38(1) and (6) of ICTA.

1237. *Subsection (1)* sets out various circumstances in which a lease may be treated as ceasing other than on the date specified in the lease. Rules 1, 2 and 3 in subsection (1) are based on section 38(1)(a), (1)(b) and (1)(c) of ICTA respectively.

Section 304: Applying the rules in section 303

1238. This section is based on section 38(2), (3) and (4) of ICTA.

1239. Section 38(4) of ICTA refers to benefits conferred and payments made for the purposes of securing a tax advantage "in the application of this Part". Section 38 of ICTA is in Part 2 of ICTA (provisions relating to the Schedule A charge), which consists of sections 21 to 43G of ICTA.

1240. Other than the lease premiums rules in sections 34 to 39 of ICTA, the sections of Part 2 of ICTA which are in force are sections 21 to 21C (calculation of the profits of a Schedule A business), section 24 (construction of Part 2), section 30 (sea walls), sections 31A and 31B (deductions for expenditure by landlords on energy-saving items), section 40 (receipts and outgoings on sale of land), section 42 (appeals against determinations under sections 34 to 36), section 42A (regulations about non-residents) and sections 43A to 43G (rent factoring).

1241. It is considered that the only tax advantage that could be secured in the context of section 38(4) of ICTA would be under sections 34 to 39 of ICTA. So *subsection (4)* refers instead to a tax advantage "in the application of this Chapter or sections 34 to 39 of ICTA".

Section 305: Information about effective duration of lease

1242. This section is based on section 38(5) of ICTA.

1243. Section 38(5) of ICTA says that an inspector may issue a notice requiring a person having information relevant to ascertaining the duration of a lease to supply that information within a specified time. "Inspector" is defined in section 832(1) of ICTA as "any inspector of taxes".

1244. This section provides instead for a notice to be issued by "the Inland Revenue". "Inland Revenue" is defined in section 878(1) of this Act as "any officer of the Board of Inland Revenue". See *Change 149* in Annex 1.

Section 306: Provisions about premiums

1245. This section is based on section 24(2), (3) and (4) of ICTA. The definitions in section 24(2) to (4) of ICTA are rewritten in this Chapter as they apply only to the lease premiums rules.

Section 307: Interpretation

1246. This section is based on section 24(1), (4) and (5) of ICTA.

1247. *Subsection (1)* defines "premium" so as to include payments to a person "connected with" the landlord. "Connected person" is defined in section 839 of ICTA (see section 878(5) of this Act).

Chapter 5: Profits of property businesses: other rules about receipts and deductions

Overview

1248. This Chapter contains provisions that supplement the basic calculation rules in Chapter 3 of this Part of the Act.

1249. The provisions in this Chapter are about particular receipts or more unusual circumstances.

Section 308: Furnished lettings

1250. This section brings the "letting" of furniture, when it is part and parcel of the letting of accommodation, within the property income charge. It is based on sections 15 and 65A of ICTA.

1251. Without this provision, rent paid for use of the furniture in furnished lettings would not be included in the property income charge because the "rent" for the furniture does not derive from land.

1252. The purpose of*subsection (1)(b)* is to make it clear that related revenue expenses such as the expenses of repair and insurance of the furniture are deductible in calculating the profits of the property business.

1253. *Subsection (2)* excludes income and expenses where the hiring of the furniture is not simply incidental to exploiting an interest in land.

1254. *Subsection (4)* refers to a "caravan and a houseboat". There is a new Act-wide, uniform definition of "caravan": see the commentary on section 875 and *Change 148* in Annex 1.

1255. There is also a new Act-wide, uniform definition of "houseboat": see the commentary on section 878(1) and *Change 150* in Annex 1.

Section 309: Rent-a-room relief

1256. This section modifies the normal profit calculation rules in Part 3 of this Act when a property business consists of, or includes, rent-a-room lettings as defined in Chapter 1 of Part 7 of this Act. It is new.

1257. When the lettings meet the conditions for rent-a-room relief in Part 7 of this Act the income from these lettings may, depending on the total amount, either be exempt from tax or subject to a special calculation rule. This section ensures that the rent-a-room rules take priority over the usual calculation rules in the property income Part.

Section 310: Acquisition of business: receipts from transferor's UK property business

1258. This section taxes certain receipts when a continuing UK property business is transferred from one person to another along with the right to receive future business sums to which the transferor is entitled. It is based on sections 21B and 106 of ICTA.

1259. *Subsection (1)* sets out the circumstances in which the section applies and states the three conditions necessary for it to apply.

1260. *Subsection (2)* treats the "sum" received as a receipt of the property business. As this rule affects the calculation of the profits of a property business it appears in this Chapter rather than with the post-cessation receipt rules of which, in the source legislation, it forms part.

1261. The source legislation applies "for all purposes". This section applies for income tax purposes. Section 106(2) of ICTA (as amended by paragraph 85 of Schedule 1 to this Act) applies for corporation tax purposes. Section 37(1) of TCGA ensures that any sums received as a result of the transfer are not charged to capital gains tax.

1262. *Subsection (3)* makes it clear that these sums are not post-cessation receipts.

Section 311: Reverse premiums

1263. This section sets out the rules for taxing reverse premiums as receipts of a property business. It is based on Schedule 6 to FA 1999.

1264. *Subsection (1)* refers to a "reverse premium". In accordance with *subsection (6)* that expression has the same meaning as in section 99. So this section applies to reverse premiums excluding any of the "excluded cases" within section 100. The subsection also excludes any reverse premium that is charged to tax as a trade receipt by section 101.

1265. *Subsections (2)* and *(3)* bring the reverse premium within the scope of the property income rules. The subsections treat the recipient as entering into a transaction for generating income from land (see sections 264 and 265). So, even if the recipient is not already carrying on a property business, the reverse premium is treated as a receipt of a property business.

1266. If a property business is deemed to be carried on, it is a UK property business if the land is in the United Kingdom or an overseas property business if the land is outside the United Kingdom. So the territorial restrictions on the scope of the charge in section 269 for non-resident or remittance basis persons may apply.

1267. Paragraph 72 of Schedule 2 to this Act rewrites the transitional provision in section 54(2) of FA 1999. These sections do not apply to pre-1999 reverse premiums.

Section 312: Deduction for expenditure on energy saving items

1268. This section provides a deduction for certain expenditure on energy saving items where that expenditure would not otherwise be allowable because it is capital. It is the first of three sections that are based on sections 31A and 31B of ICTA.

1269. The source legislation is a closely targeted relieving provision that provides for a deduction for specified energy-saving items installed in let residential property. It applies to all income tax payers including:

- non-resident companies liable to income tax;
- those with lettings of overseas property, the income from which is charged in the source legislation under Schedule D, Case V; and
- income tax paying members of partnerships.

1270. But it is not available in respect of "rent-a-room" properties or furnished holiday lettings (see Part 7 of this Act).

1271. *Subsection (1)* sets out the basic conditions. *Subparagraph (a)* makes it clear that relief is available only against property business income in respect of a let dwelling house. "Dwelling house" is not a defined term so it takes its ordinary meaning.

1272. *Subsection (1)(c)* states the date by which the expenditure must be incurred. Expenditure incurred before that date (and on or after 6 April 2004) is deductible in what is the appropriate period of account on normal accountancy principles.

1273. *Subsection (1)(d)* states the essence of the relief: it is for expenditure that is incurred wholly and exclusively for the purposes of the property business but which would not otherwise be allowable because it is capital expenditure.

1274. *Subsection (2)* provides for the deduction and in so doing introduces a change. In the source legislation the relief is given only when a formal claim is made. Section 312 provides for the relief as a simple deduction in calculating the profits of the property business that includes the dwelling house in question. See *Change 74* in Annex 1.

1275. *Subsection (4)* allows an apportionment of the expenditure where only part of it, for whatever reason, falls within the scope of the relief. Examples are when only a part of a single amount of capital expenditure is incurred on qualifying energy saving items or when part of the otherwise qualifying capital expenditure is incurred on a let building other than a dwelling house.

Section 313: Restrictions on relief

1276. This section imposes certain restrictions on the relief that would otherwise be due under section 312. It is based on sections 31A and 31B of ICTA.

1277. *Subsection (2)* prevents relief when the expenditure is simply part of the build cost of a new property or the purchase price of an acquired one.

1278. *Subsection (3)* prevents relief in respect of let property that is within Chapter 6 of Part 3 of this Act (commercial letting of furnished holiday accommodation). It makes explicit two aspects that are only implicit in section 31A(11) of ICTA.

1279. The first is that section 31A(11) of ICTA excludes any properties (a) that meet the definition of "commercial letting of furnished holiday accommodation" in section 504 of ICTA and (b) could therefore benefit from the concessions that section 503 of ICTA offers even if they do not, in fact, do so.

1280. The second is that it makes clear the duration of the exclusion. The purpose of the source legislation is to prevent people getting the relief if they are using the property for furnished holiday lettings. A property falls within section 504(4) of ICTA for a year of assessment. Because of the stringency of the conditions in section 504 of ICTA the property can drop in and out of qualifying section 504 of ICTA status from one year to the next. The restriction on relief under these provisions is intended to apply only if the expenditure is incurred in a year of assessment for which the property is within section 504 of ICTA (as described in the previous paragraph) and only for that or those years. So section 313(3) refers specifically to "the tax year".

1281. *Subsection (4)* makes it clear that the relief cannot apply when rent-a-room relief is given (see Chapter 1 of Part 7 of this Act). This prohibition does not apply however if neither form of rent-a-room relief is, in fact, taken.

1282. *Subsection (5)* adapts the general preliminary expenditure deduction rules to the specific circumstances of this relief: the expenditure window is reduced to prevent claims in respect of past expenditure when the dwelling may have been the landlord's own home and it is later let.

Section 314: Regulations

1283. This section provides for the Treasury's powers to make regulations for the purposes stated. It is based on section 31A(13) of ICTA.

1284. The relief applies potentially to all income tax payers, including those non-resident companies liable to income tax. *Subsection (2)* reflects, among other things, the fact that it is not available to companies in respect of their liability to corporation tax.

Section 315: Deduction for expenditure on sea walls

1285. This is the first of four sections that provide relief to a landlord for expenditure on making a sea wall or other embankment to protect let premises against flooding by the sea or a tidal river. They are based on section 30 of ICTA.

1286. Section 315 states the circumstances under which the relief is given. It is based on sections 30 and 65A of ICTA.

1287. *Subsection (1)(b)* states the subject of the relief. Repair and maintenance of an existing sea wall normally qualify for relief as revenue expenses of a property business but the making of a new wall is capital expenditure and would not qualify for relief without special provision.

1288. *Subsection (2)* makes it clear that to obtain a deduction for seawalls expenditure, the person carrying on the property business and the person incurring the seawalls expenditure must be the same person. This may appear to be stating the obvious but section 30(1) of ICTA says merely that the person incurring the expenditure is treated as making a payment "for the purpose of computing the profits of *any* Schedule A business carried on in relation to those premises" (emphasis added). This cannot be taken literally to mean any such business carried on by someone other than the person incurring the expenditure. There would be no point in deeming the payment to be made by that person if it were otherwise. And the provisions on transfer of interests in section 30(2) and (3) of ICTA reflect the notion that the deemed payment, and hence the right to relief, moves from the former owner to the transferee. There is no suggestion of involvement by any other party.

1289. *Subsection (3)* defines the "deduction period" referred to in subsection (2). Qualifying expenditure is deducted over 21 years in calculating the profits of the property business. The "deduction period" is comparable to the "writing-down period" over which expenditure qualifying for capital allowances is written off. This reflects the similarity between the relief given by the sea walls provisions and certain capital allowances provisions. The relief is for expenditure which would otherwise be capital in nature. And the expenditure is not relieved all at once but over a period, even if there are changes in the person who obtains the relief.

Section 316: Transfer of interest in premises

1290. This section deals with the case where the person who incurred the sea walls expenditure sells the premises during the 21 year period over which the deduction is due. It is based on section 30(2) and 30(3) of ICTA.

1291. *Subsection (1)* applies to transfers of the relevant interest "whether by operation of law or otherwise". These words derive directly from the source legislation. They ensure that the provision applies to, for example, successions to estates as well as the sort of merger of interests envisaged in section 317.

1292. *Subsection (2)(b)* requires any apportionment to be "just and reasonable" whereas section 30(2)(a) of ICTA refers simply to an apportionment that is "just". This change reflects the approach that was adopted in CAA and which has been followed in similar contexts elsewhere for consistency. There is no practical difference between the two forms of words. See *Change 14* in Annex 1.

1293. *Subsection (5)* makes explicit what is merely implicit in the source legislation, namely, the extent of the transferor's entitlement to a deduction in subsequent years. In particular, subsection (5)(a) makes it clear that if the transfer is of only part of the premises, the transferor continues to be entitled to a deduction in relation to the part not transferred.

Section 317: Ending of lease of premises

1294. This section deals with the case where the sea walls expenditure is incurred by a lessee and the lease comes to an end before the end of the deduction period. It is based on section 30(3) of ICTA.

1295. The cases to which *subsection (3)* applies include renewals of the lease to the same person. Then the deduction passes to the immediate reversioner.

1296. In the source legislation "lease" is defined for the purposes of the sea walls provisions in section 24(6)(a) of ICTA. But that definition is redundant and, since it no longer applies to any other provisions, is not rewritten in this Act. It is redundant in the sea walls context for the following reasons.

1297. Section 24(6)(a) of ICTA defines references to a lease as extending only to a lease conferring a right, as against the person whose interest is subject to the lease, to the possession of the premises. It originated as paragraph 16 of Schedule 4 to FA 1963. Notes on Clauses to FA 1963 explain that the reference to possession was to ensure that a "lease" in Schedule A and sections 25 to 31 of ICTA must be one of land and not of incorporeal hereditament. So a lease of sporting rights, or a right of way, would not be covered. However, Street v Mountford [1985], AC 809 established that a "lease" of land which does not confer on the tenant exclusive possession is not, in fact, a lease but a licence.

1298. Section 30(2) of ICTA does not explain the meaning of the transfer of the whole of a person's interest in any premises or part of any premises. The transfer of the whole of a person's interest is significant because it can lead to the transfer of entitlement to a deduction for sea walls expenditure. But entitlement to a deduction for sea walls expenditure does not arise anyway unless a person is the owner or tenant of premises.

A lease which makes a person a tenant of premises is not a lease of an incorporeal hereditament. So, although section 30 of ICTA does not expressly exclude leases of incorporeal hereditaments, to the extent that they might cover leases of incorporeal hereditaments references to "leases" in that provision are simply redundant.

Section 318: Transfer involving company within the charge to corporation tax

1299. This section ensures that entitlement to a deduction for expenditure on seawalls continues properly when the interest in the premises is transferred between an income tax payer and a corporation tax payer. It is based on section 30(2) of ICTA.

1300. Entitlement to a deduction for expenditure on seawalls can be transferred with ownership of the premises. That transfer can be between an income tax payer and a corporation tax payer. Section 316 deals with transfers between income tax payers. But it cannot deal with a transfer from a corporation tax payer to an income tax payer or the reverse because the provisions in this Act apply only to income tax payers.

1301. Section 318 allows the seawalls provisions in this Act to work properly in respect of the party to the transfer who is subject to income tax.

1302. *Subsection (4)* signposts the reader to the source provision in ICTA that deals with the party to the transfer who is subject to corporation tax.

Section 319: Relief in respect of mineral royalties

1303. This section provides that only half the net profits received in respect of mineral royalties are charged to income tax. It is based on section 122 of ICTA. The other half of the profits are charged to capital gains tax by section 201 of TCGA.

1304. The section applies only to mineral royalties that are not taxed under Chapter 8 of this Part of the Act. That Chapter taxes rents and royalties from concerns such as mines and quarries. In practice nearly all mineral royalties will be taxed under Chapter 8 of Part 3 of this Act. For this reason this section cross-refers to the definitions in that Chapter.

Section 320: Nature of item apportioned on sale of estate or interest in land

1305. This section preserves the capital or revenue nature of an amount due, or payable in arrears, apportioned to a seller on the sale of land. It is based on section 40(3)(b) of ICTA.

1306. Most of section 40 of ICTA is not rewritten because it has become redundant following the application of Schedule D Case I principles to Schedule A.

1307. The original predecessor of section 40 of ICTA (section 20 of FA 1964) was introduced to deal with a specific problem. That was reflecting, in the calculation of income from land, any apportionments of rent (as a receipt or an expense) that took place between seller and purchaser when land was sold. That required two kinds of rule. The first were calculation rules. They were necessary because at the time section 20 of FA 1964 was introduced the charge on income from land was based on *entitlement* to incoming rent and *payment* of outgoing rent. Where there were apportionments on sale there might be neither entitlement nor payment by the "right" person. The second were timing rules to ensure that the consequential adjustments fell in the right tax year.

1308. As a result of the 1995 Schedule A reforms these rules are no longer necessary. Two main factors lead to this conclusion.

1309. The first relates to the object of charge under Schedule A: the profit of a Schedule A business. For there to be a Schedule A business a person has to be exploiting United Kingdom land for rent (section 15(1)1(1) of ICTA). In order to be a receipt (or outgoing) of the Schedule A business it is enough that an amount relates to a period when the person was exploiting the land.

1310. The second factor relates to the time when income within the charge is brought into account. The accruals principle of accounting has been imported from Schedule D Case I into Schedule A. The accruals principle brings an item into account in the period to which it relates. So the rules in section 40(1) to (3) of ICTA about the time of receipt and payment are unnecessary.

1311. Section 40(4) of ICTA is similarly now unnecessary. It provides that any reference in section 40(1) and (2) of ICTA to a party to a contract includes a person to whom the rights and obligations of that party under the contract have passed by assignment or otherwise. Since the test of whether or not an item is to be brought into account under Schedule A is whether it arises from a person's exploitation of land then whether the rights and obligations under the contract pass by assignment or otherwise, the person to whom they pass will be the person exploiting the land.

1312. Section 40(4A) of ICTA is not rewritten. It is linked to the parts of section 40 of ICTA that are unnecessary and also gives in certain circumstances the wrong result.

1313. Section 40(3)(b) of ICTA has a clear anti-avoidance purpose that is preserved in section 320. But it also contains a timing rule. The timing rule in section 40(3)(b) of ICTA is not rewritten because the accruals principle again attributes the apportioned amount to the correct period.

1314. Section 320 rewrites the anti-avoidance part of section 40(3)(b) of ICTA which preserves the capital or revenue nature of any amount due or paid in arrears and apportioned by the buyer to the seller on the sale of land.

1315. This rule was originally introduced to deal with the common (at the time) practice whereby, under normal conditions of sale, that part of any rent paid in arrears, apportioned to the seller and to be paid to him or her by the purchaser, was adjusted by means of an addition to the sale price. As capital gains tax did not exist the apportioned rent taken as increased sale price escaped tax altogether.

1316. Capital gains tax now takes away much of the incentive to deal with rent in this way. But this rule may still serve a useful deterrent purpose and needs to be preserved.

1317. The time of apportionment referred to in the section is normally the time of completion of the sale.

Section 321: Mutual business

1318. This section makes it clear that the concept of "mutuality" does not apply in the property income context. It is based on section 21C of ICTA.

1319. Mutuality is a concept that has been developed by the courts over a long period. It derives from the principle that one cannot make a profit out of oneself. It may arise in the trading context where a class of contributors to a common fund are entitled, as a class, to share in the surpluses of that fund.

1320. The approach in section 321 is different from that in section 21C of ICTA and simpler. The approach in section 21C of ICTA is to apply the normal profit calculation rules to any "mutual business" and add the result to the profits of the rest of the Schedule A business. Section 321 on the other hand prevents, from the outset, the concept of mutuality operating on amounts within Part 3 of this Act.

Chapter 6: Commercial letting of furnished holiday accommodation

Overview

1321. The sections in this Chapter define the lettings that can qualify for special tax advantages: "the commercial letting of furnished holiday accommodation". They are based on section 504 of ICTA.

1322. The sections do not themselves provide the tax advantages. That is the function of the particular "relieving" provisions (such as the loss relief provisions) that are cross-referred to.

1323. The primary purpose of this Chapter is to provide a central definition of this particular type of letting, income from which benefits from tax advantages provided for in other Acts.

1324. The location of these sections in a separate Chapter of Part 3 of this Act reflects detailed consideration of the concept of "the commercial letting of furnished holiday accommodation" in the source legislation.

1325. When the provisions which were the predecessors of what are now sections 503 and 504 of ICTA were first introduced they were complete and free-standing in a way which is no longer the case. That is, at that time they:

- imported a then very valuable "use trade profits calculation rules" principle; and
- set out the full range of the "trading" treatment that lettings qualifying as the commercial letting of furnished holiday accommodation enjoyed, including the equally valuable capital gains tax reliefs.

1326. Since then however the practical significance of sections 503 and 504 of ICTA has been progressively eroded by changes elsewhere:

- all property letting now attracts most trade profits calculation rules anyway; and
- the detail of the main benefits of furnished holiday letting status is set out elsewhere (in the capital allowances and capital gains tax provisions).

1327. Section 504 of ICTA merely defines the commercial letting of furnished holiday accommodation for the purposes of particular rules, the detail of which is set out elsewhere. And section 503 of ICTA refers only to what might be considered rather less significant advantages: trade-type loss relief and the treatment of profits as earned income and "relevant earnings" for pension etc relief.

1328. Where best to locate the definition of "commercial letting of furnished holiday accommodation" was therefore carefully considered. The conclusion was that readers will intuitively expect to find the central definition of a particular type of letting with the property income rules. And that is so even if the tax advantages are not prescribed in the same place. So it is located in Part 3 of this Act.

1329. This income remains part of the single property business in section 264 and chargeable therefore under this Part.

Section 322: Introduction

1330. This section is introductory and explanatory. It is new. It makes clear that the provisions that provide for the tax advantages are to be found elsewhere.

1331. *Subsection (2)(f)* refers to "relevant earnings". There are transitional rules in paragraphs 74 and 75 of Schedule 2 to this Act which ensures that the ICTA rules about "relevant earnings" apply until 5 April 2006.

Section 323: Meaning of "commercial letting of furnished holiday accommodation"

1332. This section defines the lettings that can benefit from the special tax treatment. It is based on section 504 of ICTA.

1333. It is not sufficient that the letting is simply of furnished holiday accommodation: it must also be "qualifying holiday accommodation". *Subsection (3)(b)* signposts to the sections that define "qualifying holiday accommodation".

Section 324: Meaning of "relevant period" in sections 325 and 326

1334. This section defines the period during which certain conditions need to be satisfied in order to benefit from the special tax treatment. It is based on section 504(4) of ICTA.

1335. *Subsection (1)* introduces the concept of "the relevant period".

1336. *Subsection (2)* gives the rule for identifying the relevant period for the tax year in which the letting (as furnished accommodation) begins.

1337. *Subsection (3)* gives the rule for identifying the relevant period for the tax year in which the letting (as furnished accommodation) ends.

1338. *Subsection (4)* gives the general rule and identifies the relevant period as the tax year for the case where there is established and continuing letting. It follows the source legislation (in section 504(4)(c) of ICTA) by putting the general rule covering what is likely to be the most common case, last. This is because a person still needs to read the first two rules to know whether he or she falls within the general rule.

1339. Subsection (4) defines the "relevant period" by reference to the tax year for non-resident companies liable to income tax in respect of furnished holiday accommodation. See *Change 75* in Annex 1.

Section 325: Meaning of "qualifying holiday accommodation"

1340. This section sets out the additional tests the letting must satisfy to qualify for the special treatment. It is based on section 504(3) and section 504(4) of ICTA.

1341. Subsection 504(3) of ICTA is particularly complex. The three tests it imposes in paragraphs (a) to (c) are referred to in this section as, respectively, the "availability", "letting" and "pattern of occupation" conditions. If all three are met, the accommodation is "qualifying holiday accommodation".

1342. *Subsection (1)* introduces the term "qualifying holiday accommodation" and defines it by reference to the three conditions that are set out in the subsequent subsections.

1343. *Subsections (4)* to *(6)* are based on section 504(3)(c) of ICTA. Section 504(3)(c) of ICTA is particularly ambiguous and this section seeks to reduce that ambiguity. The approach is different from that in the source legislation and involves a change. See *Change 76* in Annex 1.

Section 326: Under-used holiday accommodation: averaging elections

1344. This section allows accommodation that would be "qualifying holiday accommodation", were it not simply for insufficient actual letting, nevertheless to qualify if, *on average*, the letting condition in section 325(3) is met. It is based on section 504(6) to (8) of ICTA.

1345. *Subsection (1)* introduces a new term to denote this accommodation: "under-used accommodation".

1346. *Subsection (4)* introduces a change. This changes the period over which lettings are averaged for the purpose of treating infrequently let property as qualifying holiday accommodation from the tax year to the relevant period (as defined in section 324). See *Change 77* in Annex 1.

1347. *Subsection (5)* prevents the same accommodation from being used more than once in an averaging calculation.

1348. *Subsection (6)* reflects the rewrite approach to aligning time limits with the Self Assessment cycle.

Section 327: Capital allowances and loss relief

1349. This is the first of two sections that provide for separate calculations in order to give effect to the tax advantages of qualifying holiday lettings. It is new.

1350. There is no explicit requirement for separate furnished holiday lettings calculations in section 503 of ICTA. But it is clearly not possible to give effect to the special income tax treatments available to furnished holiday lettings without separating out the relevant income and expenditure. Requiring, where appropriate, separate calculations makes explicit what is only implicit in section 503 of ICTA. Section 327 and section 328 provide a mechanism to ensure that the special rules that can give tax advantages in respect of these lettings work properly and clearly in the context of a UK property business of which the furnished holiday lettings is part: the profit from such lettings must be identified separately but only when there is a practical need to do so.

Section 328: Earned income and relevant UK earnings for pension purposes

1351. This is the second of two sections that provide for separate calculations to give effect to the tax advantages of qualifying holiday lettings. It is new.

Chapter 7: Adjustment income

Overview

1352. This Chapter applies the rules about a change of basis to property businesses, broadly as those rules apply to trades. The main rules for trades are in Chapter 17 of Part 2 of this Act.

1353. Section 21A of ICTA provides that "the profits of a Schedule A business are computed in the same way as the profits of a trade are computed for the purposes of Case I of Schedule D". And section 21B of ICTA specifically applies the rules for change of accounting basis in FA 1998.

1354. The rules in Schedule 22 to FA 2002 apply to property businesses because they have effect "in place of" the 1998 rules (see section 64(6) of FA 2002), even though the necessary textual amendment to section 21B of ICTA was overlooked.

1355. So the change of basis rules apply to a Schedule A business.

1356. Section 65A(5) of ICTA provides that "the income from an overseas property business shall be computed … in accordance with the rules applicable to the computation of the profits of a Schedule A business".

1357. Although the change of basis rules apply to a Schedule A business, they do so by virtue of section 21B of ICTA. That section deals with "other rules applicable to Case I of Schedule D". On the other hand, section 21A of ICTA deals with rules about the computation of profits of a trade. So section 65A of ICTA imports only the computation rules in section 21A and the change of basis rules do not apply to an overseas property business.

1358. The following trading income rules (in Chapter 17 of Part 2 of this Act) cannot apply to a property business. So there is no corresponding rule in this Chapter:

- Section 226: Professions and vocations;
- Sections 236 and 237: Change from realisation basis to mark to market (A property business cannot hold assets that are valued on a mark to market basis.);
- Sections 238 and 239: Barristers and advocates; and

- Section 240: Liability of personal representatives if person liable dies. (This section applies if an adjustment income charge is spread: none of the spreading rules applies to a property business.)

1359. The following trading income rules apply to property businesses but are not in separate sections in this Chapter:

- Section 231: Calculation of the adjustment; (This rule is applied by section 330(1).)
- Section 234: No adjustment for certain expenses previously brought into account; (This rule is applied by section 330(4).)
- Section 235: Cases where adjustment not required until assets realised or written off. (A property business cannot have trading stock or work in progress; the rule about depreciation is in sections 333 (2) and 334(2).)

Section 329: Application of Chapter

1360. This section sets out the circumstances in which an adjustment may arise. It is based on section 64 of FA 2002. The equivalent rule for trades is in section 227.

Section 330: Adjustment income and adjustment expense

1361. This section sets out how to calculate an adjustment and how it is treated for tax purposes. It is based on paragraphs 2, 4, 5 and 6 of Schedule 22 to FA 2002.

1362. *Subsection (4)* is a cross-reference to the trading income rule about expenses for which a deduction has already been made.

Section 331: Income charged

1363. This section sets out the amount charged to tax. In FA 2002 the charge is under Schedule D Case VI. So section 69 of ICTA applies.

Section 332: Person liable

1364. This section states who is liable for any tax charged. In FA 2002 the charge is under Schedule D Case VI. So section 59(1) of ICTA applies.

Section 333: Treatment of adjustment income

1365. This section sets out the rules for the treatment of adjustment income. It is based on paragraphs 4(2) and 7 of Schedule 22 to FA 2002.

1366. *Subsection (3)* treats the income as property income for the purpose of loss relief. So any losses of the property business brought forward can be set against the income.

Section 334: Treatment of adjustment expense

1367. This section sets out the rules for the treatment of a negative adjustment. It is based on paragraphs 5 and 7 of Schedule 22 to FA 2002.

Chapter 8: Rent receivable in connection with a UK section 12(4) concern

Overview

1368. This Chapter charges as property income rent receivable in connection with a section 12(4) concern. It also provides for certain deductions and reliefs to be given from that income.

Section 335: Charge to tax on rent receivable in connection with a UK section 12(4) concern

1369. This section charges rent receivable in connection with a UK section 12(4) concern to tax. It is based on section 119(1) of ICTA.

1370. The loss regime in section 392 of ICTA applies to income charged under this Chapter and not the regime in sections 379A and 379B of ICTA.

1371. The charge under Schedule D Case III imposed by section 119(2) of ICTA is not rewritten.

1372. Section 119(2) of ICTA provides for the rent to be taxed under Schedule D Case III if the rent is paid in produce of the concern. If section 119(2) of ICTA does not apply the rent is charged under Schedule D Case VI.

1373. When section 119 of ICTA was introduced as section 34 of FA 1934 the lessee was required to deduct income tax when paying rent to the lessor. This was achieved by treating the rent as a royalty paid in respect of the user of a patent. But it would be impractical to deduct income tax if the rent were paid in kind. So what is now section 119(2) of ICTA charged rent paid in kind under Schedule D Case III. This avoided the requirement to deduct income tax because these rents are not a category of income from which tax is deducted.

1374. Since the requirement to deduct income tax from rents taxable under section 119 of ICTA was repealed by FA 1995 a separate charge on rents paid in kind is no longer required.

Section 336: Meaning of "rent receivable in connection with a UK section 12(4) concern".

1375. This section clarifies:

- what is meant by "UK section 12(4) concern";
- what is meant by "rent"; and
- when rent is treated as "receivable in connection with" such a concern.

1376. It is based on section 119(1) and (3) of ICTA.

1377. *Subsection (1)* identifies when rent is receivable in connection with a section 12(4) concern. It uses the language of section 266(1) (meaning of "generating income from land") to rewrite the phrase "in respect of any land or easement" in section 119(1) of ICTA. Section 266 is based on paragraph 1(1) of Schedule A (section 15(1) of ICTA). That provision identifies the scope of Schedule A. The approach in section 336 assumes that the income taxed by section 119 of ICTA would otherwise be taxed under Schedule A.

1378. The justification for this assumption is that section 119 of ICTA can have no application to income that is already taxed under Schedule D Case VI. Neither is there any question that the rent would go untaxed if it were not for section 119 of ICTA. Rents are clearly annual profits or gains as described in Schedule D Case VI of ICTA. The effect of section 119 of ICTA is to take income that would be taxed under Schedule A and tax it under Schedule D. So in identifying the scope of the charge it is possible to use the ordinary property business definitions and avoid the need to rewrite the complicated definitions of "easement" and "rent" in section 119(3) of ICTA.

1379. The section makes explicit a territorial restriction to the United Kingdom that is implicit in section 119(1) of ICTA. If a section 12(4) concern is located outside the United Kingdom it would be a foreign possession for the purposes of the charge under Schedule D Case V. Any income arising from such a possession would be taxed under Schedule

D Case V. Section 119 of ICTA can have no application to income that is already taxed under Schedule D.

1380. *Subsection (2)* provides that the section applies also to "dead rents". It is based on section 119(1)(b) of ICTA.

1381. A "dead rent" is usually paid only for the lease of mineral rights. It is a flat rent that is payable whether the minerals are worked or not. The rent is recoverable from the rent due when the minerals are worked. It acts as an economic incentive to work the minerals.

1382. *Subsection (3)* provides the definition of rent. It is based on section 119(3) of ICTA. As explained in the commentary on subsection (1), this section is based on the assumption that the rents taxed by section 119 of ICTA would otherwise be taxed under Schedule A. This means it is not necessary to reproduce the definition of "rent" in section 119(3) of ICTA.

Section 337: Income charged

1383. This section sets out the amount charged to tax. It is based on section 69 of ICTA.

1384. *Subsection (2)* is a signpost to the deductions and reliefs that are available against this income.

Section 338: Person liable

1385. This section states who is liable for any tax charged. It is based on section 59 of ICTA.

Section 339: Deduction for management expenses of owner of mineral rights

1386. This section allows a deduction for the expenses of managing mineral rights. It is based on section 121(1) of ICTA.

1387. *Subsection (1)* sets out the conditions for the section to apply. It does not reproduce the condition that the expenses must be incurred "necessarily". See *Change 78* in Annex 1.

1388. *Subsection (2)* provides that a deduction is allowed for the qualifying expenses paid in the tax year. This rewrites the requirement that the expenses are "disbursed" in the tax year.

1389. The relief applies only to rents received from a UK section 12(4) concern. If the income is taxed as income from a UK property business, there is no need for special rules identifying what deductions are allowable. The normal rules apply.

Section 340: Relief in respect of mineral royalties

1390. This section provides that only half of the net profit earned in respect of mineral royalties is charged to income tax. It is based on section 122 of ICTA. The other half of the net profits is charged to capital gains tax by section 201 of TCGA.

1391. The provision was introduced in FA 1970 to give relief from the high marginal rates of tax that could arise if the income was liable to betterment levy, surtax and income tax. It has been retained despite the abolition of the first two of those taxes.

1392. *Subsection (1)* limits the relief to royalties taxed under Chapter 8 of Part 3 of this Act. If the royalty is not taxed under this Chapter the same relief is given by section 157 or section 319.

Section 341: Meaning of "mineral lease or agreement" and "mineral royalties"

1393. This section defines various terms used in section 340. It is based on section 122(5) and (6) of ICTA.

1394. Section 364 includes a definition of "lease" that applies for the purposes of the property income Part. It is based on section 24 of ICTA, which applies for the purposes of Schedule A in the source legislation. Because the definition applies only for Schedule A in strictness it does not extend to the income taxed under section 340. But the definition of "mineral lease or agreement" in section 122(6) of ICTA applies to any agreement to win and work minerals in the United Kingdom. Such an agreement would also satisfy the definition in section 24 of ICTA so there is no change in the law.

Section 342: Extended meaning of "mineral royalties" etc. in Northern Ireland

1395. This section modifies the definition of "mineral royalties" to deal with the different rules that apply to the ownership of mineral rights in Northern Ireland. It is based on section 122(7) of ICTA.

1396. The right to win, and win and work, most minerals in Northern Ireland is vested in the Department of Enterprise, Trade and Investment (DETI). The DETI will grant licences to work the minerals and make compensatory payments to the former owners of the mineral rights under various Acts of the Northern Ireland Parliament. This section treats those payments as mineral royalties for the purposes of section 340.

Section 343: Power of Board to determine what counts as "mineral royalties"

1397. This section allows the Board of Inland Revenue to make regulations concerning the application of the relief in section 340. Any regulations made under this power would apply also to sections 157 and 319 through sections 157(3) and 319(3).

Chapter 9 Rent receivable for UK electric-line wayleaves

Overview

1398. This Chapter rewrites the Schedule D Case VI charge on rent received in respect of a wayleave granted in the United Kingdom. It is based on section 120 of ICTA.

1399. If a landowner receives rent in respect of a UK electric-line wayleave section 120 of ICTA provides that:

- the rent is charged under Schedule A if the landowner receives other rent in respect of the same land; otherwise
- the rent is charged under Schedule D.

1400. In practice this means that if the landowner carries on a trade on the land the rent can be treated as a trade receipt. See *Change 5* in Annex 1. Otherwise the rent is taxed under Schedule D Case VI.

1401. Section 392 of ICTA gives the rules for dealing with Schedule D Case VI losses. In order to preserve that loss regime it is necessary to isolate the income that ICTA charges under Schedule D Case VI.

Section 344: Charge to tax on rent receivable for a UK electric-line wayleave

1402. This section charges to tax rent receivable for a UK electric-line wayleave to tax. It is based on section 120 of ICTA.

Section 345: Meaning of "rent receivable for a UK electric-line wayleave"

1403. This section provides the definition of "rent receivable for a UK electric-line wayleave". It is based on section 120(1) and (5) of ICTA.

1404. Section 120(1) of ICTA identifies the right in respect of which the rent is payable as an "easement". Section 120(5) of ICTA cross-refers to the definition of "easement" in section 119(3) of ICTA. Section 119 of ICTA is rewritten as Chapter 8 of this Part.

As explained in the commentary on section 22 both this Chapter and section 22 use the term "wayleave" to describe the right in respect of which the rent is received. In practice this is how most of the payments covered by this section are usually described. But the generality of the words in section 119(3) of ICTA has not been lost. The section also uses the Scottish term for "easement", "servitude".

1405. *Subsection (2)* clarifies the meaning of "electric, telegraph or telephone wire or cable". It does not repeat the reference to "transformer" in the source legislation. In its context it is clear that "apparatus" would include "transformer".

Section 346: Extent of charge to tax

1406. This section sets out the two exceptions under which the rent received in respect of a UK electric-line wayleave is not taxed under this Chapter. It is based on section 120(1A) of ICTA.

1407. *Subsections (1)* and *(2)* deal with the case in which the taxpayer receives other rent in respect of the land except rent from another wayleave. The rent from the wayleave is taxed as property income.

1408. *Subsections (3)* and *(4)* deal with the case in which the taxpayer carries on a trade on the land. See *Change 5* in Annex 1. The rent may be taxed as a trade receipt.

Section 347: Income charged

1409. This section sets out the amount charged to tax. It is based on section 69 of ICTA.

Section 348: Person liable

1410. This section states who is liable for any tax charged. It is based on section 59 of ICTA.

Chapter 10: Post-cessation receipts

Overview

1411. This Chapter applies the rules about post-cessation receipts to property businesses, broadly as they apply to trades. The main rules for trades are in Chapter 18 of Part 2 of this Act. The application of the rules to property businesses is based on section 21B of ICTA, which specifically mentions sections 103 to 106 of ICTA.

1412. Section 65A(5) of ICTA provides that "the income from an overseas property business shall be computed … in accordance with the rules applicable to the computation of the profits of a Schedule A business".

1413. Although the post-cessation receipt rules apply to a Schedule A business, they do so by virtue of section 21B of ICTA. That section deals with "other rules applicable to Case I of Schedule D". On the other hand, section 21A of ICTA deals with rules about the computation of profits of a trade. So section 65A of ICTA imports only the computation rules in section 21A and the post-cessation receipt rules do not apply to an overseas property business.

1414. The following trading income rules (in Chapter 18 of Part 2 if this Act) cannot apply to a property business. So there is no corresponding rule in this Chapter:

- Section 241: Professions and vocations;
- Section 252: Transfer of trading stock or work in progress; (A property business cannot have trading stock or work in progress.)
- Section 253: Lump sums paid to personal representatives for copyright etc; (Such sums cannot arise from a property business.) and

- Section 256: Treatment of post-cessation receipts. (Property income cannot be relevant UK earnings or earned income.)

1415. The following trading income rules apply to property businesses but are not in separate sections in this Chapter:

- Sections 248, 249 and 250: Rules about debts and post-cessation expenditure; (These rules are applied by section 354(2).)
- Sections 254 and 255: Allowable deductions; (These rules are applied by section 351(2)(a).) and
- Section 257: Election to carry back. (This rule is applied by section 351(2)(b).)

Section 349: Charge to tax on post-cessation receipts

1416. This section charges post-cessation receipts to tax. It is based on sections 103 and 104 of ICTA, as applied by section 21B.

Section 350: Extent of charge to tax

1417. This section restricts the charge on the post-cessation receipts. It is based on sections 103 and 104 of ICTA.

Section 351: Income charged

1418. This section sets out the amount charged to tax. In ICTA the charge is under Schedule D Case VI. So section 69 of ICTA applies.

Section 352: Person liable

1419. This section states who is liable for any tax charged. In ICTA the charge is under Schedule D Case VI. So section 59(1) of ICTA applies.

Section 353: Basic meaning of "post-cessation receipt"

1420. This section defines post-cessation receipts of a property business. It is based on sections 103 and 104 of ICTA, as applied by section 21B of ICTA.

1421. *Subsections (2)* and *(3)* set out the position if a property business is carried on in partnership. It is based on section 110(2) (and sections 111 and 113) of ICTA. A partner who leaves a firm may receive a post-cessation receipt that is charged to tax.

Section 354: Other rules about what counts as a "post-cessation receipt"

1422. This section brings together signposts to rules that operate so as to treat certain sums as post-cessation receipts and to exclude others from the charge. It is new.

1423. *Subsection (1)* is a signpost to the section that deals with the transfer of a right to receive a post-cessation receipt to a person who does not carry on a property business.

1424. *Subsection (2)* lists the trading income rules that apply to create post-cessation receipts for the purpose of this Chapter.

1425. *Subsection (3)* draws attention to the rule in Chapter 5 of this Part of the Act that treats a sum received as not being a post-cessation receipt if the right to it was transferred with a property business. It also mentions the rule in Part 8 of this Act that can treat profits of an overseas property business as post-cessation receipts if they become remittable after the taxpayer has ceased to carry on the business.

Section 355: Transfer of rights if transferee does not carry on UK property business

1426. This section sets out the positions of the transferor and transferee if the right to a post-cessation receipt is transferred for value. It is based on section 106 of ICTA, as applied by section 21B of ICTA.

Section 356: Application to Schedule A businesses

1427. This section deals with the case of a person who receives a sum that arises from a Schedule A business that was carried on before 2005-06. It is new.

1428. *Subsection (1)* sets out the general rule. The business from which a sum arises for the purpose of section 353 may be either a UK property business (as defined in this Act for 2005-06 and later years) or a Schedule A business. The Schedule A business may be one carried on by an income tax payer before 2005-06 or one carried on by a company.

1429. *Subsection (2)* deals with the case of a non-resident company liable to income tax. If a company ceases to be liable to corporation tax it is treated as ceasing to carry on its Schedule A business. A post-cessation from that business may be charged to income tax.

Chapter 11: Overseas property income

Section 357: Charge to tax on overseas property income

1430. This section charges overseas property income to tax. It is based on Schedule D Case V in section 18 of ICTA.

Section 358: Meaning of "overseas property income"

1431. This section defines "overseas property income", in cases where the remittance basis applies. It is new.

1432. Section 65(4) of ICTA provides that, for a person to whom the remittance basis applies, section 65A of ICTA does not apply. This means that there cannot be an overseas property business. And there are no rules in ICTA for calculating the income.

1433. This Chapter uses the expression "overseas property income" to describe income from land outside the United Kingdom which would usually be treated as part of an overseas property business (see section 265) but is not treated in that way because the overseas property business of a remittance basis taxpayer includes only profits from land in the Republic of Ireland (see section 269(3)). So overseas property income does not include any Irish income.

Section 359: Income charged

1434. This section sets out the amount charged to tax and takes the form of a signpost to the remittance basis of assessment in section 832. It is based on section 65(5) of ICTA.

Section 360: Person liable

1435. This section states who is liable for any tax charged on overseas property income when the remittance basis applies. It is based on section 59(1) of ICTA.

Chapter 12: Supplementary

Section 361: Changes in trustees and personal representatives

1436. This section sets out what happens if there is a change in the trustees or personal representatives who are carrying on a property business. It is based on section 113(7) of ICTA, as applied by section 21B of ICTA.

1437. In section 113(1) of ICTA the phrase "change in the persons engaged in carrying on any trade" is wide enough to include a change in trustees. There is no need to treat a property business as ceasing solely on account of a change of trustees. So in section 113 of ICTA subsection (7) overrides subsection (1) "for the purposes of this section". The same rule applies to personal representatives as to trustees.

1438. The property business is treated as continuing even if there is a complete change of trustees or personal representatives. And, in the case of a partial change of trustees or personal representatives, this section makes it clear that for the purposes of the property income Part no person is treated as ceasing to carry on the property business. There is a similar rule for trading income in section 258.

Section 362: Effect of company starting or ceasing to be within charge to income tax

1439. This section applies only to companies and deems a commencement or cessation of a UK property business to take place in particular circumstances. It is based on section 337 of ICTA.

1440. Section 337 of ICTA is primarily a corporation tax rule. It applies only to companies and originates from the introduction of corporation tax. However it can be relevant to income tax.

1441. That is because non-resident companies are within the charge to income tax in respect of United Kingdom trade profits (when the trade is not carried on through a United Kingdom permanent establishment) and UK property business income. Section 337 of ICTA applies in cases of either inward or outward company migration. Where that involves a continuing trade or UK property business there will be a change of taxing regime from income tax to corporation tax or vice versa.

1442. Section 362 says what happens when a company enters or leaves the income tax regime: then its UK property business income is calculated as though it had commenced or discontinued the business.

Section 363: Overseas property businesses and overseas land: adaptation of rules

1443. This section sets out how the rules for United Kingdom property businesses are to be adapted to apply to overseas property businesses. It is based on section 65A(8) of ICTA.

1444. The section explains how to apply the UK property business rules if foreign property law does not correspond exactly with United Kingdom property law. This is particularly useful when applying the lease premium rules in Chapter 4 of this Part of the Act to foreign leases.

Section 364: Meaning of "lease" and "premises"

1445. This section is based on sections 24 and 65A(5) of ICTA.

Part 4: Savings and investment income

Overview

1446. This Part contains the rules relating to savings and investment income. It consists of income that is charged under Schedule D Cases III, IV, V and VI; Schedule F and non-schedular charges in the source legislation.

1447. There is a separate Chapter for each category of income arranged as follows:

- interest (Chapter 2);
- dividends and other distributions from UK resident companies (Chapter 3);

- dividends from non-UK resident companies (Chapter 4);
- stock dividends from UK resident companies (Chapter 5);
- release of loan to participator in close company (Chapter 6);
- purchased life annuity payments (Chapter 7);
- profits from deeply discounted securities (Chapter 8);
- gains from contracts for life insurance etc. (Chapter 9);
- distributions from unauthorised unit trusts (Chapter 10);
- transactions in deposits (Chapter 11);
- disposals of futures and options involving guaranteed returns (Chapter 12); and
- sales of foreign dividend coupons (Chapter 13).

Structure of Chapters

1448. The basic structure of each Chapter is:

- charge to tax on income;
- the amount to be charged to tax;
- the person liable for the tax charged; and
- rules specific to that income.

1449. This Part does not contain exemption provisions. Signposts to the exemptions most likely to be relevant have been placed in the charge to tax provisions.

Chapter 1: Introduction

Section 365: Overview of Part 4

1450. This section sets out the income charged in this Part, the approach to exempt income and where to find the priority rules. It is new.

Section 366: Provisions which must be given priority over Part 4

1451. This section provides rules which determine which Part will take priority in the event of any overlap in the charging provisions. It is based on sections 18, 20 and 95 of ICTA, and section 9D of TMA.

1452. *Subsection (1)* ensures that, if any amount falls within a charge in Part 4 of this Act and the charge on trade profits, Chapter 2 of Part 2 of this Act will charge that amount as a trade receipt. This takes account of section 95 of ICTA which sets out the circumstances in which a distribution made by a UK resident company, or a payment which is representative of such a distribution is brought into account in calculating the profits of a trade.

1453. Section 95 of ICTA brings a distribution into account in calculating the trade profits if the recipient is a dealer in relation to that distribution. Subsection (1) instead focuses on the nature of the receipt. See *Change 79* in Annex 1.

1454. Subsection (1) also reflects the decision to give effect to the Crown Option. See *Change 66* in Annex 1.

1455. In the case of non schedular charges it is unlikely that there would be any overlap. But in theory it is possible that, for example, stock dividends (Chapter 5 of Part 4 of this

Act) and gains from contracts for life assurance (Chapter 9 of Part 4 of this Act) may rank as trade receipts. Taxing such income under Chapter 2 of Part 2 of this Act accords with the policy and practice of taking trade receipts into account in calculating trade profits and not otherwise. See *Change 66* in Annex 1.

1456. *Subsection (2)* ensures that, if any amount falls within a charge in Part 4 of this Act and the charge on a UK property business, Chapter 3 of Part 3 of this Act will charge that amount as a receipt of a UK property business. This reflects the priority of Schedule A over Schedule D and is based on section 18(1)(b) of ICTA and Schedule D Cases III(a) and VI.

1457. Section 95 of ICTA can have no application to property income and there is no overlap between the Schedule A and Schedule F. The rule that Schedule F takes priority over Schedule A has not therefore been reproduced.

1458. Similarly as there is no overlap between Schedule A and the non schedular charges in section 249 of ICTA (stock dividends rewritten in Chapter 5 of Part 4 of this Act) and section 421 of ICTA (release of loan to participator in a close company rewritten in Chapter 6 of Part 4 of this Act) there is no need to exclude these charges from this priority rule.

1459. *Subsection (3)* ensures that ITEPA takes priority over Part 4 of this Act except for the charging provisions in Chapter 3 of Part 4 of this Act (dividends etc. from UK resident companies) and Chapter 6 of Part 4 of this Act (release of loan to participator in a close company). This reflects the priority that ITEPA has over Schedule D in the source legislation. It is based on section 18(1)(b) of ICTA and Schedule D Cases III(a) and VI of ICTA.

1460. A new provision, section 716A, has been added to ITEPA (see paragraph 615 of Schedule 1 to this Act) which gives priority to Chapter 3 of Part 4 of this Act over charges in ITEPA. This takes account of the fact that Schedule F has priority over ITEPA in the source legislation. It is based on section 20(1) and (2) of ICTA.

1461. In the source legislation there is a potential charge under section 421 of ICTA (which is rewritten in Chapter 6 of Part 4 of this Act (release of loan to a participator in a close company)) and section 188 of ITEPA. Section 189 of ITEPA gives priority to section 421 of ICTA. Section 189 of ITEPA will continue to assign priority to the charge in Chapter 6 of Part 4 of this Act.

1462. *Subsection (4)* provides that an amount can be used in calculating a chargeable event gain under Chapter 9 of Part 4 (gains from contracts for life insurance etc.) although it may also be used in calculating income under another provision in this Act. This is because the calculation of gains under Chapter 9 of this Part uses different principles from those used in other charges. However, section 527 of this Act ensures that the gain calculated under Chapter 9 is reduced by the amount charged elsewhere, to avoid a double charge on the same amount.

Section 367:Priority between Chapters within Part 4

1463. This section provides rules which determine which Chapter will take priority in the case of any overlaps in the charging provisions within Part 4 of this Act. It is based on sections 18 and 20 of ICTA and Schedule 15 of FA 1996.

1464. Usually, by their nature, the particular amounts charged in Part 4 of this Act can fall only within one Chapter so there is no need to make any special provision. This section covers a couple of exceptions.

1465. *Subsection (1)* provides the priority rule for two charging sections which are based on Schedule D Case III and Cases IV and V. Chapter 8 (profits from deeply discounted securities) has priority so that discounts continue to be taxed under the special rules for deeply discounted securities (previously relevant discounted securities) rather than under the general charge on interest which includes “all discounts”.

1466. *Subsection (2)* is concerned with the priority between Chapter 3 (dividends etc. from UK resident companies) and the other Chapters in Part 4 of this Act. Chapter 3 is based on section 20(2) of ICTA which provides specifically for Schedule F to take priority over the other Schedules. But *subsection (3)* provides for two exceptions to this basic rule. Dividends paid by building societies and by industrial and provident societies are treated as interest.

Section 368: Territorial scope of Part 4 charges

1467. This section provides that income within Part 4 of this Act is only charged to tax if it is from the United Kingdom or, if from outside the United Kingdom, it arises to a UK resident. It is based on section 18(1) of ICTA.

1468. Under section 18(1)(a) of ICTA income from any kind of property arising to a resident of the United Kingdom is chargeable to tax wherever that property is situated, while such income is chargeable on a non-resident only when it is from property within the United Kingdom.

1469. Section 18(1)(b) of ICTA, which charges tax in respect of “all interest of money, annuities and other annual profits or gains not charged under Schedule A or ITEPA and not specially exempted from tax”, does not mention the residence status of the person on whom the income or profits are chargeable.

1470. The exact scope of section 18(1)(b) of ICTA and its relation to the rules in section 18(1)(a) of ICTA is not entirely clear. Section 18(1) of ICTA appeared in broadly its present form in the Income Tax Act 1853, borrowing wording from the Income Tax Act 1842. The 1842 Act is famously impenetrable but the provisions from which the words have been borrowed (sections 100 and 102) may be read as having territorial restrictions. It is difficult to believe that the 1853 provision that is now section 18(1)(b) of ICTA was not intended to share the same territorial restrictions as the provision that is now section 18(1)(a) of ICTA.

1471. Profits charged under Schedule D Case VI may fall within section 18(1)(a) of ICTA where they represent income from any kind of property. But the Income Tax Acts also charge certain specific profits or gains, which would not otherwise be chargeable to income tax, under Case VI and when they are not specified as income from property they fall more comfortably under section 18(1)(b) of ICTA as “annual profits or gains”.

1472. In practice the same territorial restrictions are applied to Case VI profits falling within section 18(1)(b) of ICTA as within section 18(1)(a) of ICTA. This is both by analogy with the Case VI charge on income as well as under a general rule of law on territoriality mentioned below.

1473. Where non-schedular charges do not contain a territorial restriction, in practice the same territorial restrictions are applied as for section 18(1)(a) of ICTA. Again, this is both by analogy with the schedular charges and under a general rule of law on territoriality.

1474. Guidance is, however, available from case law. Since Colquhoun v Brooks (1889), 2 TC 490 HL the courts have followed Lord Herschell’s judgement that (page 499):

“The Income Tax Acts, however, themselves impose a territorial limit, either that from which the taxable income is derived must be situate in the United Kingdom or the person whose income is to be taxed must be resident there.

1475. Whether Lord Herschell’s words referred to the statutory rules of the time or to a general statement of the law, it is as the latter that they have been subsequently applied by the courts. For example in Perry v Astor (1935), 19 TC 255 HL Lord Russell of Killowen states (page 280):

"There must, of course, be the necessary limitation which is inherent in all our Income Tax legislation, namely, that what is taxed under or by virtue of this provision can only be either (1) income which is here, or (2) income of a person resident here.

1476. Additionally there is the general principle of United Kingdom law that, unless the contrary intention appears, an enactment is taken as not applying to matters outside the United Kingdom.

1477. The Schedule F charge on dividends and other distributions from UK companies contains its own territorial restriction, namely where the income arises from a company resident in the United Kingdom.

1478. *Subsections (1)* and *(2)* are drafted in terms of the "source" of the income. Although section 18 of ICTA refers to profits or gains from "property", the usual statutory term elsewhere in the Income Tax Acts and in case law for the same concept is "source" and this has been adopted as the more familiar and modern term.

1479. However, while the term "source" may apply to the majority of receipts chargeable to income tax it does not apply to all such receipts. "Source" is something from which income arises and not all sums charged to income tax are by nature income. "Source" may not be the appropriate term where the amount charged to tax represents a profit on a transaction which is not by nature income and would not be charged to income tax without a specific charge. Indeed, the chargeable profit may arise on the disposal of an income source. This restricted meaning of "source" is supported by Lord Hoffmann's judgement in Walker v Centaur Clothes Group Ltd (2000), 72 TC 379[7] HL and a more detailed discussion of this topic may be found in the commentary on Chapter 1 of Part 8 of this Act.

1480. It has therefore been necessary to consider how to express the territorial scope in cases where there is no natural source of income.

1481. *Subsection (3)* is broadly worded to catch such income. Where the connection such income has to the United Kingdom is comparable to the connection that income with a source in the United Kingdom has to the United Kingdom, then it is treated for the purposes of this section as income from a source in the United Kingdom.

Chapter 2: Interest

Overview

1482. This Chapter charges to tax interest and income that is treated as interest.

Section 369: Charge to tax on interest

1483. This section charges all interest to tax, whether from a source within or outside the United Kingdom. It is based on Schedule D Cases III(a), IV and V in section 18 of ICTA.

1484. *Subsection (1)* sets out the charge to tax.

1485. This section does not reproduce the separate charging provision in section 18(3)(c) of ICTA for "income from securities which is payable out of the public revenue of the United Kingdom or Northern Ireland". All the income which would fall into this category can be charged to tax under other provisions of this Act.

1486. Neither has the section reproduced the words "of money whether yearly or otherwise" in section 18(3) Case III (a) of ICTA.

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7 STC [2000] 324

1487. The cases of Re Euro Hotel (Belgravia) Ltd (1975), 51 TC 293[8] HC and Riches v Westminster Bank Ltd (1947), 28 TC 159 HL demonstrate that the reference to "of money" is to the debt upon which the interest itself is payable rather than the interest. Since the words "of money" add nothing to "interest" they have been dropped.

1488. The words "yearly or otherwise" follow the historical recognition by tax legislation of a distinction between yearly interest and short interest. Although the separate charging rules for these two types of interest were merged in 1918 the reference to "yearly or otherwise" was retained. The distinction between yearly and short interest is still relevant in some areas, for example the deduction of tax provisions in section 349(2) of ICTA, but as the words do not add anything to the charge to tax on "any interest…" in section 18(3)(a) of ICTA, they have not been reproduced in this section.

1489. The words in section 18(3) Case III (a) of ICTA "whether such payment is payable within or out of the United Kingdom" have not been reproduced. The place of payment is only one of a number of factors derived from case law which may be taken into account in determining the source of interest.

1490. The section charges interest to tax whether or not it arises within the United Kingdom. Whether interest arises from a source outside the United Kingdom will, as explained, depend on a number of factors. Some of these are considered in Westminster Bank Executor and Trustee Co (Channel Islands) Ltd v National Bank of Greece SA (1970), 46 TC 472 HL.

1491. For individuals, unless a particular charge specifies otherwise, interest arising from a source outside the United Kingdom is taxed under Schedule D Case IV if it arises from securities outside the United Kingdom but otherwise under Case V. This treatment is confirmed by Lord Manton's Trustees v Steele (1927), 11 TC 549 CA and Westminster Bank Executor and Trustee Co (Channel Islands) Ltd v National Bank of Greece SA (1970), 46 TC 472 HL.

1492. Not all the income within this Chapter can have a foreign source and in some cases it would be most unusual for interest from a source outside the United Kingdom to arise. This is so with building society dividends and share interest from an industrial and provident society. In other cases it may be impossible for such income to have a foreign source. The following paragraphs look at foreign source income in relation to particular categories of income treated as interest under this Chapter.

Building Societies

1493. Under section 66 of FA 1988 a society incorporated under the Building Societies Act 1986 will be resident in the United Kingdom through incorporation. As long as dividends are paid by a UK resident company they have a UK source under the principle in Bradbury v The English Sewing Cotton Company Ltd (1923), 8 TC 481 HL.

1494. But a society may be non-resident where it satisfies a residence test in the territory of a treaty partner and the treaty awards residence to that other territory. Section 249 of FA 1994 will then apply to treat the society as non-resident. Theoretically dividends paid by a building society may therefore arise from a source outside the United Kingdom. This would be most unlikely, however, since a building society may only be incorporated under the Building Societies Act 1986 if its principal office is in the United Kingdom. With the place of incorporation and the principal office in the United Kingdom a residence test is unlikely to be satisfied in another territory.

Open-ended Investment Companies

1495. The definition of an open-ended investment company in section 468(10) of ICTA carries a limitation that the company should be incorporated in the United Kingdom

8 STC [1975] 682.

under the OEIC regulations of 1996. Section 468(10) of ICTA is inserted in section 468 of ICTA by Regulation 10(4) (Open-ended Investment Companies (Tax) Regulations 1997 SI 1997/1154). All open-ended investment companies within the definition in section 468(10) of ICTA are therefore subject to the company residence rule in section 66 of FA 1988 ("regarded for the purposes of the Taxes Acts as resident"). Open-ended investment company interest distributions treated as made by a UK resident company will be UK source income. Although, as explained in connection with industrial and provident societies, it may be theoretically possible for section 249 of FA 1994 to make such companies non-resident, this is most unlikely in practice.

Authorised Unit Trusts

1496. It is possible for the FSA to recognise a non UK unit trust scheme for marketing into the UK. However, only those UK tax resident unit trusts that are "authorised" by the FSA come within section 468 of ICTA. Section 468(1) of ICTA provides that the Tax Acts apply to UK authorised unit trusts and shall have effect as if the trustees of the authorised unit trust were a company resident in the United Kingdom. Although the application of section 468(1) of ICTA is by reference to the trustees' income (and relief for capital expenditure), the treatment of the trustees as a UK resident company carries through for the purposes of taxing interest distributions treated as made to unit holders. That is because section 468L(2) of ICTA provides that the Tax Acts shall have effect as if such interest distributions were made "by the company referred to in section 468(1)". As these distributions are treated as made by such a company, that is a UK resident company, they can only be UK source income.

Industrial and Provident Societies

1497. Under section 66 of FA 1988 a society registered under the Industrial and Provident Societies Acts will be resident in the United Kingdom through incorporation. A society may, however, be non-resident where it also satisfies a residence test in the territory of a treaty partner of the United Kingdom and the treaty awards residence to that other territory. Section 249 of FA 1994 will then apply to treat the society as non-resident.

1498. Section 486(4) of ICTA provides that share or loan interest is chargeable under Schedule D Case III. Theoretically therefore payments by a registered society may arise outside the United Kingdom but be charged under Schedule D Case III and not able to benefit from treatment specific to Schedule D Cases IV and V. For the sake of consistency this section treats such income arising outside the United Kingdom as relevant foreign income and therefore able to benefit from the special rules in Part 8 of this Act. See *Change 131* in Annex 1.

1499. Section 18(3)(b) of ICTA charges "all discounts" to tax under Case III. Although these words could be read as embracing discounts that arise outside the United Kingdom, it has long been the practice to charge discounts with a foreign source under Schedule D Cases IV or V. There is however little direct authority in case law for this approach, although it is fully accepted by the commentaries.

Section 370: Income charged

1500. This section sets out the amount of interest charged to tax on sources both within and outside the United Kingdom. It is based on sections 64, 65 and 68 of ICTA.

1501. *Subsection (1)* sets out the amount of interest charged to tax. This is the full amount of interest arising in the tax year.

1502. Section 64 of ICTA sets out the basis of assessment for income chargeable under Schedule D Case III. It requires that income tax should be computed "…on the full amount of the income…without any deduction". There are no specific provisions allowing deductions from the amount charged to tax under Schedule D Case III and it is not clear what such deductions would represent. There are no rules allowing expenditure in earning Schedule D Case III income. The words "full amount of the income" carry some weight in suggesting that the amounts chargeable are without deduction.

1503. In relation to certain sources of income falling within Schedule D Case III, for example interest on savings bank deposits or private loans, the phrase "without any deduction" will not usually have any significance, as interest in such cases necessarily represents net income. There may, however, be such items as costs of collection but these cannot be deducted. Likewise in the case of discounts no set off can be made for losses incurred where the assessment is made under Schedule D Case III.

1504. The charging provision for Schedule F in section 20(1) of ICTA, which charges "all dividends and other distributions…of a company resident in the United Kingdom" does not state that the dividends are without any deduction. The words would be superfluous since no provision exists to give deductions from dividends from UK companies.

1505. For these reasons it is thought that the words are superfluous in the context of Schedule D Case III and they have therefore been omitted.

1506. The omission of these words also affects the following 'income charged' sections in this Act which are based on Schedule D Case III, section 424 (Chapter 7 of Part 4 of this Act, purchased life annuities) and 684 (Chapter 7 of Part 5 of this Act, annual payments not otherwise charged). In each case the income charged is expressed as: "Tax is charged under this Chapter on the full amount of the [annuity payments] [annual payments] arising in the tax year".

1507. The word "arising" has been the subject of a number of tax cases. "Arising" includes received and also credited to a bank account (Parkside Leasing v Smith (1984), 58 TC 282[9] HC). However, "arising" has a wider meaning than this. For example, it was held in Dunmore v McGowan (1978), 52 TC 307[10] CA, to include the "swelling of a person's assets", even where the person had no immediate right of access to the income. In view of the wide meaning given to "arising", and the fact that it is a term with which practitioners are familiar, the word has been retained.

1508. *Subsection (2)* makes subsection (1) subject to the rules in Part 8 of this Act. This enables income that is non-UK source and which would have been charged under Schedule D Cases IV or V to obtain the benefit of the special rules for such income.

Section 371: Person liable

1509. This section states who is liable for any tax charged. It is based on section 59(1) of ICTA.

1510. Section 59 of ICTA gives the person chargeable as the person "receiving or entitled to" the income.

1511. The phrase "receiving or entitled to" has been considered at length by the courts, although no clear definition of it has emerged. In early cases the courts placed greater emphasis on the concept of receipt than on entitlement - see, for example, Dewar v Commissioners of Inland Revenue (1935), 19 TC 561 CA. Later, equal importance was attached to each part of the phrase - see, for example, Aplin v White (1973), 49 TC 93[11] HC. The most recent cases, such as MacPherson v Bond (1985), 58 TC 579[12] HC, and Peracha v Miley (1990), 63 TC 444[13] CA, have hinged on whether or not any benefit has accrued to the taxpayer.

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9 STC [1985] 63.
10 STC [1978] 217.
11 STC [1973] 322.
12 STC [1985] 678.
13 STC [1990] 512.

1512. As the phrase is well established in case law, it is retained in the rewritten legislation. It is not, however, considered appropriate to include any further explanation of the phrase because of its wide interpretation by the courts.

Section 372: Building society dividends

1513. This section treats building society dividends as interest. It is based on section 477A of ICTA.

1514. *Subsection (1)* provides that any building society dividend is to be treated as paid by way of interest for the purposes of this Act. See *Change 80* in Annex 1. The wording "for the purposes of this Act" is necessary here since building society dividends are not treated as interest for all income tax purposes. They are treated as dividends for the purposes of deducting tax, by virtue of regulations made under section 477A(1) of ICTA (regulation 3(1) of the Income Tax (Building Societies) (Dividends and Interest) Regulations 1990 SI 1990/2231) or by virtue of section 349(3A) of ICTA.

Section 373: Open-ended investment company interest distributions

1515. This section and the two sections that follow provide investors, who are liable to income tax, with the information required to determine their taxable income from the open-ended investment company (OEIC). The tax provisions relevant to the OEIC, which is liable to corporation tax, are not in this Act.

1516. This section is based on section 468L of ICTA and the Open-ended Investment Companies (Tax) Regulations 1997 SI 1997/1154. These regulations provide that the tax treatment of investors (shareholders) in an OEIC generally follows the tax treatment of investors (unit holders) of an authorised unit trust (AUT). For an outline of the treatment of investors in an AUT see the commentary on section 376.

1517. The section provides for amounts that are not interest and would otherwise be something else to be treated as interest received by the investors. The amounts so treated are charged to tax by section 369 and are subject to the deduction of tax rules in section 349 of ICTA as amended by section 468L(4) of ICTA.

Section 374: Date when interest payments under section 373 made

1518. This section is based on sections 468H and 468L of ICTA and the Open-ended Investment Companies (Tax) Regulations 1997 SI 1997/1154. It applies to the amounts treated as interest.

Section 375: Interpretation of sections 373 and 374

1519. This section is based on sections 468H and 832 of ICTA and the Open-ended Investment Companies (Tax) Regulations 1997 SI 1997/1154.

1520. The regulations contained in SI 1997/1154, in so far as they apply to invoke the AUT rules for the tax charge on OEIC investors liable to income tax, are rewritten in the preceding sections. The regulations remain in place in respect of investors liable to corporation tax and all other aspects concerning OEICs. A saving has been made in Part 5 of Schedule 2 to this Act to preserve the power in section 152 of FA 1995 so that regulations may continue to be made for achieving any purpose that could be achieved by such regulations before enactment of these sections.

Section 376: Authorised unit trust interest distributions

1521. This section and the two sections that follow provide investors, who are liable to income tax, with the information required to determine their taxable income from the authorised unit trust (AUT). The tax provisions relevant to the AUT are not in this Act. This is because the AUT trustees are treated as a company liable to corporation tax under section 468(1)(a) of ICTA.

1522. This section is based on section 468L of ICTA which is part of the special tax rules for AUTs. These rules provide that AUTs are *treated for tax purposes* as though *all* of the money shown in their distribution accounts, as available for distribution or in the case of investors holding accumulation units, for adding to the capital value of their share of the fund, is *actually paid out* to unit holders. This means that the investors are taxed when they receive the benefit of the distribution made by the AUT rather than when they sell their units.

1523. The investors are treated as receiving a payment of interest or a dividend depending on how the AUT has allocated the money in its accounts. There are various rules which determine how and when this allocation can be made by the AUT.

1524. The amounts treated as interest are charged to tax by section 369 and are subject to the deduction of tax rules in section 349 of ICTA as amended by section 468L(4) of ICTA. The amounts treated as dividends are dealt with in section 389.

Section 377: Date when interest payments under section 376 made

1525. This section is based on sections 468H and 468L of ICTA. It applies to the amounts treated as interest.

Section 378: Interpretation of sections 376 and 377

1526. This section is based on sections 468H and 832 of ICTA.

Section 379: Industrial and provident society payments

1527. This section provides that share interest from industrial and provident societies is treated as interest. It is based on section 486 of ICTA.

1528. Section 486(4) of ICTA provides that share or loan interest is chargeable under Schedule D Case III. The definition of "share interest" in section 486 of ICTA is "any interest, dividend, bonus or other sum….". This section treats the dividend, bonus and other sums as interest. See *Change 81* in Annex 1.

1529. *Subsections (2)* to *(5)* are definition subsections. The reference to "the Department of Agriculture for Northern Ireland" in section 486(12) of ICTA is rewritten in subsection (5) as the "the Department of Agriculture and Rural Development", its current title.

1530. The closing words of section 486(12) of ICTA ("and references to the payment of share interest or loan interest include references to the crediting of such interest") are not rewritten. They are relevant to the rules within that section on the deduction of tax rather than the charge.

Section 380: Funding bonds

1531. This section provides for an issue of funding bonds in respect of a liability to pay interest to be treated as a payment of interest. It is based on section 582 of ICTA.

1532. There is one specific situation where a funding bond is chargeable to tax under Schedule D Case VI rather than Schedule D Case III. Section 582(2)(a) of ICTA provides that where funding bonds are issued some bonds have to be retained on account of income tax. However, section 582(2)(b) of ICTA provides that where it is "impracticable" to do this the recipient is chargeable to tax under Schedule D Case VI on the amount of interest treated as having been paid by the issue of the bonds. This section charges this income also as interest for income tax purposes. One consequence is that all funding bond interest will be included in what was Schedule D Case III income in section 1A of ICTA as consequentially amended. See *Change 82* in Annex 1.

1533. Relief for losses under the former Schedule D Case VI provisions will still be available under section 392 of ICTA.

1534. Section 582(1) of ICTA treats the issue of funding bonds as a payment of interest and they are taxed accordingly. The deemed interest is equal to the value of the bond at the time of issue. This section clarifies that the value which applies is the market value of the bond and not its nominal value. If the value were the nominal value a change in value could only occur in the unlikely circumstance of a change in the face value of the bond after issue. Moreover, tax could be easily avoided by issuing bonds with a low face value but repaying at a premium.

Section 381: Discounts

1535. This section treats discounts taxed under Schedule D Case III(b) as interest. It is based on section 18 of ICTA.

1536. Although section 18 of ICTA includes discounts as a separate category of charge without treating them as interest, this section provides for them to be charged as if they were interest. See *Change 83* in Annex 1.

Chapter 3: Dividends etc. from UK resident companies etc.

Introduction

Section 382: Contents of Chapter

1537. This section explains the scope of the Chapter. The Chapter contains the charge to tax on dividends and other distributions (and amounts treated as dividends) from companies resident in the United Kingdom. It also contains special provisions about dividends paid in respect of shares awarded under approved share incentive plans ("SIPs"). And, it contains provisions about tax credits and deduction of tax.

1538. Exemptions from the charge to tax under this Chapter are signposted in *subsection (3)*.

1539. The exemptions include section 498 of ITEPA which is part of the SIP code (see further the commentary on section 392 of this Act and the overview to the SIP provisions). The SIP code provides various exemptions from tax for persons participating in an approved SIP. The code also imposes tax charges in certain circumstances, for example, if shares are not held within the plan for the prescribed period of time. Section 498 of ITEPA provides an exemption from the charge to income tax that arises if dividend shares cease to be subject to the plan, if the participant is a "good leaver". In the source legislation, section 498 of ITEPA is expressed as a proviso to section 251C of ICTA (see section 251C(6) of ICTA). But as the charge to tax in respect of all dividends and other distributions of a UK resident company falls under Chapter 3 of Part 4 of this Act, section 498 of ITEPA is signposted as an exemption from the tax charge under this Chapter.

1540. S*ubsection (4)* replicates the position under the source legislation by ensuring that stock dividends that are taxed under Chapter 5 of Part 4 of this Act are not dividends for the purposes of this Chapter. (Despite their name, they do not count as dividends for the purposes of Schedule F. See further the commentary on Chapter 5 of Part 4 of this Act.)

1541. See the commentary on paragraph 10 of Schedule 1 to this Act for an explanation of the repeal of Schedule F.

Section 383: Charge to tax on dividends and other distributions

1542. This section charges to tax dividends and other distributions from UK resident companies. It is based on Schedule F in section 20 of ICTA.

1543. The section charges to tax "dividends and other distributions". The expression "distribution" is not defined in this Act except by reference to section 832(1) of ICTA (see the index of defined expressions in Part 2 of Schedule 4 to this Act).

1544. The main reason for not rewriting "distribution" in this Act is the importance of the expression in a corporation tax context (because, for example, distributions of companies resident in the United Kingdom are not taken into account in computing profits for corporation tax purposes - see section 208 of ICTA - and do not give rise to a tax deductible expense for the distributing company - see section 337A of ICTA). The expression therefore needs to be retained in a corporation tax context. Rewriting it in an income tax context would mean maintaining similar but not identical provisions for different purposes (some of the provisions - for example, section 209(5) to (7) of ICTA - are not relevant for income tax purposes). This is not thought to be straightforward or convenient for users of the legislation.

1545. Section 20(1) paragraph 1 of ICTA charges to tax all dividends and other distributions. But this is subject to section 95(1A)(a) of ICTA (taxation of dealers in respect of distributions). Section 95(1A)(a) of ICTA provides that tax is not charged under Schedule F where a dealer receives a "relevant distribution". Instead, tax is charged under Schedule D Case I or II. Section 383 does not explicitly rewrite the proviso in section 20(1) of ICTA but the effect of the proviso is replicated by section 366(1) of this Act (which gives charging priority to Chapter 2 of Part 2 of this Act for income which is a receipt of a trade). So a distribution made by a UK resident company which is a receipt of a trade is charged to tax under Part 2 of this Act and not under this Chapter.

1546. The charge to tax under Schedule F in the source legislation is also subject to section 171(2) of FA 1993 (Lloyd's underwriters: taxation of profits and allowance of losses) (see section 20(2) of ICTA). As with dealers, the tax charge in the source legislation is Schedule D Case I and not Schedule F. But section 171(2) of FA 1993 additionally provides that the amount of the profits arising from assets in an ancillary trust fund is calculated under the relevant Schedule or Case. Again, section 383 does not explicitly rewrite the proviso in section 20(2) of ICTA but the effect of that section is replicated by section 366(1) of this Act (which gives charging priority to Chapter 2 of Part 2 of this Act). And section 2(4) of this Act ensures that the calculation can be made under this Chapter.

1547. *Subsections (2)* and *(3)* confirm that the distribution is regarded as income for all income tax purposes even if it would otherwise be treated as capital (a capital dividend is a distribution – see section 209(2)(a) of ICTA).

Section 384: Income charged

1548. This section sets out the amount charged to tax and is based on section 20(1) paragraphs 1 and 2 of ICTA. The amount charged is the amount or value of the dividends paid and distributions made in the tax year. But if the recipient of the distribution is entitled to a tax credit, the amount charged is the amount or value of the distribution plus the tax credit (see *subsection (3)*).

1549. Dividends are treated as paid for the purposes of the Corporation Tax Acts "on the date when they become due and payable, except in so far as Chapter III of Part XII makes other provision for dividends treated as paid by virtue of that Chapter" (see section 834(3) of ICTA).

1550. The "Corporation Tax Acts" means the enactments relating to the taxation of the income and chargeable gains of companies and company distributions (including provisions relating to income tax) (see section 831(1) of ICTA). Chapter 3 of Part 12 of ICTA (referred to in the previous paragraph) specifies the date on which dividends which an authorised unit trust is treated as paying, are paid. So in all other cases the date on which a dividend is paid is the date on which the dividend becomes due and payable.

1551. The date when a final dividend becomes due and payable is usually established by a resolution of the company. The dividend becomes due when the date on which it is expressed to be payable arrives. Only then is payment enforceable. In the case of a final dividend where a date for payment is not specified, an immediately enforceable debt is created so that the date of declaration of the dividend is the due and payable date.

1552. An interim dividend can be varied and rescinded at any time before payment and can therefore only be regarded as "due and payable" when the date for payment arrives.

1553. The main case law authority for the above propositions is Potel v CIR (1970), 46 TC 658 HC (which particularly indicates that the declaration of a dividend by a company and its payment are two separate matters). Paragraph 2007b of the Inland Revenue's Company Taxation Manual (CT2007b) provides the Inland Revenue's interpretation of section 834(3) of ICTA and the meaning of "paid".

Section 385: Person liable

1554. This section states who is liable for any tax charged.

1555. Under the source legislation there is no provision expressly stating who is liable for the tax charged. Although section 20(1) paragraph 1 of ICTA makes it clear that the charge to tax encompasses all distributions of a UK resident company made in a tax year, and includes a reference to the recipient, it does not actually specify the person liable.

1556. The person liable can however be deduced from the legislation as a whole (and this has been reflected in *subsection (1)*).

1557. Section 20(1) of ICTA refers to recipients of distributions and persons entitled to tax credits. Paragraph 1 of section 20(1) of ICTA provides that distributions are regarded as income "…however they fall to be dealt with in the hands of the recipient"; paragraph 2 of that section provides that where "…a person is entitled to a tax credit" in respect of a distribution it is the aggregate of the distribution and the tax credit which is taxed.

1558. Section 231(1) of ICTA (tax credits for certain recipients of qualifying distributions) provides that a UK resident "receiving" a qualifying distribution is entitled to a tax credit. And section 232 of ICTA (tax credits for non-UK residents) refers to distributions "received" by certain individuals. Section 231(4) of ICTA deals with the case where a distribution "is, or falls to be treated as, or under any provision of the Tax Acts is deemed to be, the income of a person other than the recipient", so that other person is treated as receiving the distribution for the purposes of section 231 of ICTA. So, section 231(4) of ICTA suggests that where the distribution actually belongs to someone other than the recipient, or under any provision of the Tax Acts is treated as belonging to someone other than the recipient, that other person is liable for the tax charged.

1559. Section 209 of ICTA is the main provision which defines the term "distribution". Section 209(1) of ICTA provides that "The following provisions of this Chapter, together with section 418 of ICTA, shall, subject to any express exceptions, have effect with respect to the meaning of "distribution" and for determining the persons to whom certain distributions are to be treated as made ...".

1560. Where an asset or liability is transferred by a company to a member, section 209(4) of ICTA requires an amount to be treated as a distribution made to the member.

1561. Distributions are made, in most circumstances, to shareholders. For the purposes of Part 6 of ICTA (company distributions, tax credits etc) section 254(12) of that Act regards something done "in respect of a share" as being done to the shareholder, or to someone who has at a particular time been the shareholder. This suggests that someone to whom a distribution is treated as made for the purposes of Part 6 of ICTA is liable.

1562. The definition of distribution is extended by section 418(1) of ICTA to include any amount which is required to be treated as a distribution by section 418(2) of ICTA. Under section 418(2) of ICTA, where a close company incurs expense in providing a benefit or facility for a participator "the company shall be treated as making a distribution to him of an amount equal to so much of that expense as is not made good to the company". While it does not explicitly identify the person liable in respect of the distribution, in practice the participator is regarded as the person liable.

1563. So, while there is no express person liable provision (as there is for Schedule D for example), there are provisions covering:

- the person to whom a distribution is made or to whom it is treated as made for the purposes of Part 6 of ICTA – sections 209(1) and (4), 254(12) and 418(2) of ICTA;
- the person receiving a distribution – sections 20(1)1, 231(1) and (4) and 209(4) of ICTA;
- the person entitled to the distribution – sections 20(1)2 and 231(4); and
- the person to whom the distribution, under any provision of the Tax Acts, is treated as belonging (where that person is not the recipient) – section 231(4) of ICTA.

1564. A provision stating who is liable for any tax charged on distributions from UK resident companies needs to cover all these possibilities save the last one. If a distribution is treated under any provision of the Tax Acts as the income of a person other than the recipient, that legislation will provide who is liable for the tax.

Section 386: Open-ended investment company dividend distributions

1565. This section and the two sections that follow provide investors, who are liable to income tax, with the information required to determine their taxable income from the open ended investment company (OEIC). The tax provisions relevant to the OEIC, which is liable to corporation tax, are not in this Act.

1566. This section is based on section 468J of ICTA and the Open-ended Investment Companies (Tax) Regulations 1997 SI 1997/1154. These regulations provide that the tax treatment of investors (shareholders) in an OEIC generally follows the tax treatment of investors (unit holders) of an authorised unit trust (AUT). For an outline of the treatment of investors in an AUT see the commentary on section 376.

1567. The section provides for amounts that are not dividends and would otherwise be something else to be treated as dividends received by the investors. The amounts so treated are charged by section 383 and the provisions about tax credits or tax being treated as paid at sections 397 to 399 will apply as appropriate.

Section 387: Date when dividends paid under section 386

1568. This section is based on sections 468, 468H and 468J of ICTA and the Open-ended Investment Companies (Tax) Regulations 1997 SI 1997/1154. It applies to the amounts treated as dividends.

Section 388: Interpretation of sections 386 and 387

1569. This section is based on sections 468H and 832 of ICTA and the Open-ended Investment Companies (Tax) Regulations 1997 (SI 1997/1154).

1570. The regulations contained in SI 1997/1154, in so far as they apply to invoke the AUT rules for the tax charge on OEIC investors liable to income tax, are rewritten in the preceding sections. The regulations remain in place in respect of investors liable to corporation tax and all other aspects concerning OEICs. A saving has been made in paragraph 78 of Schedule 2 to this Act to preserve the power in section 152 of FA 1995 so that regulations may continue to be made for achieving any purpose that could be achieved by such regulations before enactment of these sections.

Section 389: Authorised unit trust dividend distributions

1571. This section and the two sections that follow provide investors, who are liable to income tax, with the information required to determine their taxable income from the authorised unit trust (AUT). The tax provisions relevant to the AUT are not in this Act. This is because the AUT trustees are treated as a company liable to corporation tax under section 468(1)(a) of ICTA.

1572. This section is based on section 468J of ICTA which is part of the special tax rules for AUTs. For an outline of the treatment of investors in an AUT see the commentary on section 376.

1573. The amounts treated as dividends received by the investors are charged by section 383 and the provisions about tax credits or tax being treated as paid at sections 397 to 399 will apply as appropriate.

Section 390: Date when dividends paid under section 389

1574. This section is based on sections 468H and 468J of ICTA. It applies to the amounts treated as dividends.

Section 391: Interpretation of sections 389 and 390

1575. This section is based on sections 468H and 832 of ICTA.

Shares in approved share incentive plans ("SIPs")

Overview

1576. Section 392 and the following four sections are based on sections 251A to 251C of ICTA which are part of the legislation relating to SIPs. The SIPs legislation was originally contained in Schedule 8 to the FA 2000 (introduced by section 47 of FA 2000) and was rewritten in ITEPA. The majority of the SIP code is contained in Chapter 6 of Part 7 of and Schedule 2 to ITEPA.

1577. The SIP code is designed to encourage employee share ownership. The core of the SIP code is that a company establishes a share incentive plan. Under the plan various types of share can be acquired or awarded - free shares, partnership shares and matching shares. In addition, scheme participators may, with the dividends paid on their shares, acquire "dividend shares".

1578. The shares awarded or acquired under the plan are held on behalf of the scheme participant by the trustees of the scheme. Therefore, any dividend paid by the company on those shares is paid to the trustees.

1579. The participant may choose (or the company may require) that all cash dividends paid on the shares be reinvested in further shares. If so, the cash dividend is used by the trustees of the scheme to acquire further shares. Those shares are called dividend shares.

1580. Section 493 of ITEPA (which is rewritten as section 770(2)(a) of this Act) provides that a scheme participant is not liable to income tax on the amount applied by the trustees in acquiring dividend shares on the participant's behalf.

1581. But a tax charge may arise if the dividend shares subsequently cease to be subject to the approved SIP. The special rules applying when dividend shares cease to be subject to the plan are rewritten in section 394.

1582. If the trustees cannot reinvest the cash dividend either because the amount of the cash dividend is not sufficient to acquire a share or because there is an amount remaining after acquiring shares, the trustees may keep the cash dividend and carry it forward with a view to reinvestment at a later date (see paragraph 68(2) of Schedule 2 to ITEPA). In that case, section 496 of ITEPA (rewritten as section 770(1)(b) of this Act) provides that the participant is not liable to income tax in respect of the amount of the cash dividend held by the trustees.

1583. But if the trustees subsequently pay over the cash dividend to the participant, the tax charge may revive. The special rules applying when the cash dividend held by the trustees is paid over to the participant is rewritten in section 393.

Section 392: SIP shares: introduction

1584. This section introduces the special rules about SIPs. It is based on section 251A of ICTA.

1585. *Subsections (2)* to *(7)* ensure that sections 393 to 396 apply only if the participant has benefited from the tax advantages of an approved SIP. Those tax advantages apply to an individual who is chargeable to tax under Part 2 of ITEPA in respect of eligible employment (as defined in *subsection (4)*) or, if the shares were awarded before ITEPA came into force, under Schedule E.

Section 393: Later charge where cash dividends retained in SIPs are paid over

1586. This section is based on section 251B of ICTA.

1587. The trustees of the scheme may only hold on to a cash dividend and carry it forward for three years from the date the dividend is paid by the company. Additionally, any amount not reinvested must be paid to the participant if the participant ceases to be in "relevant employment" or if a termination notice is issued in respect of the plan (see paragraph 68(4) of Schedule 2 to ITEPA).

1588. *Subsection (2)* ensures that in any of these circumstances, the participant is charged to income tax for the tax year in which the dividend is paid over.

1589. Tax is charged on the amount of the cash dividend paid over and not on the amount of the cash dividend originally paid by the company (*subsection (3)*).

1590. Whether the participant is entitled to a tax credit and, if so, the amount of it, is determined by reference to the tax year in which the cash dividend is paid over by the trustees and not by reference to the tax year the company actually paid the dividend (see *subsection (5)*).

1591. Section 251B of ICTA is rewritten so that the original tax charge is postponed (contrast section 394 which deems a further distribution to be made). This approach has rendered the phrase "except to the extent that it represents a foreign cash dividend" redundant. In effect, the cash dividend paid over by the trustees does not lose its original character as either a cash dividend paid by a UK resident company (in which case it is dealt with under this Chapter) or a cash dividend paid by a non-UK resident company (in which case it is dealt with under Chapter 4 of Part 4 of this Act).

1592. But the definition of "foreign cash dividend" in section 251D of ICTA does suggest that it is the date that the company originally paid the dividend that determines, under the source legislation, whether the tax charge falls under Schedule F (if UK resident company) or Schedule D Case V (if non-UK resident company). This is rewritten in *subsection (6)*.

Section 394: Distribution when dividend shares cease to be subject to SIP

1593. This section is based on section 251C of ICTA and applies if the dividend shares acquired with the cash dividend cease to be subject to the approved SIP within three years of acquisition.

1594. *Subsection (2)* deems a distribution to have been made to the participant in the tax year in which the dividend shares cease to be subject to the plan.

1595. *Subsection (3)* confirms that tax is charged on the amount of the cash dividend applied to acquire the shares (which have ceased to be subject to the plan) rather than, for example, the amount or value of the dividend shares.

Section 395: Reduction in tax due in cases within section 394

1596. This section is based on section 251C of ICTA and applies if tax has been paid in respect of any capital receipts received in connection with the holding of the dividend shares which cease to be subject to the approved SIP.

1597. *Subsection (2)* operates to reduce the amount of tax due under section 394.

Section 396: Interpretation of sections 392 to 395

1598. This section is based on section 251D of ICTA.

Section 397: Tax credits for qualifying distributions: UK residents and eligible non-UK residents

1599. This section and the following four sections deal with:

- a person's entitlement to a tax credit attaching to qualifying distributions;
- the tax treatment of qualifying distributions where the person is not entitled to a tax credit; and
- the tax treatment of non-qualifying distributions.

1600. The sections are based on sections 231, 232 and 233 of ICTA.

1601. By virtue of sections 231(1) and 232 of ICTA tax credits are available to certain recipients in respect of certain qualifying distributions from companies resident in the United Kingdom.

1602. Tax credits attach to qualifying distributions which are made either to residents of the United Kingdom or to certain non-UK resident persons. The source legislation has been rearranged so that there is a single provision dealing with both categories of recipients (UK resident and non-UK resident) who are entitled to tax credits.

1603. Most distributions of companies resident in the United Kingdom are "qualifying distributions" (see section 14(2) of ICTA). Only the issue of redeemable share capital (unless that share capital is taxed under the stock dividends legislation) or the issue of securities in respect of shares or securities of a company otherwise than wholly for new consideration, are non-qualifying distributions.

1604. In line with the decision not to define the expression "distribution" in this Act, the expression "qualifying distribution" is likewise not defined (other than by reference to section 832(1) of ICTA).

1605. *Subsection (1)* sets out who is entitled to the tax credit, in what circumstances and what the value of that tax credit is. Those entitled to the tax credit include "eligible non-UK residents".

1606. *Subsection (2)* deals with how the tax credit may be used and rewrites section 231(3) of ICTA. Section 231(3) in the source legislation is subject to section 231(3AA) of ICTA. This is rewritten in a slightly different way. *Subsection (3)* treats the tax credits attaching to qualifying distributions as reduced if those distributions are not brought into charge to tax. So, for example, if an individual's total income is reduced by deductions (for example, personal allowances) such that the qualifying distributions are not, or are not wholly, brought into charge to tax, the value of the tax credits attaching to those distributions are correspondingly reduced. So a person may be entitled to a tax credit whose value is nil.

1607. Although companies resident in the United Kingdom are expressly excluded in section 231(3) of ICTA, (because section 231(3) of ICTA applies to a person "not being a company resident in the United Kingdom") this exclusion has not been adopted. See *Change 84* in Annex 1.

1608. *Subsection (4)* defines eligible non-UK resident. Section 232 of ICTA extends the entitlement to tax credits to certain non-UK resident individuals. These are referred to as individuals who:

"having made a claim in that behalf, [are] entitled to relief under Chapter I of Part VII by virtue of section 278(2) …

1609. The words about making the claim in section 232 of ICTA are unnecessary because the individual will have to make a claim for personal allowances under section 278(8) of ICTA before the tax credit can be taken into account.

1610. Also, section 278 of ICTA does not specify whether the individual concerned has to come within one of the given categories (eg Commonwealth citizen or EEA national) throughout the tax year in question or merely at any time during the tax year in question. However, given personal allowances are available to these individuals simply for falling within a particular category, subsection (4) has followed this approach and has used the words "at any time".

1611. *Subsection (5)* rewrites section 231(4) of ICTA. The words "(and accordingly the question whether he is entitled to a tax credit in respect of it shall be determined by reference to where he, and not the actual recipient, is resident)" have been omitted. The revised wording of the section makes the words unnecessary.

Section 398: Increase in amount or value of dividends where tax credit available

1612. This section is based on section 20(1) of ICTA (including the proviso "other than section 95(1)"). It applies for all income tax purposes including the case where the recipient of the distribution is a member of Lloyd's. But the section does not apply if the recipient of the distribution is a dealer (in which case only the net amount of the distribution is taken into account in calculating the profits of the dealer).

Section 399: Qualifying distributions received by persons not entitled to tax credits

1613. This section deals with the tax treatment of qualifying distributions received by persons not entitled to a tax credit (for example, because they are non-resident and do not fall within the definition of "eligible non-UK resident"). As mentioned in the commentary on section 397(3), a person may be entitled to a tax credit whose value is nil. The person is nevertheless entitled to a tax credit and therefore this provision does not apply to such a person. It is based on section 233(1) and (1A) of ICTA.

1614. *Subsection (2)* provides that the non-UK resident is treated as having paid income tax at the dividend ordinary rate (Schedule F ordinary rate in the source legislation) on the amount or value of the distribution.

1615. The amount or value of the distribution will either be the actual amount of the distribution (if the person is a non-UK resident company receiving the qualifying distribution in a beneficial capacity) or that amount is "grossed up" by reference to the dividend ordinary rate. *Subsections (3)* and *(4)* explain when the grossed up amount (as defined in *subsection (5)*) is substituted for the actual amount.

1616. The words "not being a company resident in the United Kingdom" in section 233(1) of ICTA and "any person who is not a company" in section 233(1A) of ICTA create the same difficulties as those in section 231(3) of ICTA. So this section follows a similar approach to that taken in section 397(2) by rewriting sections 233(1) and 233(1A) of ICTA without any exclusion for companies. See *Change 84* in Annex 1.

1617. Section 233(1)(c) of ICTA treats the amount or value of the distribution as not brought into charge to tax for the purposes of sections 348 and 349 of ICTA. Section 233(1)(c) of ICTA is not rewritten in this Act. But rather than leaving the provision "stranded" in section 233 of ICTA, it has been incorporated in section 348 of ICTA as paragraph (a) of a new subsection (4) (see paragraph 147(3) of Schedule 1 to this Act).

Section 400: Non-qualifying distributions

1618. This section is based on section 233(1) of ICTA and applies when a person receives a non-qualifying distribution.

1619. A non-qualifying distribution is defined as any distribution which is not a qualifying distribution (see *subsection (6)*). A qualifying distribution is defined in section 14(2) of ICTA. Broadly, a non-qualifying distribution is an issue of redeemable share capital (unless the share capital is taxed as a stock dividend) or of securities in respect of shares or securities of the issuing company otherwise than wholly for new consideration. A non-qualifying distribution does not carry a tax credit.

1620. *Subsection (2)* treats the recipient of the non-qualifying distribution as having paid income tax at the dividend ordinary rate (Schedule F ordinary rate in the source legislation) on the actual amount of the non-qualifying distribution (that is, there is no grossing up).

1621. The words "not being a company resident in the United Kingdom" in section 233(1) of ICTA create similar difficulties to those in sections 231(3) and 233(1A) of ICTA. See *Change 84* in Annex 1.

1622. *Subsections (4)* and *(5)* are based on section 233(1B) of ICTA. In the case of trustees of accumulation or discretionary trusts, the trustees are taxed on the amount or value of the distribution at the dividend trust rate (Schedule F trust rate in the source legislation). However, the trustees' tax liability is reduced by an amount of income tax equivalent to the dividend ordinary rate (Schedule F ordinary rate in the source legislation).

Section 401: Relief: qualifying distribution after linked non-qualifying distribution

1623. This section is based on section 233(2) of ICTA.

1624. A non-qualifying distribution is generally the first part of an event that will eventually be a qualifying distribution. So the issue of redeemable share capital (unless a stock dividend) is a non-qualifying distribution (see section 14(2)(a) of ICTA) but the repayment of that share capital is a qualifying distribution. So section 233(2) of ICTA provides relief to avoid double taxation for higher rate taxpayers.

1625. The section applies where a taxpayer pays income tax at the dividend upper rate (Schedule F upper rate in the source legislation) on the receipt of a non-qualifying distribution and is liable to income tax at the dividend upper rate (Schedule F upper rate in the source legislation) on the receipt of the linked qualifying distribution. *Subsection (1)* enables a taxpayer to set his or her extra tax liability (ie, the higher rate element) arising on the non-qualifying distribution against the extra liability arising on the qualifying distribution so that the taxpayer is only liable to pay the balance.

1626. *Subsections (5)* and *(6)* explain how the extra liability is calculated in earlier tax years (because the rates at which higher rate taxpayers have paid tax have changed over the years).

Chapter 4: Dividends from non-UK resident companies

Overview

1627. This Chapter introduces a separate charge to income tax on dividends from companies not resident in the United Kingdom.

1628. Under section 18(3) of ICTA, there are no individual charges according to types of income within the Schedule D Case IV or V charge. But the system of identifying and classifying income by Schedule and Case has been replaced in this Act by individual charges on types of income.

1629. Income which, under the source legislation, is charged to tax under Schedule D Cases IV or V, has, where appropriate, been fully integrated with the equivalent income arising from a UK source. In the case of dividends from non-UK resident companies there is no exact equivalent in terms of UK source income. The closest equivalent is the charge to tax on dividends and other distributions from UK resident companies (section 20 of ICTA, Schedule F in the source legislation). But there is no precise overlap. The UK charge, by the adoption of the definition of "distribution" from Part 6 of ICTA (see the commentary on Chapter 3 of Part 4 of this Act) can include dividends or distributions of a capital nature and can also operate to convert payments that would otherwise be treated as interest into distributions. Any charge on distributions from non-UK resident companies must be confined to income only. For this reason (and also because the basis of assessment is different – see the commentary on section 403 elow), it is not thought appropriate to integrate the charges. So a separate charge is needed to cover dividends from non-UK resident companies.

Section 402: Charge to tax on dividends from non-UK resident companies

1630. This section charges to tax dividends of companies not resident in the United Kingdom. It is based on section 18(1) and (3) of ICTA.

1631. For the reasons explained in the overview, the expression "distribution" has not been adopted. It is possible that a non-UK resident company may make a distribution of income which would not fall within Chapter 4 of Part 4 of this Act because it is not a "dividend". But if the distribution comprises income it will fall to be dealt with either under alternative specific charges (eg interest) or within "income not otherwise charged", the charge on which appears in Chapter 8 of Part 5 of this Act.

1632. The term "dividend" is not defined in this Act. "Dividend" is a widely used and understood term and is defined only in very specific circumstances not applicable in this context (see, for example, section 49 of ICTA – dividends held in the name of Treasury). It is not thought appropriate to attempt to define "dividend" here. It will usually be a matter of referring to the relevant company law to determine whether or not a payment made by a company is a dividend.

1633. *Subsection (2)* highlights an exemption from income tax for dividends paid under approved share incentive plans ("SIPs") and *subsection (3)* signposts section 498 of ITEPA. See further the commentary on the SIPs legislation in Chapter 3 of Part 4 of this Act and Chapter 9 of Part 6 of this Act (particularly the commentary on section 770 of this Act).

1634. *Subsection (4)* ensures that dividends of a capital nature do not fall within the charge to tax under this Chapter. In determining whether a payment is income in nature, it is necessary (as it is under the source legislation) to analyse the payment under local law (see CIR v Trustees of Joseph Reid (dec'd) (1949), 30 TC 431 HL and Rae v Lazard Investment Co Ltd (1963), 41 TC 1 HL). Whiteman on Income Tax, Third Edition, on page 1107, comments in this context "the proper test in such circumstances is, applying the local law, whether or not the corpus of the asset is left intact after the distribution. If it is not, the receipt will be a capital receipt; if it is, the payment will be chargeable".

Section 403: Income charged

1635. This section sets out the amount charged to tax and is based on section 65(1) of ICTA.

1636. *Subsection (1)* charges tax on the full amount of the dividends arising in the tax year. The term "arising" has been retained (see the commentary on income charged in Chapter 2 of Part 4 of this Act). The arising basis is different from the paid basis which applies to the charge to tax on dividends and other distributions from UK resident companies (for a discussion of the paid basis see the commentary on Chapter 3 of Part 4 of this Act) and, given they do not mean exactly the same, "paid" has not been used in this context.

1637. *Subsection (2)* makes the basis of assessment in subsection (1) subject to the SIPs rules and Part 8 of this Act. Part 8 contains the special rules which apply to foreign income (see further the commentary on Part 8 of this Act).

Section 404: Person liable

1638. This section states who is liable for any tax and is based on section 59(1) of ICTA.

Section 405: SIP shares: introduction

1639. This section and the following three sections are based on sections 68A to 68B of ICTA which were inserted into ICTA by ITEPA. They are part of the SIPs code. See also the commentary on the SIPs legislation in Chapter 3 of Part 4 of this Act.

1640. This section introduces the special rules about charges to tax on SIP dividends.

1641. *Subsection (2)* provides that sections 406 to 408 apply only if the participant has benefited from the tax advantages of an approved SIP. Those tax advantages will only apply to an individual who is chargeable to tax under Part 2 of ITEPA in respect of eligible employment, or, in the case of shares awarded before ITEPA came into force, under Schedule E.

Section 406: Later charge where cash dividends retained in SIPs are paid over

1642. This section is based on section 68B of ICTA.

1643. SIP trustees may only retain a cash dividend and carry it forward for three years from the date the dividend is paid by the company. Any amount not reinvested must be paid to the participant if the participant ceases to be in "relevant employment" or if a termination notice is issued in respect of the plan (see paragraph 68(4) of Schedule 2 to ITEPA).

1644. This section makes provision about amounts so paid over.

1645. The definition of "foreign cash dividend" in section 68C of ICTA suggests that it is the date that the company originally paid the dividend that determines whether the tax charge falls under Schedule F or Schedule D Case V in the source legislation. This is rewritten in *subsection (5)*.

Section 407: Dividend payment when dividend shares cease to be subject to SIP

1646. This section is based on section 68B(2) of ICTA and applies if the dividend shares acquired with the cash dividend cease to be subject to the approved SIP within three years of acquisition.

Section 408: Reduction in tax due in cases within 407

1647. This section is based on section 68B(3) of ICTA. *Subsection (1)* provides that the section applies if the participant has paid tax in respect of any capital receipts received in connection with the holding of the dividend shares which cease to be subject to the approved SIP.

1648. *Subsection (2)* operates to reduce the amount of tax otherwise due under Chapter 4 of Part 4 of this Act by an amount equal to the tax paid on the capital receipts.

Chapter 5: Stock dividends from UK resident companies

Overview

1649. This Chapter deals with the charge to income tax on stock dividend income.

1650. "Stock dividend" is a term often given to particular form of dividend made by a UK resident company which is subject to a particular charge to income tax.

1651. A bonus issue of non-redeemable shares by a company is not a distribution (see, for example, CIR v Blott (1921), 8 TC 101 HL, CIR v Fisher's Executors (1926), 10 TC 302 HL, and CIR v Wright (1926), 11 TC 181 CA). Without any special provision it would not have any income tax consequences for the shareholder.

1652. A bonus issue of redeemable shares, however, is a distribution (see section 209(2)(c) of ICTA). Without any special provision it would be charged to tax under the source legislation under Schedule F. However, there is a special provision – the charge to tax on stock dividends under section 249 of ICTA. And, under section 230 of ICTA, anything that is a stock dividend:

- is not a distribution for Schedule F purposes;
- is not treated as a distribution for the purposes of section 210 of ICTA (repayment of share capital followed by bonus issue); and
- does not count as a bonus issue for the purposes of section 211 of ICTA (bonus issue followed by repayment).

1653. In this Chapter, the term "stock dividend income" is defined by reference to the issue of the share capital by a UK resident company in two circumstances. These circumstances are set out in section 249(1) and (2) of ICTA. These subsections are not rewritten in this Act because of their relevance to corporation tax.

1654. The first circumstance is where share capital is issued as a result of the shareholder exercising an option to choose whether to receive an ordinary cash dividend or additional share capital (section 249(1)(a) of ICTA).

1655. The second circumstance is where the company issues "bonus share capital" in respect of shares which, under their terms (whether original or otherwise), carry the right to bonus share capital (section 249(1)(b) and (2) of ICTA). (This is distinct from a bonus issue which arises from a specific resolution and not from the terms of the shares themselves.)

1656. Section 249(7) of ICTA is spent and is therefore repealed by this Act. Subsections (8) and (9) of section 249 of ICTA are open-ended and so have been retained in ICTA (but are amended by paragraph 119(4) and (5) of Schedule 1 to this Act).

Section 409: Charge to tax on stock dividend income

1657. This section charges stock dividend income to tax. It is based on section 249 of ICTA.

Section 410: When stock dividend income arises

1658. This section explains when and to whom stock dividend income is treated as arising. It is based on section 249(4) to (6) of ICTA.

1659. If stock dividends are issued to personal representatives during the administration period, stock dividend income is treated as arising (see *subsection (4)*) but that income is not taxed under Chapter 5 of this Part. Instead, that income forms part of the aggregate income of the estate for the purposes of Chapter 6 of Part 5 of this Act or section 701(8) of ICTA. "Personal representatives" is defined in section 878 of this Act.

Section 411: Income charged

1660. This section sets out the amount charged to tax and is based on section 249(4) and (6) of ICTA.

1661. *Subsection (2)* defines the amount charged to tax. It is the cash equivalent of the stock dividends issued (see section 412) grossed up at the dividend ordinary rate (the Schedule F ordinary rate in the source legislation). For the meaning of "grossing up" see section 877 and the commentary on that section.

Section 412: Cash equivalent of share capital

1662. This section explains how to calculate the cash equivalent of the stock dividend (in other words the net amount of the stock dividend income to be grossed up). It is based on section 251 of ICTA. This section also rewrites part of Statement of Practice A8.

1663. The source legislation is complex, particularly where the stock dividend is bonus share capital. Section 412 simplifies the rules for both types of stock dividend (ie, stock dividends in lieu of cash dividends and bonus share capital). See *Change 85* in Annex 1.

1664. *Subsection (1)* deals with stock dividends within section 249(1)(a) of ICTA – an issue of share capital in lieu of a cash dividend. The cash equivalent of such share capital is the amount of the cash dividend alternative unless subsection (2) applies.

1665. *Subsection (2)* applies if the difference between the cash dividend alternative and the share capital's market value equals or exceeds 15% of that market value. In that case, the cash equivalent is not the amount of the cash dividend alternative but rather the market value of the share capital.

1666. *Subsection (3)* deals with stock dividends within section 249(1)(b) of ICTA - bonus share capital. The cash equivalent of such share capital is its market value.

1667. Section 251(2)(a)(ii) and (4) of ICTA have been omitted, making the rule relating to bonus share capital more straightforward. See *Change 85* in Annex 1.

1668. *Subsection (4)* specifies the date on which the "market value" is to be taken for the purposes of these provisions. It is based on section 251(2) and (3) of ICTA.

1669. *Subsection (5)* gives definitions for "listed" and "market value". Section 251(3) of ICTA includes more complicated references to the relevant provisions in TCGA. Subsection (5) instead simply imports the definition of "market value" in sections 272 to 273 of TCGA save for subsection (2) of section 272 of TCGA.

Section 413: Person liable

1670. This section states who is liable for any tax charged and is based on section 249(4) to (6) of ICTA.

1671. *Subsection (2)* deals with individuals who are beneficially entitled to the stock dividend income. Such individuals could include outright owners, a beneficiary of a bare trust or one with an interest in possession, or the beneficial owner under a nominee arrangement.

1672. *Subsection (3)* indicates that the trustees of an accumulation and discretionary trust are the persons liable if:

- stock dividends are issued to them; and

- had the trustees been paid a cash dividend in respect of the shares, any of that cash dividend would be income to which section 686 of ICTA applies (accumulation and discretionary trusts: special rates of tax).

1673. *Subsection (4)* deals with stock dividend income arising to personal representatives during the administration of a deceased person's estate. As personal representatives are not charged to tax under Chapter 5 of this Part they are not "persons liable". This means that they are not treated as having paid income tax under section 414 but see further the commentary on section 680.

1674. *Subsections (5)* and *(6)* deal with joint ownership of share capital and are based on section 249(3) of ICTA.

Section 414: Income tax treated as paid

1675. This section explains how a person's income tax liability is satisfied (in whole or in part). It is based on section 249(4) and (6) of ICTA.

1676. Under *subsection (1)*, the taxpayer is treated as having paid income tax at the dividend ordinary rate (Schedule F ordinary rate in the source legislation) on the amount charged to tax. The words "and where trustees are so liable … the income is treated as if it were chargeable to tax at that rate" are based on section 249(6)(b) of ICTA and have been retained because they were considered significant in Howell and another v Trippier 2004[14] EWCA Civ 885.

1677. *Subsection (2)* provides that the tax treated as paid is not repayable. This applies even if the person liable is a non-taxpayer.

1678. *Subsections (3)* to *(5)* ensure that individual taxpayers cannot be given credit for income tax on more than the amount charged to income tax. So, for example, if the individual's total income is reduced by deductions (for example, personal allowances) such that the stock dividend income is only partially brought into charge to tax, credit will only be given for so much of the stock dividend income as is so taxed.

1679. Section 249(4)(c) of ICTA deals with tax rates and treats the stock dividend income as not brought into charge to tax for the purposes of sections 348 and 349 of ICTA. Section 249(4)(c) of ICTA is not rewritten in this Chapter. But rather than leaving it "stranded" in section 249 of ICTA, it is rewritten in amendments to sections 1A and 348 and 349 of ICTA (see paragraphs 3 and 147(3) of Schedule 1 to this Act respectively).

Chapter 6: Release of loan to participator in close company

Section 415: Charge to tax under Chapter 6

1680. This section is based on sections 421(1) and 422(5) and (6) of ICTA. It imposes a charge to tax if a close company lends money to a participator and subsequently releases or writes off all or part of the debt.

1681. "Close company" and "participator" are defined in the interpretative provisions of Part 6 of ICTA (see sections 414 and 417 of that Act). Broadly, a close company is a UK resident company controlled by five or fewer participators (or any number of participators who are also directors of the company). A UK resident company may also be close if on the winding-up of the company more than half of the assets of the company would be distributed to five or fewer participators (or any number of participators who are also directors of the company). "Participator" is given a very wide meaning and includes any person having a share or interest in the capital or income of the company.

14 STC [2004] 1245

1682. *Subsection (1)* sets out the circumstances giving rise to the charge to tax. The expressions “releases”, “writes off”, “debt”, “loan” and “advance” have been preserved from the source legislation. There is no compelling reason to change any of these words and they need to be preserved to maintain the link with section 419 of ICTA.

1683. The tax charge under subsection (1) is subject to section 418 (see*subsection (2)*). This prevents double taxation under this Chapter and Chapter 5 of Part 5 of this Act.

1684. *Subsections (3)* and *(4)* rewrite section 422(5) and (6) of ICTA. If a loan is made by a company (“B”) which is controlled by a close company (“A”), in circumstances where section 419 of ICTA would not otherwise apply, section 422(1) of ICTA treats the loan as made by A (so section 419 of ICTA applies). If B releases or writes off the loan, section 422(5) of ICTA effectively treats A as having released or written off the loan (so section 421 of ICTA applies). Further, section 419(2) of ICTA gives “loan” an extended meaning. So, if a person incurs a debt to a close company or a debt due from a person to a third party is assigned to a close company, the close company is treated as having made a loan. This extended meaning of loan is applied to B by section 422(6) of ICTA.

Section 416: Income charged

1685. This section sets out the amount charged to tax and is based on section 421(1) of ICTA.

Section 417: Person liable

1686. This section states who is liable for any tax charged.

1687. *Subsection (1)* explains that it is the person to whom the loan or advance was made unless that person has died or the loan or advance was made to trustees of a trust which has come to an end (*subsection (2)*).

1688. There is no reference, here or in the source legislation, to the position where the burden of the debt has been passed to a third party. This is because it is not possible in law for a debtor to assign a debt. Any transfer of debt must be made by way of novation, which would involve the existing debtor being released from the debt and the new debtor taking on a new debt. In such a case, therefore, a charge to tax under section 421 of ICTA would arise on the release of the existing debtor. The interpretation is based on the cases of Collins v Addies and Greenfield v Bains (1992), 65 TC 190 CA[15].

Section 418: Relief where borrowers liable as settlors

1689. This section is based on sections 421(3) and 677(3) of ICTA. Together these provisions prevent double taxation on the release or writing off of a loan where a sum in respect of the loan is treated as the borrower’s income in his or her capacity as settlor of a settlement.

1690. Section 677 of ICTA charges a settlor to income tax where the trustees of the settlement directly or indirectly make a capital payment to the settlor. A charge to income tax is only made if, and to the extent that, the payment can be matched against income retained within the settlement.

1691. So, it is possible that in respect of a particular tax year the borrower is liable to income tax in his or her capacity as settlor on a sum in respect of a loan and is also liable to tax under section 421 of ICTA in respect of amounts released or written off. Likewise, it is possible that the borrower has been liable to income tax in an earlier tax year in his or her capacity as settlor on a sum in respect of a loan or under section 421 of ICTA in respect of amounts released or written off.

1692. Section 421(3) of ICTA provides relief for sums which fall to be included as income under section 677 of ICTA. It suggests that section 677 of ICTA takes precedence:

15 STC [1991] 445; STC [1992] 746

"This section shall not have effect in relation to a loan or advance made to a person if any sum falls in respect of the loan or advance to be included in his income by virtue of section 677, except so far as the amount released or written off exceeds the sums previously falling to be so included (without the addition for income tax provided for by subsection (6) of that section).

1693. But section 677(3) of ICTA provides:

"Where any amount is included in a person's income by virtue of section 421 in respect of any loan or advance, there shall be a corresponding reduction in the amount (if any) afterwards falling to be so included in respect of it by virtue of this section.

1694. This suggests that section 421 of ICTA takes precedence.

1695. The purpose of these provisions (which were introduced in the same Finance Act) is to prevent the same sum being taxed both under section 421 of ICTA and section 677 of ICTA. It is believed that "afterwards falling to be so included" in section 677(3) of ICTA is a reference to later tax years. So, for the purposes of section 677 of ICTA amounts charged in earlier tax years under section 421 of ICTA will be taken into account, but within the same tax year section 677 of ICTA will take precedence. This would mean that "previously falling to be so included" in section 421(3) of ICTA would include amounts charged to tax under section 677 of ICTA in the same and earlier tax years.

1696. So section 418:

- makes it clear that section 677 of ICTA (rewritten as section 633 of this Act) takes precedence over section 421 of ICTA; and
- ensures that the same sum is not taxed twice.

1697. *Subsections (2)* to *(6)* set out the steps to be taken to determine whether tax is charged under section 415. In particular, subsections (2) and (3) require the "total amount previously charged" (that is, sums taxed under section 633 of this Act either in previous tax years or in the same tax year and amounts taxed under this Chapter) to be compared with the "total amount released". Only if the total amount released exceeds the total amount previously charged, is tax charged under this Chapter.

1698. Any amount that is charged to tax under section 415 is grossed up at the dividend ordinary rate (Schedule F ordinary rate in the source legislation) in the usual way (see subsection (3)).

1699. Subsection (5) provides that, when calculating the amount that has already been charged under section 633of this Act, only the net amount is taken into account, not the amount produced by the grossing up required under section 640(1) of this Act.

Section 419: Loans and advances to persons who die

1700. This section deals with who is liable for any tax charged where the original debtor has died and the loan is released or written off during the administration of the estate, or at some later point. It is based on section 421(2) of ICTA.

1701. If the conditions in *subsection (1)* are met, s*ubsection (2)* confirms that there is no charge under section 415. Instead, the amount that would have been charged under that section is treated as forming part of the aggregate income of the estate and may be charged under Chapter 6 of Part 5 of this Act or section 701(8) of ICTA.

1702. If subsection (2) does not apply,*subsection (3)* will (so that tax is charged under this Chapter).

Section 420: Loans and advances to trustees of trusts that have ended

1703. This section is based on section 421(2) of ICTA and applies where a loan has been made to trustees of a trust and the loan is released or written off after the trust has come to an end.

Section 421: Income tax treated as paid

1704. This section explains how a person's income tax liability is satisfied (in whole or in part). It is based on section 421(1)(b) of ICTA.

1705. Under *subsection (1)*, the person liable is treated as having paid income tax at the dividend ordinary rate (Schedule F ordinary rate in the source legislation) on the gross amount released or written off.

1706. If the debt is released or written off during the administration of a deceased person's estate, the personal representatives are not charged to tax under this Chapter but the amount of income that would otherwise be so charged forms part of the aggregate income of the estate for the purposes of Chapter 6 of Part 5 of this Act or section 701(8) of ICTA. As personal representatives are not charged to tax under this Chapter they are not "persons liable". This means that they are not treated as having paid income tax under this section (but see the commentary on section 680). "Personal representatives" is defined in section 878 of this Act.

1707. *Subsection (2)* provides that the tax treated as paid is not repayable. This applies even if the person is a non-taxpayer.

1708. *Subsections (3)*, *(4)* and *(5)* ensure that an individual cannot be given credit for income tax on more than the amount of the loan released or written off which is charged to tax.

1709. Section 421(1)(c) of ICTA deals with tax rates and treats the amount charged to tax as not brought into charge to tax for the purposes of sections 348 and 349 of ICTA. Section 421(1)(c) of ICTA is not rewritten in this Chapter. But rather than leaving it "stranded" in section 421 of ICTA it is rewritten in amendments to sections 1A of ICTA and 348 and 349 of ICTA (see paragraphs 3 and 147(3) of Schedule 1 to this Act respectively).

Chapter 7: Purchased Life Annuity Payments

Overview

1710. Annuity payments made under a purchased life annuity are annual payments and taxable under the source legislation by section 18 of ICTA under Schedule D Case III or Case V. However, because of the special exemption that applies to payments made under a purchased life annuity (see the commentary on Chapter 7 of Part 6 of this Act) and because such payments are generally regarded as investment income, a specific charge has been carved out of the residual annual payments charge (which is in Chapter 7 of Part 5 of this Act).

1711. In line with the approach of bringing together all exemptions in one Part, the exemption for part of the purchased life annuity payment is in Chapter 7 of Part 6 of this Act.

Section 422: Charge to tax on purchased life annuity payments

1712. This section is based on section 18(1) and Schedule D Case III and Case V in section 18(3) of ICTA. It charges to tax annuity payments made under a purchased life annuity.

Section 423: Meaning of "purchased life annuity"

1713. This section rewrites the definition of "purchased life annuity" in section 657(1) of ICTA.

Section 424: Income charged

1714. Section 424 sets out the amount charged to tax on annuity payments and is based on section 64 and section 65(1) of ICTA. The amount charged may be reduced if the exemption in section 717 (exemption for part of purchased life annuity payments) applies.

1715. The words “without any deduction” in section 64 of ICTA have not been reproduced. They are considered unnecessary. There are no provisions in the source legislation allowing deductions from Schedule D Case III income and one of the defining characteristics of an annual payment is that it represents pure income profit in the hands of the recipient. See further the commentary on section 370. In the case of annuity payments arising from a source outside the United Kingdom, *subsection (2)* makes *subsection (1)* subject to the special rules for foreign income in Part 8 of this Act (see further the commentary on Part 8).

Section 425: Person liable

1716. This section is based on section 59(1) of ICTA and states who is liable for any tax charged. The phrase “receiving or entitled to” has been retained because it is generally understood and has been widely interpreted by the courts. See further the commentary on section 371.

Section 426: Annuity payments received after deduction of tax

1717. This section provides that if income tax has been deducted by the payer of the annuity, the recipient is treated as having paid that income tax. It is based on section 348(1)(d) of ICTA and case law.

1718. The policy has been adopted that only those tax deduction rules which both relate to the recipient and to amounts of tax treated as paid, will be rewritten in this Act. So, section 348(1)(c) of ICTA, for example, is not rewritten.

1719. Under section 348(1)(d) of ICTA, tax deducted from annual payments under section 348(1)(b) of ICTA is treated as paid by the recipient. Case law extends this proposition to tax deducted under sections 348(2) and 349 of ICTA. This section fills the legislative gap otherwise filled by case law.

1720. Section 348(1) of ICTA deals with annual payments within Schedule D Case III (other than interest) which are payable wholly out of profits or gains brought into charge to income tax. Under section 348(1)(b) of ICTA the payer is entitled, but not obliged, to deduct and retain out of the annual payment a sum representing income tax. Under section 348(1)(c) of ICTA the recipient has to allow the tax to be deducted by the payer. The recipient is charged to tax on the full amount of the payment (that is, the actual payment received plus the tax deducted) but is treated as having paid income tax equal to the amount of the sum deducted (see section 348(1)(d) of ICTA).

1721. Sections 348(2) and 349 of ICTA provide for certain other payments also to be made after deduction of tax, but there is no equivalent provision to say that the tax deducted should be treated as tax paid by the recipient. Various tax cases, however, extend the effect of section 348(1)(d) of ICTA to these provisions.

1722. In Allchin v Corporation of South Shields (1943), 25 TC 445 HL, Viscount Simon LC said (on page 461):

“If and in so far as the annual payment is not payable and paid out of profits or gains brought into charge, the person making the payment is bound to deduct from it Income Tax at the current rate and to account to the Crown for the amount deducted. In effect, the payer in such a case acts as collector for the Crown of the tax due from the recipient. The requirement that the recipient must allow the deduction and treat the payer as acquitted of liability in respect of this amount is not repeated in Rule 21, but must be implied.

1723. The final sentence quoted clearly follows the text of section 348(1)(c) of ICTA and effectively extends it to section 349 cases. The words of section 348(1)(d) of ICTA are not mentioned but the obiter words, "In effect, the payer in such a case acts as collector for the Crown of the tax due from the recipient", amount to the same thing because it follows from them that once deduction has occurred, the recipient has paid his or her tax.

1724. In Stokes v Bennett (1953), 34 TC 337 HC, a divorced wife received maintenance payments, "free of tax", under a UK court order from her former husband who was not resident in the United Kingdom. There was no evidence that tax was deducted from the payments and no such tax was accounted for to the Inland Revenue. Also, there was no evidence that the husband received income which was subject to UK income tax. The wife was taxed under Schedule D Case III on the amounts received.

1725. It was held in the High Court, however, that the wife should be treated as having received sums from which tax had been deducted and no further assessments could therefore be made. As the order was for an amount to be paid "free of tax", and because the husband had paid the same amounts as the free of tax amounts (rather than the grossed up amounts), the court thought that the correct inference was that he had deducted tax.

1726. As there was no evidence that the payments were out of taxed income, it was a case within what is now section 349 of ICTA, rather than section 348 of ICTA. Deduction of tax was presumed to have occurred and Lord Simon's dicta from Allchin v Corporation of South Shields were applied so that the requirement that the recipient must allow the deduction and treat the payer as acquitted of his liability had to be implied. It followed that the wife could not sue her husband for the tax because she would be met with the defence that he was acquitted of his liability. Therefore the wife fell to be treated as the recipient of an amount that had borne tax. Collection of the tax was a matter between the payer and the Crown. The husband had become in effect an agent for the Crown, as the collector for the Crown of the tax due from (and in effect paid by) the wife. This is tantamount to the provision in section 348(1)(d) of ICTA.

1727. Section 349 of ICTA is regarded as applying to annual payments made under United Kingdom court orders etc not wholly out of profits or gains bought into charge to income tax even where the payer is not UK resident.

1728. In Grosvenor Place Estates Ltd v Roberts (1960), 39 TC 433 CA, the National Coal Board failed to deduct tax from certain payments which were not made out of profits or gains brought into charge to tax. The recipient company was taxed on the full amount of the payments. On appeal the company contended that as the National Coal Board was obliged to deduct tax no assessment could be made on the recipient. It was held, however, that the recipient could be assessed to tax where the payer failed to deduct tax, notwithstanding the express rights of the Inland Revenue to assess the payer. Donovan LJ said (on page 453):

"The power and duty of the General Commissioners to make assessments upon annual payments charged with tax under Schedule D where such payments are made out of profits or gains not brought into charge to tax still remains. This does not involve liability to double taxation, once by deduction at source and again by assessment upon the same income. It is true there is nothing in the Act expressly prohibiting such an injustice, but the prohibition is implicit in its provisions, as the Courts have frequently said.

1729. In effect this means that section 349 of ICTA impliedly contains the provision in section 348(1)(d) of ICTA, that the deduction is treated as tax paid by the payee.

Chapter 8: Profits from deeply discounted securities

Overview

1730. This Chapter rewrites the provisions in Schedule 13 to FA 1996 that deal with "relevant discounted securities". FA 2003 introduced various changes to Schedule 13, principally repealing reliefs for losses and allowances for expenditure, but with transitional rules for securities held since before 27 March 2003. Since these losses and allowances continue to apply for securities held since that date it was considered more helpful to set out the law relating to them in this Chapter rather than relegate them to Schedule 2 to this Act.

Section 427: Charge to tax on profits from deeply discounted securities

1731. This section charges to tax profits on deeply discounted securities which arise when the security is disposed of (for whatever reason) or, in certain circumstances, is treated as being disposed of. It also ensures that gains which would not otherwise be income are treated as such. The section is based on paragraph 1 of Schedule 13 to FA 1996.

1732. Although Schedule 13 to FA 1996 refers to a "relevant discounted security", this Act uses the term "deeply discounted security". This seems a more appropriate term to reflect both the nature of the security and the nature of the tax charge while distinguishing this regime from the "deep gain securities" regime of Schedule 11 to FA 1989.

Section 428: Income charged

1733. This section sets out the amount charged to tax on profits that arise on a disposal of securities that are within or outside the United Kingdom. It is based on sections 64, 65 and 68 of ICTA and on paragraph 1 of Schedule 13 to FA 1996.

1734. Paragraph 1(1) of Schedule 13 to FA 1996 provides that profits arising from a security out of the United Kingdom are chargeable under Schedule D Case IV. This allows the assessment rules for Case IV income in section 65 of ICTA to apply.

1735. *Subsection (3)(a)* treats such profits as arising from a source outside the United Kingdom. This links to the definition of "relevant foreign income" in section 830, thus attracting the special rules for such income in Part 8 of this Act.

1736. *Subsection (3)(b)* then makes the rule in *subsection (1)* subject to the rules in Part 8 of this Act for such profits.

Section 429: Person liable

1737. This section states who is liable for any tax charged. It is based on paragraph 1 of Schedule 13 to FA 1996.

Section 430: Meaning of "deeply discounted security"

1738. This section provides a general definition of "deeply discounted security" for the purposes of Chapter 8. It is based on paragraph 3 of Schedule 13 to FA 1996.

1739. The main test to identify relevant discounted securities is spread over paragraph 3(1), (3) and (4) of Schedule 13 to FA 1996. The test compares the amount payable on redemption with the issue price of the security to see whether, under its terms of issue, it is capable of yielding a "deep discount" on redemption.

1740. A security is capable of yielding a "deep discount" if the amount payable on redemption could exceed the issue price by more than a specified percentage of the amount payable on redemption. In the rare case where the security has an expected life of 30 years or more, the percentage specified is 15%. In all other cases the percentage specified is equal to half the number of years between the date of issue and the date of redemption.

1741. This means that a deep discount occurs where the amount payable on redemption could exceed the issue price and the potential difference amounts to more than 0.5% of the amount payable on redemption for each year of the security's life. For example, a five year bond issued for £90 and redeemable for £100 is a deeply discounted security because the discount is more than the specified 2.5% (that is, 0.5% for each year of the bond's life). This is expressed in s*ubsection (1)* by means of a formula.

Section 431: Excluded occasions of redemption

1742. This section exempts from the charge under this Chapter certain securities which were not issued to gain a tax advantage and where redemption is not within the power of the holder. It is based on paragraph 3 of Schedule 13 to FA 1996.

1743. Under section 430(1) the test for a deep discount can be applied on maturity or any possible occasion of redemption. Those occasions of redemption are ignored if the conditions in subsection (2) or (3) of this section are met.

1744. In *subsection (2)* the conditions in paragraphs 3(1A) and 3(1C) of Schedule 13 to FA 1996 have been amalgamated and renamed "the third-party option conditions". These apply where the achieving of a tax advantage (defined in section 460(2)) is not a main benefit and the security is issued to a person who is not connected with the issuer (see *subsection (7)* and section 878(5) of this Act) and is not redeemable by the holder.

1745. *Subsection (3)* provides the second conditions which have been renamed "the commercial protection conditions". These exempt from charge securities which can only be redeemed as the result of an event which in practice is likely to be outside the power of the holder and which could not have been anticipated when the securities were issued.

1746. Under *subsection (4)* neither of these two sets of conditions is considered as met simply because an occasion of redemption happens to takes place coincidentally at the same time that one of these sets is met.

1747. For the "third-party option conditions" to apply the security must be issued to a person who is not connected with the issuer. *Subsection (5)* provides that where those conditions are met but the security is then acquired by a connected person (or the holder becomes such a person) the conditions will cease to apply.

1748. *Subsection (6)* deals with the reverse of the condition provided for in subsection (5). Where a person who is not connected with the issuer acquires a security which fails to satisfy the "third-party option conditions" only because it was issued to a person connected with the issuer, then it ceases to be a deeply discounted security from that date. This subsection also applies where a security which is a deeply discounted security as a result of subsection (5) is acquired.

Section 432: Securities which are not deeply discounted securities

1749. This section excludes certain specified securities from the scope of the general definition of deeply discounted security in section 430. It is based on paragraph 3 of Schedule 13 to FA 1996.

Section 433: Meaning of "excluded indexed security"

1750. This section explains what is meant by an "excluded indexed security" referred to in the previous section. It is based on paragraph 13 of Schedule 13 to FA 1996.

1751. *Subsection (1)* explains that a security is an "excluded indexed security" if the amount payable on redemption depends on any future change in the value of certain assets or on the change in an index of the value of certain assets.

1752. Some securities provide for the investor to get back a percentage of his or her original investment if the value of the assets (or the index) fails to rise to a certain level. This will not prevent the security being a deeply discounted security provided the specified percentage is not more than 10% of the issue price (*subsection (2)*). This means that if £100 is invested the investor must get no more than £10 back, losing the other £90. Unless the investor can lose 90% of the original investment it is not an excluded indexed security but a deeply discounted security.

1753. *Subsection (3)* ensures that interest on redemption is ignored in the calculation under this section. It is clear that this is the intention of the legislation from the fact that paragraph 3(2)(c) of Schedule 13 to FA 1996 takes excluded indexed securities outside the definition of deeply discounted securities and that paragraph 3(6) of that Schedule (rewritten in section 430(4)) excludes interest from the general calculation of deep discounts.

1754. *Subsection (4)* defines "redemption period" for the purpose of this test. This definition differs from the one for the deeply discounted security test in section 430 to allow flexibility for the chargeable assets referred to in subsection (1) to be valued on dates other than, but close to, the issue and redemption dates. Likewise, an index of the value of chargeable assets may not be computed for the actual issue and redemption dates and some approximation is required.

1755. *Subsection (5)* defines "chargeable asset" for the purpose of this test. The underlying premise is that where the disposal of the asset whose value is linked to the security would be within the scope of capital gains tax, then disposals of securities fully linked to the value of such assets should also be subject to capital gains tax and excluded from the income tax regime.

1756. "Chargeable asset" is defined, in paragraph 13(6) of Schedule 13 to FA 1996, as an asset which on disposal can give rise to a chargeable gain for the purposes of TCGA. In order to make this test work it is necessary to make some assumptions about the asset (found in paragraph 13(7) of that Schedule) and these are set out in *subsection (6)*. Section 100 of TCGA applies mainly for corporation tax purposes and unauthorised unit trusts are the only persons liable to income tax benefiting from subsection (6)(b).

Section 434: Securities issued in separate tranches: preliminary

1757. This section introduces two special rules for determining whether securities issued in tranches under a single prospectus are deeply discounted securities. The first rule is called "the basic rule" and the second rule "the nominal value rule". Broadly, where securities are issued in tranches under a single prospectus, either all of them are treated as deeply discounted securities or none of them is. The section is based on paragraphs 3 and 10 of Schedule 13 to FA 1996.

1758. *Subsection (2)* explains that following an initial issue of deeply discounted securities under a prospectus the nominal value rule will not apply to any of the securities issued at any time under that prospectus but the basic rule will apply.

1759. *Subsection (3)* explains the position where, in contrast to the position in subsection (2), the original issue does not include any deeply discounted securities. In that case both rules may apply to later issues.

Section 435: Securities issued in separate tranches: basic rule

1760. This section sets out the first rule, known as the basic rule. It is based on paragraph 3 of Schedule 13 to FA 1996.

1761. *Subsection (1)* provides that if any of the securities issued under a prospectus at any time are not deeply discounted securities under section 430, then any securities issued subsequently will not be deeply discounted securities, even if they would be deeply discounted securities under that section. But this will not be the case if a security is a deeply discounted security because it is issued to a person connected with the issuer or acquired by a person who becomes so connected (see *subsection (2)*).

1762. The words "(disregarding that paragraph)" from paragraph 3(2)(f) of Schedule 13 to FA 1996 are not rewritten. They may be read in such a way as to conflict with the words "subject to paragraph 10" at the beginning of paragraph 3(2)(f) of that Schedule, which are clearly intended to prevail.

Section 436: Deeply discounted securities issued in separate tranches: nominal value rule

1763. This section sets out the second rule, known as the nominal value rule. It is based on paragraph 10 of Schedule 13 to FA 1996.

1764. *Subsection (3)* sets out the condition that must be satisfied for the rule in this section to apply. It is that the aggregate nominal value of deeply discounted securities issued after an original non-deep discount issue should exceed the aggregate nominal value of all the other securities issued under the prospectus up to that time.

1765. *Subsection (4)* provides the rule, which is that if the condition in subsection (3) is satisfied, all the securities issued under the prospectus will be treated, for the purposes of any later acquisition or disposal, as if they were deeply discounted securities when they were acquired. This applies even if the securities are not deeply discounted securities within the terms of section 430 or are not deeply discounted securities because of the application of the basic rule in section 435.

1766. *Subsections (5)* and *(6)* provide that a security is not a deeply discounted security for the purpose of applying this rule if it is only a deeply discounted security because it is issued to a person connected with the issuer or acquired by a person who becomes so connected as set out in section 435(2) and the person holding it at the relevant time is not so connected.

Section 437: Transactions which are disposals

1767. This section defines the events giving rise to the income tax charge (or loss relief) relating to deeply discounted securities. It is based on paragraphs 1, 4 and 5 of Schedule 13 to FA 1996.

1768. *Subsection (1)* brings together the occasions in Schedule 13 to FA 1996 which give rise to profits. The subsection includes occasions when someone "transfers" a deeply discounted security or "becomes entitled ... to any amount on its redemption" (paragraph 1(2) of that Schedule) and a profit is realised. It also includes the conversion of the security into shares or other securities.

1769. The essential point is that the person no longer owns the security and has realised a profit, or sustained a loss, when ownership ceases. The events giving rise to the tax charge are referred to by the section as "disposals" and all the circumstances in which a disposal occurs (apart from under the special rules applying for strips of government securities) are described in this one section.

1770. *Subsection (3)* deals with a deemed transfer of a deeply discounted security to personal representatives immediately before death, in the source legislation found in paragraph 4(2) of Schedule 13 to FA 1996. It crystallises the increase in value at the time of death. "Personal representatives" is defined in section 878(1) of this Act.

Section 438: Timing of transfers and acquisitions

1771. In most cases it is clear when a disposal occurs. But this section provides a timing rule for transfers and acquisitions where that may be less clear; for example, where the holder of a security enters into an agreement to sell the security to someone else at a future date. The section is based on paragraph 4 of Schedule 13 to FA 1996.

1772. The section provides for the security to be treated as transferred (or acquired) when the agreement for the transfer of the security is made, so long as the person receiving it becomes entitled to it at that time. Where an agreement to transfer a security is conditional, the agreement is treated as made when the condition is satisfied.

1773. The words in brackets in paragraph 4(4) of Schedule 13 to FA 1996 ("whether by the exercise of an option or otherwise") have been omitted as an unnecessary example.

Section 439: Calculating the profit from disposals

1774. This section provides the rules for computing the profit on a disposal. It is based on paragraph 1 of Schedule 13 to FA 1996.

1775. *Subsection (2)* disallows any deduction for incidental costs on acquisition or disposal of a deeply discounted security. But (*subsection (3)*) this is subject to the deductions rule in subsection (4) and the rule on securities held since 26 March 2003 in section 455.

1776. *Subsection (4)* allows a deduction from the profits on disposal for incidental expenses if incurred before 27 March 2003. The term "relevant costs" in Schedule 13 to FA 1996 has been replaced with "incidental expenses".

1777. *Subsection (5)* deals with the case where a security has been sold and re-acquired, ensuring that it is the later acquisition only that is relevant for ascertaining the profit.

Section 440: Market value disposals

1778. This section deals with the situations in which the amount payable on disposal is determined to be the market value. It is based on paragraphs 4, 6, 8 and 9 of Schedule 13 to FA 1996.

1779. In Schedule 13 to FA 1996 these rules importing market values occur in five separate paragraphs but have now been put into this one section. There are now two rules.

1780. *Subsection (1)* introduces the first rule in which the transfer of a security of a type within *subsection (2)* is treated as disposed of for an amount equal to its market value at the time of the disposal. This is subject to the second rule, in subsection (4).

1781. *Subsection (4)* is the second rule. It is a qualification of the first rule and applies for a particular type of transaction. Where a deeply discounted security is converted into shares or other securities the security is instead treated as disposed of for an amount equal to the market value of the shares or securities acquired. But this is subject to a special rule for strips which has been signposted at *subsection (5)*.

Section 441: Market value acquisitions

1782. This section deals with all the situations in which the acquisition cost of deeply discounted securities is to be determined at market value. It is based on paragraphs 4, 5, 8 and 9 of Schedule 13 to FA 1996.

1783. *Subsection (2)* provides a list of the disposals giving rise to acquisitions to which the rule in *subsection (1)* applies. The list includes the acquisition of a deeply discounted security as the result of the conversion of a security into shares or other securities – subsection (2)(b). See *Change 86* in Annex 1.

1784. Also included in subsection (2)(a) of the list is the acquisition of a security transferred to a legatee by personal representatives. See *Change 86* in Annex 1.

Section 442: Securities issued in accordance with qualifying earn-out right

1785. This section provides rules for ascertaining the acquisition value of a security which forms the whole or part of the consideration on the disposal of a business. It is based on paragraph 3A of Schedule 13 to FA 1996.

1786. This section prevents a profit on deeply discounted securities being charged to capital gains tax as well as to income tax under this Chapter. Where a right to securities to be issued at some future date is part of the consideration for the disposal of a business (an "earn-out right"), a chargeable gain will arise on the difference between the right to receive those securities and their value when issued.

1787. When the securities are eventually disposed of, a deep discount may arise on the difference between the value of the right when granted (as for the chargeable gain described above) and the disposal proceeds. But this may include the increase in value that has already been included in the computation of a chargeable gain. By making the acquisition value for the deep discount legislation the same as the disposal value of the right for capital gains tax purposes, the double counting of that proportion of the discount for income tax purposes is avoided.

1788. The provision is rewritten by providing the valuation rule for securities issued as a "qualifying earn-out right" in *subsection (2)* and then defining a "qualifying earn-out right" in *subsections (3)* to *(6)*.

Section 443: Application of this Chapter to strips of government securities

1789. This section acts as an introduction to sections providing special rules for computing profits and gains on strips of securities issued by the government of any territory. It is based on paragraph 14 of Schedule 13 to FA 1996.

Section 444: Meaning of "strip" in Chapter 8

1790. This section defines "strip" for the purposes of this Chapter. It is based on section 47 of FA 1942.

1791. FA 2003 widens the definition of "strip" for Schedule 13 to FA 1996 by including securities issued by *any* government. This applies to strips acquired after 26 March 2003. In accordance with our intention of including within Chapter 8 the rules relating to strips acquired before 27 March 2003 the previous, narrower, definition has been retained in *subsection (1)(c)*. Whether the strips fall under subsection (1)(b) or (c) the conditions set out in subsections (2) to (5) must be met.

1792. *Subsections (2) to (5)* rewrite the relevant conditions in section 47 of FA 1942. The definition in Schedule 13 to FA 1996 cross-refers to that section.

Section 445: Strips of government securities: acquisitions and disposals

1793. This section provides the rules necessary for computing profits on the disposal of government securities. It is based on paragraph 14 of Schedule 13 to FA 1996.

1794. *Subsection (1)* is the first rule. It determines, by means of a formula, the acquisition cost where a gilt-edged security which is not a strip (and therefore under section 432(1)(b) not a deeply discounted security) is "stripped". The acquisition cost of each strip is computed by apportioning the market value of the underlying security between all the strips acquired.

1795. *Subsection (2)*, which contains the second rule, deals with a deemed transaction which counts as a disposal. This is the deemed transfer, followed by immediate reacquisition under *subsection (3)*, of a strip held on 5 April.

1796. Paragraph 14(4) of Schedule 13 to FA 1996 provides for a deemed reacquisition on 6 April for the same value as the disposal on 5 April. This is rewritten as disposal and immediate reacquisition. See *Change 87* in Annex 1.

1797. See paragraph 80 of Schedule 2 to this Act for the application of this rule for 2005-06.

1798. *Subsection (5)* ensures that incidental expenses are not allowed in respect of these deemed transfers even where they were incurred before 27 March 2003.

1799. The rules in subsections (2) to (5) ensure that anyone holding a strip of a government security is taxed year by year on the increase in value of the strip. This is intended to prevent investing in strips, rather than in unstripped government securities (where interest would be taxed year by year), to defer tax liability.

1800. *Subsection (6)*, which contains the final rule, deals with the situation where two or more strips are brought together and turned into a single security. Each strip is disposed of for an amount equal to its market value on consolidation.

1801. *Subsections (7)* and *(8)* ensure that both the first and final rules take precedence over both the rule on timing and transfers in section 438 and the market value rules at sections 440(4) and 441.

Section 446: Strips of government securities: relief for losses

1802. This section allows relief for losses that arise on disposals of strips of government securities. It is based on paragraph 14A of Schedule 13 to FA 1996.

1803. *Subsection (7)* prevents a double claim for loss relief by providing that relief cannot be claimed under this section if section 454 (listed securities held since 26 March 2003: relief for losses) applies.

Section 447: Restriction of profits on strips by reference to original acquisition cost

1804. This section restricts profits to the amount by which disposal proceeds exceed the original acquisition cost. Because there is a 5 April revaluation of strips on a deemed disposal each year the cost taken into account on actual disposal is the last 5 April value. This section ensures that in such cases a profit cannot exceed the difference between the disposal proceeds and the original cost of the security. It prevents taxation of an artificial gain and is the obverse of the loss restriction in section 448. See paragraph 81 of Schedule 2 to this Act where strips are acquired before 15 January 2004. The section is based on paragraph 14D of Schedule 13 to FA 1996.

1805. *Subsection (1)* sets out when the rule in this section applies, namely when a profit would, apart from this section, arise on disposal but the market value of the strip is less than the amount paid by the person to acquire the strip, thus giving rise to a greater profit than would be the case if the market value had not replaced the cost.

1806. *Subsections (2)* and *(3)* restrict that profit to the excess of the disposal proceeds over the cost of acquisition. If there is no excess because the acquisition cost does not exceed the market value, no profit is made.

1807. *Subsections (4)* and *(5)* require that the deemed disposal on 5 April (section 445) is to be ignored in considering the original acquisition cost. Paragraph 14D(6)(b) of Schedule 13 to FA 1996, which provides that the original acquisition cost should reflect the open market value rules, is not rewritten. It is considered unnecessary given that the purpose of the open market value rules for acquisition costs applies for the purposes of the whole Chapter (section 441).

Section 448: Restriction of losses on strips by reference to original acquisition cost

1808. This section restricts losses to the amount by which disposal proceeds exceed the original acquisition cost. Because there is a 5 April revaluation of strips on a deemed disposal each year the cost taken into account on actual disposal is the last 5 April value. This section ensures that in such cases a loss cannot exceed the difference between the disposal proceeds and the original cost of the security. The section is based on paragraph 14D of Schedule 13 to FA 1996.

1809. *Subsection (1)* sets out when the rule in this section applies, namely when a loss would, apart from this section, arise on disposal but the market value of the strip is less than the amount paid by the person to acquire the strip, thus giving rise to a greater loss than would be the case if the market value had not replaced the cost.

1810. *Subsections (2), (3)* and *(4)* restrict that loss to the excess of the disposal proceeds over the cost of acquisition. If there is no excess because the acquisition cost does not exceed the market value, no loss is made.

Section 449: Strips of government securities: manipulation of acquisition, sale or redemption payments

1811. This section applies where there is a scheme or arrangement and the main, or one of the main, benefits that is expected to accrue is the obtaining of a tax advantage. It substitutes market value in any case where the acquisition cost is more than the market value, or the disposal or redemption proceeds are less than market value. The section is based on paragraph 14B of Schedule 13 to FA 1996.

Section 450: Market value of strips etc.

1812. This section provides the rule for ascertaining the market value of a strip or a security exchanged for a strip. It is based on paragraph 14E of Schedule 13 to FA 1996.

Section 451: Market value of strips etc. quoted in foreign stock exchange lists

1813. This section provides the rules for ascertaining the market value of overseas strips or securities quoted on a foreign stock exchange. It is based on paragraph 14E of Schedule 13 to FA 1996.

1814. *Subsections (4)* and *(5)* make provision for cases where the mechanics of overseas stock exchanges might differ from those in the United Kingdom, in particular where separate buy and sell prices are not given.

1815. *Subsection (6)* acts as a tie-breaker where the strip or security is listed on more than one foreign exchange.

Section 452: Power to modify this Chapter for strips

1816. This section allows the Treasury to make regulations for the treatment of strips as a response to future developments in the strips market. It is based on paragraph 14 of Schedule 13 to FA 1996.

Section 453: Application of sections 454 to 456

1817. This section is the first of four sections providing special rules for securities held since 26 March 2003. FA 2003 introduces several changes to Schedule 13 to FA 1996 which affect securities held after that date. It is based on paragraph 6 of Schedule 39 to FA 2003.

1818. With the one exception for government strips, loss relief is no longer available for disposals on or after 27 March 2003, nor is there a deduction for incidental expenses incurred on or after that date. Where, however, a deeply discounted security held since before that date is disposed of, loss relief is still available if the security is listed on a recognised stock exchange. Although the provisions for these reliefs are repealed by FA 2003 for securities acquired after 26 March 2003 they are rewritten in this Chapter to make it easier for the taxpayer with securities acquired before 27 March 2003 to ascertain the relevant rules. Paragraph 7 of Schedule 13 to FA 1996 which deals with losses on certain exempt income is rewritten in paragraphs 82 and 83 of Schedule 2 to this Act as it is of limited application.

Section 454: Listed securities held since 26th March 2003: relief for losses

1819. This section provides for any loss sustained on the disposal of a listed deeply discounted security to be relieved by set-off and explains when a loss is incurred. It is based on paragraphs 2 and 6 of Schedule 13 to FA 1996.

1820. *Subsection (2)* provides that a loss is incurred where the amount paid on acquisition exceeds the amount paid on disposal disregarding any incidental costs. Incidental costs may increase the loss but not create a loss. See section 455 for how the loss is computed.

1821. *Subsection (3)* signposts section 455(2) to (4) which allow costs in computing the profit where the security has been continuously held since 26 March 2003.

1822. The set-off rules for persons who are not trustees (*subsection (4)*) differ from those for trustees (*subsection (5)*).

1823. See paragraphs 82 and 83 of Schedule 2 to this Act for further provisions on trustees.

Section 455: Listed securities held since 26th March 2003: calculating the profit or loss on disposals

1824. This section gives the rules for computing profits and losses on disposals of securities held continuously since 26 March 2003. Deductions for incidental expenses of acquiring and disposing of deeply discounted securities are only available for listed securities held on 26 March 2003. The section is based on paragraphs 1, 2, 14 and 15 of Schedule 13 to FA 1996.

1825. *Subsections (2*) and *(3)* explain how to compute the loss referred to in section 454(2). The loss sustained is effectively increased by the deduction of the incidental expenses incurred in connection with the acquisition and disposal of the security. This is expressed by allowing the costs, which include both sets of incidental expenses and the cost of acquisition, as a deduction from the disposal proceeds.

Section 456: Securities issued to connected persons etc. at excessive price: subsequent transfers to connected persons

1826. This section prevents a loss arising on the transfer of deeply discounted securities where securities are issued at a value above that at which they are subsequently transferred and the issue and transfer are to connected persons. The section is based on paragraph 9A of Schedule 13 to FA 1996.

1827. The market value rules in sections 440 and 441 do not apply to securities on issue but only to subsequent disposals. The application of those rules therefore produces a loss where a security has been issued at above the market value to a connected person and is then transferred to another connected person at market value. These transactions thereby benefit from the fact that the market value rules do not apply on issue, and when they might apply, on a transfer, the price is at market value.

1828. *Subsection (1)* provides the general rule that no loss will arise where certain conditions are met. These conditions are set out in subsections (2) to (6).

1829. The conditions in*subsections (2)* and *(3)* must both apply, together with either the condition in *subsection (4)* or those in both *subsections (5)* and *(6)*. These conditions provide that the person disposing of the security was either connected with the issuing company or controlled it and that the security was acquired on issue at above market value.

1830. It is considered unnecessary to rewrite paragraph 9A(2)(b) of Schedule 13 to FA 1996, because if the transferor were connected with the issuer condition C (paragraph 9A(1)(b) of that Schedule) would apply.

1831. *Subsections (5)* and *(7)* ensure that the rule also applies where a deeply discounted security is issued by a close company where the person to whom it is issued, together with others, controls the issuing company, wherever the company is resident.

Section 457: Trustees

1832. This section gives rules for applying this Chapter to trustees. It is based on paragraph 6 of Schedule 13 to FA 1996.

1833. Under section 429 the person liable is the person making the disposal.

1834. *Subsection (2)* ensures that the profits are treated, for the purposes of Chapter 5 of Part 5 of this Act, as income arising under a settlement and therefore potentially chargeable on the settlor.

1835. *Subsection (3)* ensures that the profits are treated as income in applying the rules on the liability of trustees in Chapter 1C of Part 15 of ICTA.

1836. Paragraph 6(1) of Schedule 13 to FA 1996 refers to amounts "treated as income chargeable to tax". This must simply mean 'chargeable to tax' since paragraph 1 of that Schedule makes use of a straightforward charge on the gain rather than a deemed income approach. The "deemed" wording has not been reproduced. But the wording of the charge has been reflected in section 427.

1837. *Subsection (5)* disapplies subsections (2) to (4) in the case of unauthorised unit trusts. Under section 469(2) of ICTA income arising to the trustees of unauthorised unit trusts is regarded as income of the trustees and not as income of the unit holders and such income is chargeable at the basic rate.

Section 458: Non-UK resident trustees

1838. This section provides that non-UK resident trustees are not charged to tax on profits and gains from deeply discounted securities. It is based on paragraph 6 of Schedule 13 to FA 1996.

Section 459: Transfer of assets abroad

1839. Sections 739 and 740 of ICTA provide rules to counter avoidance of income tax by the transfer of assets abroad. They depend on income being payable to a person resident or domiciled outside the United Kingdom which a person domiciled or resident within the United Kingdom has the power to enjoy. This section provides that profits on a disposal of deeply discounted securities by a non-UK resident or non-UK domiciled person are regarded as income paid to that person for the purpose of those rules. The section is based on paragraph 12 of Schedule 13 to FA 1996.

Section 460: Minor definitions

1840. This section provides some minor definitions for the provisions in this Chapter. It is based on section 103 of FA 1996 and paragraph 15 of Schedule 13 to FA 1996 and paragraph 14 of Schedule 25 to FA 2002.

Chapter 9: Gains from contracts for life insurance etc.

Overview

1841. This Chapter charges to tax the investment profit from life insurance policies, life annuity contracts and capital redemption policies. It is based on Chapter 2 of Part 13 of ICTA.

1842. The Chapter uses "gains" to describe what is charged to tax, as in the source legislation. The term "profits" is not used because it has different, well established meanings in the context of policies of life insurance etc. For example, the insurance industry uses "profits", as in "with profits" policies, to describe bonuses which are not "gains" within the meaning of this charge.

1843. Whereas the source legislation often deals separately with each type of policy and contract falling within this charge, the Chapter deals with all three types at the same time, so far as possible, while still preserving any differences in the rules for each type.

1844. Most of the policies and contracts to which the Chapter applies are held by individuals or on trusts created by individuals. But the Chapter deals with all circumstances under which gains are charged to income tax, irrespective of the capacity of the policy holder.

1845. Where the gain is charged to corporation tax (that is, when the rights under the policy or contract are held by a company, or on trusts created by a company, or as security for a debt owed by a company, and the company is within the charge to corporation tax), the relevant provisions are in Chapter 2 of Part 13 of ICTA, as amended by Schedule 1 to this Act.

1846. The income tax provisions in this Chapter for charging gains and the corporation tax provisions in ICTA apply independently to any policy or contract. In practice, the same event will occur, and the amount of the gain will be the same, under both sets of provisions. But a charge to tax under one or other tax (sometimes to both taxes) only arises if someone is liable for the respective tax on the gain by virtue of sections 464 to 467 of this Act or section 547(1)(b) of ICTA. The corporation tax provisions do not include the equivalent of sections 530 to 537 (income tax treated as paid and top slicing relief) and 539 to 541 (relief for deficiencies).

1847. Life insurance policies certified by the Inland Revenue as "qualifying policies", under paragraph 21 of Schedule 15 to ICTA, do not generally give rise to gains under this Chapter. The rules in Schedule 15 to ICTA include that:

- the policy must have a minimum term of ten years from the date it was made to the date it is due to end; and
- premiums of fairly even amounts must be payable at regular intervals in every year for at least ten years.

1848. Qualifying policies generally give rise to gains chargeable to tax if a "chargeable event" occurs:

- before the earlier of ten years from the beginning of the policy or three-quarters of the term for which it is due to run; or
- after the policy has – before the earlier of those two periods – been made a "paid up" policy (that is, no further premiums need be paid).

1849. The Chapter makes a number of minor changes to the law. And it includes provisions based on extra-statutory concessions.

1850. The Chapter also incorporates, so far as relating to the income tax charge, the secondary legislation for the special charge on personal portfolio bonds (the Personal Portfolio Bonds (Tax) Regulations 1999 SI 1999/1029, as amended by SI 2001/2724 and SI 2002/455). In this commentary, those regulations are abbreviated as "PPB(T)R".

1851. Date-related provisions (that is, provisions which apply only to policies or contracts issued before a particular date) are located in Parts 6 and 7 of Schedule 2 to this Act rather than in this Chapter. Part 6 is organised chronologically so that policy holders can see, in relation to their own policies or contracts, which rules qualify the provisions in the Chapter. Part 7 is wholly concerned with policies issued in respect of an insurance made before 17 March 1998 and contracts made before that date. Section 546 indicates when Schedule 2 to this Act modifies the operation of the section and the relevant paragraph(s) of the Schedule.

1852. A few date-related provisions have been retained within this Chapter where it would be unhelpful to remove them (for example, section 507(4) (method for making periodic calculations under section 498)).

1853. Some provisions in Part 5 of Schedule 2 to this Act (paragraphs 85 to 91) also apply. These depend on dates other than the date of issue of a policy or contract.

1854. The Chapter is laid out as follows-

- charge to tax under Chapter 9 (sections 461 to 463)
- person liable etc. (sections 464 to 472)
- policies and contracts to which Chapter 9 applies (sections 473 to 483)
- when chargeable events occur: general (sections 484 to 490)
- calculating gains: general (sections 491 to 497)
- part surrenders and assignments: periodic calculations and excess events (sections 498 to 509)
- transaction-related calculations and part surrender or assignment events (sections 510 to 514)
- personal portfolio bonds (sections 515 to 526)
- reductions from gains (sections 527 to 529)
- income tax treated as paid and reliefs (sections 530 to 538)
- deficiencies (sections 539 to 541)
- supplementary (sections 542 to 546)

Section 461: Charge to tax under Chapter 9

1855. This section charges gains from policies and contracts to tax. It is based on, and combines:

- the income tax charge in section 547(1) of ICTA (which stands outside the schedular system);
- the charges under Schedule D Case VI in sections 547(6) and 553(6) of ICTA; and
- the special charge on personal portfolio bonds under section 547 of ICTA by virtue of regulation 6 of PPB(T)R.

1856. The exemption mentioned in *subsection (4)* is not an exhaustive statement of exemptions that may apply.

Section 462: When gains arise from policies and contracts

1857. This section explains when a gain arises and introduces the concept of a "chargeable event". It is based on sections 540, 542, 545 and 546C of ICTA.

Section 463: Income charged

1858. This section is based on section 547 of ICTA. It sets out the amount charged to tax.

1859. *Subsection (2)* flags the one circumstance where the gain to be charged for a tax year may have arisen in an earlier tax year. That is, the tax year for the charge is not the tax year in which the chargeable event occurred.

Section 464: Person liable for tax: introduction

1860. This section and the following three sections determine who is liable for tax charged under this Chapter. (Sections 466(3) and 468 indicate when a gain arising under this Chapter is not charged under the Chapter but may instead be taken into account for certain other income tax charges.) The section is based on section 547 of ICTA.

1861. The source legislation does not preclude an overlap between the attribution of liability to one "person liable" and to another (say, both to an individual who placed a policy in trust and to the trustees who hold the legal rights in the policy). In practice, liability of a UK resident individual normally prevails over other liability and the gain is not doubly charged to tax. See also the commentary on section 467 as it applies where the rights are held by trustees on charitable trusts (when liability falls on the trustees rather than the settlor).

1862. *Subsection (3)* provides that references in sections 464 to 467 to a surrender or assignment of rights refer, where appropriate, to a surrender or assignment of a part of, or share of, the rights. A *part* of the rights means one or more discrete rights provided by the policy or contract. A *share* in the rights means part of the ownership, where there are multiple owners, of such a discrete right or rights or of all the rights in the policy or contract. (The rule applied in this subsection is also found elsewhere in the Chapter. See in particular section 469(7) (two or more persons interested in policy or contract).)

Section 465: Person liable: individuals

1863. This section sets out three ways of holding or owning the rights under a policy or contract by virtue of any of which an individual may be liable to tax on the gain. Where an individual is so liable, the amount charged is treated as part of the individual's "total income" (section 835 of ICTA). This section is based on section 547 of ICTA.

1864. Although unfettered beneficial ownership of the rights may be the most commonly met circumstance, policies and contracts are also commonly placed in trust for beneficiaries (whether for the settlor and/or other beneficiaries). Policies and contracts may also be used to secure a loan (such as a mortgage of property). If any of the three ways of holding or owning the rights applies, that is sufficient to attribute liability for tax on the gain to that individual. (But see section 467 when the rights are held on charitable trusts created by the individual.)

1865. *Subsection (1)* incorporates part of ESC B53. Under the concession, the Inland Revenue does not pursue liability to tax on a gain, where a non-UK resident individual is liable, in any of the circumstances mentioned in this subsection. The section achieves the same net effect by a different route. It simply limits attribution of liability to UK resident individuals, so that the non-UK resident individual is not liable to tax on the gain in the first place. See *Change 88* in Annex 1.

1866. Chapter 1 of Part 4 of this Act provides a general territorial limitation on the scope of the Part. As regards income arising outside the United Kingdom, it limits the charge to such income arising to a UK resident. See section 368 (territorial scope of Part 4 charges) and the related commentary on that Chapter. This section overlaps and supplements that Chapter to ensure that a non-UK resident individual is not liable to tax under this Chapter on any gains, whether arising in the United Kingdom or elsewhere.

1867. *Subsection (6)* indicates that an individual is treated as creating a trust, for the purposes of this Chapter, when a policy or contract is placed in trust under any of three specific Acts. Such trusts are commonly created, for example, when a policy (such as a mortgage protection policy) is to benefit one or both parties to a marriage. But the subsection is not an exhaustive definition of all the circumstances in which trusts are created by an individual.

Section 466: Person liable: personal representatives

1868. This section sets out how a gain is charged to tax when the rights under the policy or contract are held by the personal representatives of a deceased person's estate. It is based on sections 547 and 553 of ICTA. The term "personal representatives" is defined in section 878 of this Act.

1869. There are two possible treatments. The first is conditional on the policy or contract being one that, were an individual liable to tax in respect of the gain arising on that policy or contract, no lower rate income tax allowance would be available under section 530. Broadly, that allowance is not given where the investment profits underlying the policy or contract are not subject to tax in the hands of the insurer. That may be because the investment profits were not so taxed in the hands of a UK based insurer or the policy or contract was held with a non-UK based insurer (and there was no equivalent foreign tax charge on investment profits in the hands of the insurer).

1870. Where this condition applies, the gain is taxable on the personal representatives as their income in that capacity. The personal representatives are thus liable for the tax.

1871. If the condition does not apply, the gain is not charged on the personal representatives under this Chapter. Instead, the gain falls into the "aggregate income of the estate of the deceased" for the purposes of Chapter 6 of Part 5 of this Act (see section 664 (the aggregate income of the estate)) and of Part 16 of ICTA.

Section 467: Person liable: UK resident trustees

1872. This section sets out to what extent UK resident trustees are liable for the tax charged on a gain. It is based on section 547 of ICTA. The section sets out four circumstances under any of which trustees are liable. All four circumstances depend wholly or partly on how the rights under the policy or contract are held immediately before the chargeable event in question occurs. There are significant differences of treatment between trustees of charitable trusts and non-charitable trusts.

1873. Where the rights are held on *charitable trusts*, the liability falls on the trustees rather than on any settlor. However, the tax charge on the trustees is at the lower rate only. So there is no net liability where the lower rate income tax allowance under section 530 is available.

1874. If the rights are held on *non-charitable trusts*, the trustees are liable where:

- the settlor is non-UK resident, or is dead, or is a company or foreign institution that no longer exists (that is, the settlor could not be liable to tax on the gain or – as regards a foreign institution – be instrumental in the gain being taken into account for the purposes of section 740 of ICTA – see section 468); or
- the rights are held in any other circumstances *excluding* those already taken into account under sections 465 (where an individual is liable) or 466(1) (where personal representatives are liable), or under section 547(1)(b) of ICTA (where a company is liable).

1875. The trustees of both charitable trusts and non-charitable trusts are liable where condition D applies.

1876. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 468: Non-UK resident trustees and foreign institutions

1877. This section sets out in what circumstances a gain treated as arising under this Chapter is taken into account under section 740 of ICTA (liability of non-transferors). It is based on section 547 of ICTA.

1878. It applies when the rights under the policy or contract are held by, or held as security for a debt owed by:

- non-UK resident trustees; or
- a "foreign institution".

1879. As regards trustees, the same four circumstances (conditions A to D) of section 467 apply, with the substitution of non-UK resident trustees for UK resident trustees, to determine whether this section applies. But the section makes no other distinction between cases where rights are held on charitable trusts or non-charitable trusts.

1880. A gain taken into account for the purposes of section 740 of ICTA, as modified by this section, is not charged under this Chapter.

1881. *Subsection (6)*qualifies the meaning of "rights", where there has been an assignment or surrender of a part of or share in the rights, in the same way as does section 464 (see the commentary on that section).

Section 469: Two or more persons interested in policy or contract

1882. This section, together with sections 470 to 472, is based on section 547A of ICTA. These sections deal with cases where the rights in a policy or contract (or a share in those rights) are held immediately before the chargeable event:

- by more than one person;
- by one person in respect of different shares held in different capacities; or
- on non-charitable trusts created by two or more persons.

1883. The most common instance of this is where a husband and wife are co-owners of a policy or contract.

1884. The section apportions the gain in proportion to the "material interest" of each person with such an interest (see section 470). It treats each person with a material interest separately, for the purpose of assigning liability to tax etc, disregarding for this purpose how the Chapter applies in respect of a material interest held by another person. It also apportions deficiencies for the purposes of the relief given by section 539.

1885. Although the source legislation has effect for the purposes of section 547 of ICTA only, this section operates by reference to provisions that apply for the purposes of the Chapter. As a result of the significant reordering of the source legislation when rewriting it, section 547 of ICTA is the basis of numerous sections at various locations. The application of this section to sections that operate in a Chapter-wide context is a necessary consequence of the rewrite of section 547 of ICTA.

1886. *Subsection (6)* applies the section to someone who has two or more interests in a policy or contract exactly as the section applies where two or more persons have such interests. For example, a person may hold one interest beneficially and the other as a trustee. Each of those interests is treated separately. But there is an exception where all the material interests are held by that person only (that is, the interests are not shared) and are held in the same capacity. For example, one share may be beneficially owned by A, but held in a trust, and another share held by A absolutely. Both shares are held in the same capacity.

1887. *Subsection (7)* is similar in effect to the equivalent subsection in section 464 and section 468. See the commentary on section 464.

Section 470: Interests in rights under a policy or contract for section 469

1888. This section provides the meaning of "material interest" for the purposes of section 469. It is based on section 547A of ICTA. The circumstances in which someone is regarded as having an interest in rights under a policy or contract for this purpose mirror the circumstances set out in sections 465 to 468 (and, as regards companies chargeable to corporation tax, in section 547 of ICTA) for attributing liability to tax on gains or otherwise taking gains into account for tax purposes.

Section 471: Determination of shares etc.

1889. This section determines each person's share of the rights in the policy or contract where, because the rights are held jointly by, or as security for a debt owed by, two or more persons, that share has to be established to work out the liability of one or more persons in respect of a gain. It is based on section 547A of ICTA.

1890. *Subsections (2)* to *(5)* deal with a person's interest in a policy or contract held as security for one or more debts owed by two or more persons. Each debtor is treated as the sole debtor in respect of a separate debt. For each liable person, the share of any gain is proportionate to the share of the total debt for which security was provided.

1891. *Subsection (7)* deals with the case where different rights under a policy or contract are held by different people. For example, the right to a death benefit under a policy may be held by one person and the right to critical illness benefit under the same policy may be held by another person. The rights are shared between them on a just and reasonable basis. See *Change 14* in Annex 1.

Section 472: Trusts created by two or more persons

1892. This section determines each settlor's share of the rights, or of a share in the rights, in policies or contracts where, immediately before the chargeable event in question, the rights (or that share) are held on non-charitable trusts created by two or more persons. It also sets out how that share is determined if the property held on trust was added by different settlors, whether at the time the trust was created or at a later date. It is based on section 547A of ICTA.

1893. *Subsections (3)* to *(7)* determine the appropriate share if settlors contribute different property to the trust or a new settlor adds property to a trust already created. The trust is treated as if it had been created by all of them, including the new settlor where applicable, and each is treated as the only settlor for the purposes of this section. The rules set out explicitly when someone is regarded as having contributed property to the trust. For example, subsection (7) applies when A contributes property to what is essentially B's settlement because B has made an equivalent contribution to A's settlement. Although B's contribution is treated as property provided by A for the purposes of subsection (6), A's contribution under reciprocal arrangements with B is disregarded.

1894. Subsection (4)(c) allocates a bundle of types of property between settlors on the basis of a "just and reasonable" apportionment where this is necessary for the purposes of subsections (2) and (3). See *Change 14* in Annex 1.

Section 473: Policies and contracts to which Chapter 9 applies: general

1895. This section is based on section 539 of ICTA.

1896. *Subsection (2)* provides definitions. The definition of a "life annuity" is by reference both to this Act and to ICTA because the policy holder and the person liable (whether the tax charge is to income tax or corporation tax) may not be the same and may not be subject to charges under the same tax. The Chapter does not provide a definition for the more readily understood term "policy of life insurance" (nor is one provided in the source legislation). But section 545 indicates that "policy", unless the context otherwise requires, means both a policy of life insurance and a capital redemption policy.

1897. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 474: Special rules: qualifying policies

1898. This section is based on sections 553 and 553A of ICTA. "Qualifying policy" is defined in section 832(1) of ICTA as "a policy of insurance which is a qualifying policy for the purposes of Chapter 1 of Part 7 [of ICTA]". That is, it is in effect a policy meeting the conditions set out in Schedule 15 to ICTA.

1899. *Subsection (4)* takes away qualifying policy status from a policy issued by a non-UK resident insurer once it ceases to meet one of the conditions in paragraph 24(3) of Schedule 15 to ICTA (by virtue of which it was a qualifying policy). Broadly, the conditions in that paragraph are met when the policy forms part of business done through the insurer's UK permanent establishment.

1900. *Subsection (5)* denies qualifying policy status to a policy which is part of the overseas life assurance business of the insurer, that is, a policy taken out by a non-UK resident policy holder with an insurer operating in the United Kingdom. The subsection applies only in relation to the chargeable event in question.

Section 475: Special rules: personal portfolio bonds

1901. This section is new.

Section 476: Special rules: foreign policies

1902. Although gains from foreign policies and contracts are taxable under this Chapter alongside gains from UK policies and contracts, there are a number of differences of treatment. Primarily, these arise from the fact that the underlying investment profit has not usually been subject to UK tax (or to an equivalent tax regime). However, subject to these differences, any rule in this Chapter referring to a policy or contract, or to one or more of the insurance products listed in section 473(1), applies to foreign policies and contracts. This section is based on sections 553, 553A and 553B of and paragraph 24(1) of Schedule 15 to ICTA.

1903. The source legislation uses the terms "new non-resident policy", "overseas policy" and "new offshore capital redemption policy". The "new" in those terms indicates such policies were issued on or after the commencement date for the legislation that introduced special rules. The terms used in this Chapter simply add "foreign" to the descriptions used for comparable UK policies and contracts.

1904. The definitions for a "foreign policy of life insurance" and a "foreign capital redemption policy" each contain two categories. This reflects the introduction at different times of the modifications of treatment for policies of life insurance and capital redemption policies, which:

- are issued by a non-UK resident insurer (introduced by FA 1984); or
- are other policies forming part of the insurer's overseas life assurance business (introduced by FA 1998).

1905. Some policies in the second category may also fall into the first. However, other than for the construction of the definitions themselves, certain rules in sections 474 and 531, and paragraphs 106 and 110 of Schedule 2 to this Act, the distinction between the categories is not material to the operation of this Chapter.

1906. There is no provision in the Chapter (or relevant paragraph of Schedule 2 to this Act) that applies exclusively to a foreign contract for a life annuity (although most of the contracts affected by, say, section 531(3)(c) are foreign). No definition is therefore provided for such contracts.

1907. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 477: Special rules: certain older policies and contracts

1908. This section is new.

Section 478: Exclusion of mortgage repayment policies

1909. This section is based on section 539 of ICTA. It excludes a particular type of policy taken out in connection with a mortgage. Other types of policy taken out in that connection may be affected by the rules for qualifying policies, such as section 485. See section 879 of this Act for the meaning of "mortgage" in the application of this section to Scotland.

Section 479: Exclusion of pension policies

1910. This section is based on section 539 of ICTA. The term "registered pension scheme" reflects the FA 2004 rules about pension schemes which apply from 6 April 2006 and include a substituted definition in section 539 of ICTA. Paragraph 86 of Schedule 2 to this Act ensures that the unamended definition of a "pension policy" in section 539 of ICTA applies for the tax year 2005-06.

Section 480: Exclusion of excepted group life policies

1911. This section is based on section 539(2) and (3) of ICTA. A group life policy is typically one taken out for members of trades unions, professional associations and partnerships, paying out successively on the death of any of the lives insured. But for the exclusion provided by this section, each such death would give rise to a chargeable event under section 484(1)(b).

1912. See also section 546 (table of provisions subject to special rules for older policies and contracts) and paragraph 90 of Schedule 2 to this Act (gains from contracts for life insurance etc: pure protection group life policies).

Section 481: Excepted group life policies: conditions about benefits

1913. This section is based on section 539A of ICTA. The conditions set out here and in the next section ensure that the only policies benefiting from the exclusion are those:

- providing death benefits on equal terms for all lives covered; and
- having a minimal surrender value (if any).

1914. For example, condition A (*subsection (2)*) sets an upper age limit of 75 for any age-related restriction of the payment of benefits on death in any circumstances. It also disregards any limitation on payment of death benefits for particular reasons (for example, suicide) if the same limitation ("the same specified circumstances") applies to all lives assured.

Section 482: Excepted group life policies: conditions about persons intended to benefit

1915. This section completes the conditions relating to an excepted group life policy. It is based on section 539A of ICTA.

1916. *Subsection (3)* uses the term "connected". Section 878 of this Act applies section 839 of ICTA (how to tell whether persons are connected) for this purpose.

Section 483: Exclusion of credit union group life policies

1917. This section excludes a particular type of group life policy. It is based on section 539 of ICTA.

1918. *Subsection (2)* defines “credit union group life policy” in terms of the single stringent condition such a policy must meet to qualify for exclusion.

Section 484: When chargeable events occur

1919. This section is the first of a group of sections which set out what does or does not constitute a chargeable event under this Chapter. This section is based on sections 539, 540, 542, 545 and 546C of ICTA, and regulation 6 of PPB(T)R. Later sections in this Chapter operate by reference to this list of chargeable events (see sections 485, 491, 493, 496, 499, and 540).

1920. *Subsection (1)* groups together in paragraph (a) the events applicable to all policies and contracts and, in paragraphs (b) to (e), the events specific to one or more type of policy or contract.

1921. The source legislation treats the events in subsection (1)(a)(iii), (d) and (e) as a surrender of the rights under the policy or contract, which then triggers a chargeable event (see sections 539(4) and 542(2) of ICTA). The section treats the events themselves as chargeable events without the preliminary treatment of them as surrenders.

1922. Subsection (1)(e) makes clear that, where a capital sum is taken as an alternative to annuity payments, such payments include future payments.

1923. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 485: Disregard of certain events in relation to qualifying policies

1924. This section is based on section 540 of ICTA. It deals with circumstances in which qualifying policies do not give rise to chargeable events.

1925. Broadly, there is no chargeable event if:

- the event is:
  - the death of a person whose life is insured; or
  - the maturity of the policy; or
- the policy has run for a period measured by the earlier of:
  - ten years; or
  - three-quarters of the policy’s term;

so long as the policy has not been made “paid-up” within that same period.

1926. *Subsection (6)* re-starts this time calculation of how long the policy has run from the date of variation, if the policy is varied to increase the premiums payable.

1927. *Subsections (2)* and *(3)* do not rewrite the words in brackets in the opening of section 540(1)(b) of ICTA “whether or not the premiums thereunder are eligible for relief under section 266”. These words add nothing of substance.

1928. Paragraph (b) in each of subsections (2) and (3) reflects a circumstance in which the restriction of what is a chargeable event for a qualifying policy is itself disapplied. It operates where a company would, by virtue of section 547(1)(b) of ICTA, be a person liable to corporation tax on a gain treated as arising on the policy or contract. As described in the commentary on section 464, attribution of corporation tax liability to that company does not prevent other persons, such as an individual, also being attributable with income tax liability in respect of the gain. This rule operates at a level – what is a chargeable event – where there is no difference between the two tax regimes. See also section 546 (table of provisions subject to special rules for older policies and contracts).

1929. Such a disapplication of the restriction is unnecessary in *subsection (5)*. This subsection is based on section 546B of ICTA. Section 540(5A) of ICTA (on which the restriction in subsections (2) and (3) is based) does not apply to the restriction provided for qualifying policies by section 546B(1A) of ICTA, in relation to events that are found by applying section 546B of ICTA (see section 546C(7)(a) of ICTA for when such events arise).

1930. *Subsection (7)* deals with the circumstance where a qualifying policy replaces another policy (which may not have been a qualifying policy). It requires certain terms in paragraph 25 of Schedule 15 to ICTA to be met. The new policy will in part have been designated a qualifying policy under Schedule 15 to ICTA because those circumstances were met. This subsection is based on section 553 of ICTA.

Section 486: Exclusion of maturity of capital redemption policies in certain circumstances

1931. This section is based on section 545(1) of ICTA. The source legislation refers in part to "annual payments chargeable to tax under Schedule D". The income tax charge on such income is rewritten in the Chapters listed in the section. The corporation tax charge on such income is still under Schedule D.

Section 487: Disregard of certain assignments

1932. This section is based on sections 540, 542, 544 and 545 of ICTA. In the source legislation the assignments mentioned here are ignored only for the purposes of particular provisions under which assignments are chargeable events. But, because the assignments in question are disregarded for the purposes of this Chapter, not only is such an assignment not a chargeable event, it is ignored, as regards that policy or contract, in the operation of the rest of the Chapter.

Section 488: Disregard of some events after alterations of life insurance policy terms

1933. This section and the next are based on ESC A96. See *Change 89* in Annex 1.

1934. The disregard applies where a policy which is at least 20 years old is effectively made paid-up by the insurer. A chargeable event which might have arisen afterwards as a result of that variation is disregarded if the changes made to the policy would not themselves give rise to a chargeable event.

1935. *Subsection (3)* extends the disregard to a replacement policy issued by the insurer in lieu of the old, where the issue of such a policy is what the insurer does to give effect to the alteration of the original policy's terms.

Section 489: Conditions applicable to alterations of life insurance policy terms

1936. This section is based on ESC A96. See *Change 89* in Annex 1. The conditions in *subsections (2)* to *(8)* ensure among other things that the disregard provided by section 488 falls away if the policy is reactivated for investment purposes.

Section 490: Last payment under guaranteed income bonds etc. treated as total surrender

1937. This section supplements section 484. It is based on section 79 of FA 1997.

1938. Section 504 deals with the treatment of payments under guaranteed income bonds prior to the last payment. Subsection (7) of that section defines the term "guaranteed income bond contract". See the commentary on that section for further background.

Calculating gains: general

Overview

1939. Section 491 to 497 set out how to calculate a gain on a chargeable event *other than* one arising on any part surrender or part assignment, or an event in respect of the special charge for personal portfolio bonds.

1940. Section 491 introduces a number of terms which are used throughout the Chapter for the computation of gains (and defines them in subsection (4)). These are:

- "calculation event" (an umbrella term for events, the occurrence of which is dependent on the outcome of one of several prescribed calculations); and
- "excess event", "part surrender or assignment event" and "personal portfolio bond event" (the types of event which may flow from such a calculation).

Section 491: Calculating gains: general rules

1941. This section deals with the calculation rules for all chargeable events other than those triggered by a part surrender or part assignment of rights under the policy or contract, or by the special charge on personal portfolio bonds. It is based on sections 541, 543 and 545 of ICTA and section 79 of FA 1997. (For the relevance of section 79 of FA 1997, see section 490.)

1942. *Subsection (2)* introduces the concepts of the "total benefit value" and the "total allowable deductions". These terms are used in other sections in this Chapter (for example, section 541 (calculation of deficiencies)).

1943. *Subsection (5)* indicates that gains on a previous calculation event include gains on a "related policy" (defined in *subsection (6)*). See *Change 90* in Annex 1.

Section 492: The total benefit value of a policy or contract

1944. This section is based on sections 541, 543, 545 and 548 of ICTA, and section 79(3) of FA 1997.

1945. The "total benefit value" of a policy or contract consists of the value of the policy or contract in relation to the event (paragraph (a)) added to capital sums (or benefits or amounts treated as such) derived from the policy or contract prior to the chargeable event itself (paragraph (b)).

1946. *Subsection (2)* makes clear that capital amounts derived from a related policy are brought in for this purpose.

Section 493: The value of a policy or contract

1947. The value of a policy or contract is determined by reference to the particular kind of event. This section is based on sections 541, 542, 543, and 545 of ICTA, and section 79 of FA 1997.

1948. *Subsections (1)* and *(2)* provide for the value in the majority of events.

1949. In relation to the reference in *subsection (6)* to connected persons, see section 878 of this Act (which applies section 839 of ICTA).

Section 494: The total allowable deductions for a policy or contract

1950. This section is based on sections 541, 543, 545 and 548 of ICTA.

1951. Step 1 in *subsection (1)* lists amounts to be taken into account as deductions. Paragraph (a) deals with the vast majority of cases, where the only item to be taken into account is the total of premiums paid before the chargeable event. See also section 546 (table of provisions subject to special rules for older policies and contracts).

1952. Step 2 in subsection (1) reduces the total allowable deductions for a purchased life annuity by the exempt amount (or capital element) in payments to date. The exempt amount is determined under Chapter 7 of Part 6 of this Act and (as regards the capital element) under ICTA as appropriate (see the commentary on section 473).

1953. Paragraph (b) in Step 1 deals with the repayment of loans which were treated as a part surrender of the rights under the policy or contract.

1954. *Subsection (2)* caters for assignments for money or money's worth of capital redemption policies. In the case of such assignments paragraph (a) in Step 1 in subsection (1) applies to the price paid in respect of the most recent such assignment instead of the premiums paid before that assignment.

1955. *Subsection (3)* makes clear that premiums etc. paid in respect of a related policy (as defined in section 491) are included in the calculation of total allowable deductions.

Section 495: Disregard of certain amounts in calculating gains under section 491

1956. This section contains rules which exclude various amounts from the calculation of the total benefit value under section 492 and the total allowable deductions under section 494 in arriving at the amount of a gain under section 491. It is based on sections 541, 543 and 545 of ICTA.

1957. *Subsections (1)* and *(2)* deal with a retained replacement policy premium. This disregard is based on paragraph 20 of Schedule 15 to ICTA, which deals with the replacement of one qualifying policy by another, where the value of the old policy is used as a premium for the new policy. The old and new policies are treated as a single policy (see section 542). The value of the old policy is disregarded both in working out the total benefit value of that single policy and, as regards use of the value of the old policy as a premium for the new policy, in working out the total allowable deductions for the single policy.

1958. *Subsection (4)* reflects an amendment in FA 2002 of a rule introduced by FA 2001, under which an assignment which is not for money or money's worth (such as a gift) is not treated as giving rise to a chargeable event. But assignments which were not for money or money's worth still have to be taken into account in calculating gains if they occurred in an "insurance year" (see section 499) ending before 6 April 2001.

Section 496: Modification of section 494: qualifying endowment policies held as security for company debts

1959. Although this section refers to a policy held as security for a company's debt (a circumstance in which liability to corporation tax on a gain arises under section 547(1)(b) of ICTA), this modification is part of the income tax rules because liability on that gain can also be attributable to a person to whom sections 464 to 468 apply or are relevant. It is based on section 541 of ICTA. Where this section applies, the eligible amount of the debt is substituted for premiums paid under the policy in calculating any gain. A claim by the debtor company is required.

Section 497: Disregard of trivial inducement benefits

1960. This section is based on ESC B42. It excludes non-monetary benefits costing no more than £30, which are offered as inducements to attract life insurance business, from the computation of any gain under this Chapter. See *Change 91* in Annex 1.

1961. ESC B42 refers to "gifts" but the section refers to "benefits" as a more accurate description of what is provided. It also matches more closely the drafting of the various sections for calculating gains.

1962. *Subsection (3)* provides for a future increase (or increases), but not for any decrease, in the monetary limit set on this disregard. See section 873 of this Act for the procedural rules which apply to secondary legislation made under powers in this Act.

1963. The monetary limit is applied by reference to the "policy or contract and any linked policy or contract" taken as one. This caters for an insurance industry practice of issuing "clusters" of policies to give the policy holder any required flexibility in managing the total investment.

Part surrenders and assignments: periodic calculations and excess events
Overview

1964. Sections 498 to 509 perform the same function for chargeable events which are excess events as do sections 491 to 496 for the chargeable events those sections relate to. They set out when this type of part surrender or assignment (including something treated as a part surrender) gives rise to a chargeable event, and how to calculate the amount of the gain arising on that event. The calculation of the gain is made by reference to the history of the policy or contract from when the insurance or contract was made up to the end of the insurance year in which the surrender or assignment occurred. This is the more commonly occurring type of chargeable event arising on a part surrender and assignment.

1965. The sections introduce further expressions, such as "periodic calculations" (this term is not defined but refers to situations where sections require calculations and the incidence of chargeable events is linked to the result of the calculation).

1966. The meaning of "insurance year" and "final insurance year" is provided by section 499. These terms are widely used in this Chapter in calculating gains and in determining when a gain arises and when a chargeable event occurs.

Section 498: Requirement for periodic calculations in part surrender or assignment cases

1967. This section based on sections 540, 542, 545 and 546 of ICTA.

1968. *Subsection (1)* states that the section applies when there has been an assignment for money or money's worth or a surrender. The section omits the requirement in the source legislation that a calculation is carried out at the end of each insurance year, regardless of whether there has been any such assignment or surrender. But, in an "event-less" year, there could not be any gain, so the calculation would be pointless. See *Change 92* in Annex 1.

Section 499: Meaning of "insurance year" and "final insurance year"

1969. This section is based on sections 546, 546B and 546C of ICTA.

1970. *Subsection (1)* defines an "insurance year". The definition is applied for the purposes of this Chapter, whereas in the source legislation the application of the definition of "year" is more limited. The source legislation to which the definition is relevant, section 546 of ICTA, is rewritten in a great number of locations in this Chapter. It is no longer practical, or indeed necessary, to limit the application of the definition.

1971. *Subsection (3)* sets out how the basic rule is varied when the sequence of insurance years is broken by certain of the events listed in section 484(1). Where such an event occurs, the year ends at that point and is called the "final insurance year". An assignment of all the rights under the policy or contract is not such an event, as the policy or contract continues in existence despite the change of ownership of the rights.

1972. Where the term "final insurance year" is used in this Chapter, it therefore indicates that one of the specified events in section 484(1) has occurred.

1973. One of those events is "a death giving rise to benefits" under a policy of life insurance. The source legislation for the meaning of "insurance year" merely refers to a "death", and does not cross-refer to the definition of a chargeable event in sections 540, 542 and 545 of ICTA. A cross-reference to events under section 484, rather than words describing the event, is more precise. It also disregards a death which does not give rise to benefits.

1974. *Subsection (5)* caters for when the final insurance year would begin and end in the same tax year. But for the rule in this subsection, the previous insurance year would end in the same tax year as the final year, and any part surrender or assignment in that year might give rise to a gain that would be charged for that year in addition to the gain on the final event. To avoid (in most cases) the complexity of two sets of computations in one tax year, the previous insurance year is merged with the final year as a single insurance year, the "final insurance year".

1975. Where the year is the final insurance year, section 509(5) accordingly sets aside any chargeable event that would arise on a periodical calculation under section 507 following a part surrender or assignment,. But, where the circumstances in section 510 apply, and the year in question is the final insurance year, there will be more than one computation in that year, and there may be a gain on a transaction-related calculation as well as a gain under section 491. In most cases the persons liable in respect of the gain on the transaction-related calculation and the gain on the final event are different.

Section 500: Events treated as part surrenders

1976. This section deals with some circumstances that would not otherwise be regarded as a surrender of part of the rights under a policy or contract. Paragraph (a) is based on section 539 of ICTA, paragraph (b) on section 542 of ICTA, paragraph (c) on section 548 of ICTA and paragraph (d) on section 79 of FA 1997.

1977. Note that an "event" within this section is not a "chargeable event", unless:

- the calculation under section 507 results in a gain; and
- there is a chargeable event by virtue of section 509 or section 514.

1978. Paragraph (b) makes explicit the treatment of the circumstance where a capital sum is taken as an alternative to part of annuity payments under a contract for a life annuity. See *Change 93* in Annex 1.

1979. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 501: Part surrenders: loans

1980. This section is based on section 548 of ICTA. It counters the avoidance of tax when the profit accrued on the policy or contract is paid to the policy or contract holder in the form of a loan.

1981. The section includes references to a loan to a company, and to section 547 of ICTA, for reasons comparable to those given in the commentary on sections 485 and 496.

1982. See paragraph (c) of step 1 in section 494(1) for the inclusion, as an allowable deduction in certain calculations, of any repayment in whole or in part of a loan which is treated by virtue of this section as a part surrender under section 500.

1983. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 502: Exception from section 501 for loans to buy life annuities

1984. This section is based on section 548 of ICTA.

Section 503: Exception from section 501 for certain loans under qualifying policies

1985. This section is based on section 548 of ICTA.

1986. Condition B reflects the saving provided for certain loans made before 6 April 2000 by paragraph 18(3) of Schedule 4 to FA 1999 (when tax relief for interest was largely withdrawn).

Section 504: Part surrenders: payments under guaranteed income bonds etc.

1987. This section is based on section 79 of FA 1997. It applies to payments by the insurer from a certain type of life insurance policy – "guaranteed income bonds" – that would otherwise be taken into account for tax purposes as interest or an annual payment.

1988. *Subsection (6)* strips such a payment of any character it has as interest or an annual payment so that it is not charged to income tax in that capacity. It is treated instead as a part surrender of the rights under the contract under section 500.

1989. The meaning of "guaranteed income bond contract" is given, in *subsection (7)*, by reference to the statutory instrument regulating insurance business (under powers provided by the Financial Services and Markets Act 2000).

1990. *Subsection (5)* excludes the final such payment from the application of this section. But see section 490, under which that payment is treated as the surrender of all remaining rights under the contract.

Section 505: Assignments etc. involving co-ownership

1991. This section and section 506 are based on section 546A of ICTA. They cater for changes in the person(s) having beneficial ownership of the whole or a part of, or a share in, the rights under the policy or contract, however the change comes about. That ownership is described in these sections as the "ownership interest" (see *subsection (4)*). But this section does not apply when there is a complete change of ownership of that interest (for example, when all the rights are assigned by the old owner or owners to a completely different person or persons).

1992. These sections ensure that only those owners who have reduced their share in the ownership interest (whether partly or completely) are treated as having made an assignment which may give rise to a gain and a chargeable event. Whether the deemed assignment is an assignment for money or money's worth (which is material for section 498(1)) depends on how the change of ownership was effected between the parties.

1993. This section applies for the purposes of the Chapter (other than this section and section 506, which of necessity refer to the actual assignment). References elsewhere to an assignment have therefore to be construed in accordance with the rules in these sections.

Section 506: Assignments occurring when there is a co-ownership transaction

1994. This section introduces the term "co-ownership transaction" to describe a transaction to which section 505 applies. It is based on section 546A of ICTA.

1995. *Subsections (2)* to *(4)* define the deemed assignment for the particular permutation of before and after ownership described in each. They should be construed in the light of *subsections (5)* and *(6)*, which substitute ownership in equal shares (so that each owner is treated as having a distinct share) for joint ownership (where all owners have an interest in all rights attached to the share).

1996. Subsections (2) and (4) deal with the reduction in a person's share in the rights under the policy or contract. Subsection (3) deals with the complete disposal of a person's share in the rights.

Section 507: Method for making periodic calculations under section 498

1997. This section provides the core calculation rules which determine whether there is a gain and, if so, the amount of the gain, when there has been an assignment for money or money's worth or a surrender of part of, or a share in, rights under the policy or contract. The calculation introduces the terms "net total value of rights surrendered or assigned" and "net total allowable payments". Subsequent rules (see section 509) determine whether a chargeable event occurs in respect of that gain. It is based on sections 540, 541, 542, 543, 545, and 546 of ICTA.

1998. But the calculation under this section is displaced when certain transactions have occurred (see section 510).

1999. *Subsection (4)* sets out how the net total value of rights surrendered or assigned is found. Step 1 identifies, and step 2 totals, all relevant amounts from the current and previous insurance years. Step 3 then subtracts all such amounts taken into account on previous "calculation events". That leaves the total of those amounts since the last such event. These amounts may relate to a period of one or more insurance years, depending on when the latest calculation event occurred (the value of the rights assigned or surrendered may have been too low for this calculation to show a gain). Section 508 contains rules for how the values of part surrenders or assignments of rights are to be measured.

2000. *Subsection (5)* sets out how to calculate net total allowable payments, that is, the amount that may be deducted from the product of the calculation in subsection (4). It is similar in approach to the calculation of total allowable deductions in section 494, but treats the premiums paid in a special way. An allowance is made, equal to 5% for each insurance year to date (including the year in which the premium was paid), of each premium payment or payments. The allowance, in respect of any particular premium payment, or the payments for a particular year, cannot exceed 100% of that premium or premiums.

2001. Through the definition of "allowable payment", *subsection (6)* excludes a "retained replacement policy premium" from the amounts that can be taken into account as allowable payments in the calculation under subsection (5). As mentioned in the commentary on section 495, a retained replacement premium is a sum which becomes payable by the insurer in connection with the ending of the policy, but which is retained by the insurer and used to meet some or all of the premiums payable under a later policy.

2002. The source legislation provides that retained replacement premiums are to be ignored in calculating the amount of premiums taken into account under sections 540 and 541 of ICTA. But, in the case of a chargeable event within section 540(1)(a)(v) of ICTA, it is section 546 of ICTA that provides the method of calculating gains. In particular, section 546(1)(b) of ICTA deals with premiums to be taken into account in the calculation of part surrenders and assignments. Clearly, it is that section that paragraph 20(3) of Schedule 15 to ICTA was intended to affect, although it does not refer to section 546 of ICTA.

2003. The calculation of net total allowable payments in subsection (5), read with the definition of "allowable payment" in subsection (6), therefore rewrites the source legislation so that retained replacement premiums are ignored in the calculation of the gain arising on a part surrender or assignment.

2004. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 508: The value of rights partially surrendered or assigned

2005. This section is based on section 546 of ICTA and section 79 of FA 1997.

2006. *Subsection (1)* sets out the general rule for valuing part surrenders. It is similar to the rule for valuing the surrender of all rights under a policy or contract (see section 492(1) and

(2)). This rule fills a gap in the source legislation. In the FA 1968 legislation for taxing chargeable event gains, a gain (including a gain on a part surrender or assignment) was calculated by reference to "the amount or value of the sum payable or other benefits arising by reason of the event" (see paragraph 12(1)(b) of Schedule 9 to that Act). However, when introducing the provisions now in the source legislation, FA 1975 used slightly different wording for gains in respect of part surrenders and assignments. Section 546(1) of ICTA refers to "the value, as at the time of surrender or assignment, of any part of or share in the rights conferred by the policy or contract...".

2007. No change was intended from the value used previously for the regime. The wording in section 546(1) of ICTA was intended to refer to the amount that is paid as a result of the part surrender or assignment; that is, what the policy holder receives for the part surrender or assignment. So this section provides that, where there is a surrender of a part of, or share in, rights under a policy or contract, the value of the part or share surrendered is the amount or value of the sum payable or other benefits arising because of the surrender, unless another rule applies.

2008. *Subsection (2)* is based on section 548 of ICTA. That section provides that, in the case of the loan in question, the same results are to follow as if, at the time the sum was lent, there had been a surrender of part of the rights conferred by the policy or contract, and the sum had been paid as consideration for the surrender. This section drops the fiction that the amount of a loan is the consideration for a surrender.

Section 509: Chargeable events in certain cases where periodic calculations show gains

2009. This section is based on sections 540, 542, 545, 546 and 546B of ICTA.

2010. The transactions mentioned in conditions A and B are those that trigger the operation of section 510. *Subsection (6)* signposts what happens in such circumstances.

2011. The effect of condition C is that there cannot be a chargeable event as a result of a gain arising under the calculation in section 507 when the insurance year is the final insurance year.

Transaction-related calculations and part surrender or assignment events

Overview

2012. These sections perform the same function as sections 498 to 509 for a particular circumstance. This is where, in any insurance year, there has been:

- a part assignment of rights under the policy or contract for money or money's worth; or
- an assignment of such rights by gift after a part surrender of rights in that year.

2013. Each transaction in that year is the subject of a separate calculation. The rules here ensure that liability attaches to the person who profits from the transaction regardless of the change in the ownership of the rights in the policy or contract (otherwise liability on the gain would attach to the new owner).

Section 510: Requirement for transaction-related calculations in certain part surrender and assignment cases

2014. This section is based on section 546C of ICTA.

2015. Where the section applies, *subsection (2)* substitutes a fresh calculation under section 511, for each "relevant transaction" in the insurance year, for the discarded single calculation for that year under section 507. This is a change of approach from that taken in the source legislation, which is drafted in terms of a "section 546 excess occurring at the end of any year" being charged to tax under section 546C of ICTA. But the outcome is the same whichever approach is taken.

2016. Any assignment for money or money's worth in that year of a part of, or share in, the rights is *relevant*. Any surrender in that year of a part of, or share in, the rights is *relevant*. That is, the section applies to any such surrender in the year, regardless of whether that surrender was instrumental in triggering the section or whether it preceded or followed an assignment of any kind. This is described by *subsection (3)* as a "relevant transaction". That term is used also in sections 511 to 514.

2017. By carrying out a series of calculations, any of which may give rise to a chargeable event (see section 514), the gain is attributed to those liable at the time of that event, in accordance with sections 464 to 468, rather than to those liable by reference to how the rights are held in respect of chargeable events occurring at the end of the insurance year.

2018. *Subsection (6)* indicates that *subsections (2)* and *(4)* are modified by the rules in section 513 for the final insurance year (which provides that no subsequent calculations are made once a "gains limit" has been reached).

Section 511: Method for making transaction-related calculations under section 510

2019. This section and the next set out the calculation required by section 510. This section is based on section 546C of ICTA.

2020. The calculation in these sections is designed to isolate, for each relevant transaction, the value of the transaction in question and how much of the premiums paid to the end of the insurance year in question is available to set against that value. The excess of that value over the available premium is the chargeable gain.

Section 512: Available premium left for relevant transaction

2021. This section is based on section 546C of ICTA. *Subsection (1)* provides a calculation method to isolate the available premium for the purposes of section 511. This is described as the excess of the "available net allowable payments" over the "available net total values".

2022. The method works by identifying how much is left, after franking certain amounts, of the gross amount of allowable premiums paid under the policy or contract to the end of the insurance year, applying the twentieths rule in section 507(5). This is step 1 in *subsection (3)*. As a result of applying the rule in section 507 for net total allowable payments, so much of the premiums as has been deducted in calculating gains on a calculation event in a previous insurance year has already been removed from the pool of allowable premiums.

2023. Subsection (3) continues by deducting (in step 2) the total of the transaction values for any previous relevant transactions in this insurance year that did not give rise to a gain when the calculation in section 511 was made. This effectively mops up the equivalent amount of the gross allowable premiums.

2024. *Subsection (4)* next calculates an amount labelled the "available net total values", for the purpose of the calculation in *subsection (1)*. This is the amount found by deducting:

- the total value of all part surrenders and part assignments for money or money's worth in the insurance year (step 2); from
- the total value of all part surrenders and part assignments (as in section 507(4) steps 1 and 2; that is, including assignments not for money or money's worth if they are in an insurance year beginning on or before 5 April 2001) *less* all such values taken into account in gains on calculation events in previous insurance years (step 1).

2025. The computation in subsection (4) isolates and quantifies the value of any part surrender or part assignment between the last calculation event and the beginning of the present insurance year. That value will have been insufficient to give rise to a gain in the relevant insurance year. Again this effectively uses up the equivalent amount of the allowable premiums.

2026. Having thus deducted:

- the amount of allowable premiums used in earlier calculation events (subsection (3) step 1, by virtue of the calculation under section 507(5));
- the amount of any values for part surrenders and part assignments in years since then, but before the current year (subsection (4)); and
- the amount of any values in relevant transactions of this year which did not produce a gain (subsection (3), step 2);

there is available, against the transaction value of the relevant transaction in question, any "allowable payment" (that is, part of the premiums) accrued between the last calculation event in an earlier year and the end of the present year, as reduced by the amounts mentioned in the second and third bullets.

2027. *Subsection (2)* short-circuits the whole process for any relevant transaction of the year which occurs after the first relevant transaction to yield a gain. For such subsequent relevant transactions, the amount of available premium is nil. The gain equals the transaction value for the relevant transaction.

Section 513: Special rules for part surrenders and assignments in final insurance year

2028. This section is based on section 546D of ICTA. The purpose of the section is to ensure that the total amount of gains calculated under section 511 on relevant transactions, added to the gain subsequently calculated under section 491 on the event that brings the final insurance year to an end, is not greater than the gain on the final event would have been without relevant transaction calculations.

2029. For this purpose, the gain under section 491 is calculated disregarding gains on relevant transactions (as defined in section 510(3)). That re-calculated gain acts as a cap on the total gains to be charged in respect of the policy or contract for that year.

2030. In effect, that cap is placed on the latest gain on a relevant transaction, where that gain, added to previous gains on relevant transactions, would exceed the cap. Where that happens, so much of the gain as would exceed the cap is ignored, and the gain on any subsequent relevant transaction or on the event that brings about the end of the final insurance year is treated as nil. But the value of such transactions will already have been taken into account as appropriate in calculating the gains limit, and so have contributed to the size of the cap.

2031. *Subsection (4)* expresses this as a reduction in the transaction value for the particular relevant transaction in relation to which the total of the transaction values for the first and successive relevant transactions in the year (see *subsection (2)*) first exceeds the "gains limit". The reduction in the transaction value for that relevant transaction is the amount that eliminates the excess over the gains limit.

Section 514: Chargeable events where transaction-related calculations show gains

2032. This section provides that, if the calculation under section 511 shows a gain, the relevant transaction is itself the occurrence of a chargeable event at that time. This contrasts with chargeable events under section 509, which occur at the end of the insurance year, regardless of when in that year the part surrender or part assignment took place. This section is based on sections 546B and 546C of ICTA.

2033. *Subsections (3)* and *(4)* nevertheless allot the gain on the chargeable event under this section, for the purposes of sections 464 to 467, to the tax year in which the insurance year ends where liability to tax on the gain would otherwise fall into the preceding tax year. The date of the chargeable event may therefore be in an earlier tax year than that for which the gain is charged.

2034. *Subsection (5)* clarifies the order in which chargeable events take place in the final insurance year, when there is a transaction-related chargeable event in that year. The order prescribed here avoids any suggestion that amounts relevant only to the calculation on the final event enter into the calculations under section 511, even though both calculations take the full period of the final insurance year into account.

Section 515: Requirement for annual calculations in relation to personal portfolio bonds

2035. Sections 515 to 526 set out the special charge in respect of personal portfolio bonds.

2036. This section is modelled on the approach taken in sections 498 and 510. It is based on regulation 5(1) of PPB(T)R.

2037. *Subsection (1)* makes clear that it is the status of the policy or contract as at the end of the insurance year, that is, whether it is a personal portfolio bond at that time, which determines whether this requirement applies.

2038. *Subsection (3)* gives the time as at which the calculation is to be done. Section 553C of ICTA (the section providing the powers used to make PPB(T)R) does not use "insurance year" but instead refers to a "yearly charge", using section 546(4) of ICTA to construe "yearly". The latter section is the source legislation for the definition of "insurance year" in section 499. The section makes explicit that "yearly" refers to an insurance year.

2039. *Subsection (4)* provides that the calculation required by this section is to be made regardless of any other calculation also required by this Chapter. So a gain, treated under section 525 as arising on the chargeable event mentioned in subsection (3) of that section, is added to any other gains arising in the same tax year on other chargeable events in respect of the personal portfolio bond.

Section 516: Meaning of "personal portfolio bond"

2040. This section is based on regulation 4 of PPB(T)R. All of the types of policy or contract mentioned in section 473(1) have the potential to be a personal portfolio bond, if conditions A and B in this section are met. But, even if those conditions were met, the exclusions mentioned in section 473(3) would apply to take such policies and contracts out of the scope of this special charge.

2041. *Subsection (2)* sets out condition A. This is the *portfolio* element in a personal portfolio bond.

2042. *Subsection (4)* sets out condition B. This is the *personal* element in a personal portfolio bond. The list of persons who may be able to select property or an index includes, for example, a financial adviser who acts on behalf of a policy holder, as well as anyone "connected" with the policy holder. Section 878 of this Act applies the "connected persons" rules in section 839 of ICTA for the purposes of this Act.

2043. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 517: Policies and contracts which are not personal portfolio bonds

2044. This section introduces a let-out from the charge on personal portfolio bonds for policies and contracts where an index or property is, broadly speaking, of a public or not unusually restricted nature (as defined in sections 518 to 521). Many unit-linked policies benefit from this let-out. This section is based on regulation 4 of PPB(T)R.

Section 518: The index categories

2045. This section is based on regulation 4 of PPB(T)R.

2046. Schedule 4 to this Act indicates that the definitions of "retail prices index" in section 833(2) of ICTA and "recognised stock exchange" in section 841(1) of ICTA apply.

Section 519: The index selection conditions

2047. This section is based on regulation 4 of PPB(T)R. The selection conditions seek to ensure that the opportunity to select is not narrowly restricted. While occasionally such an opportunity is made available to all policy holders of an insurer, or their agents (the "general selection condition"), more often various products are linked to a number of indices, when the opportunity to select is offered to one or more large classes of policy holder, or their agents (the "class selection condition").

2048. It is made explicit that it is immaterial, in respect of both the general and the class selection conditions, whether the opportunity is offered to the policy holders themselves or to their agents (such as financial advisers).

Section 520: The property categories

2049. This section is based on regulation 4 of PPB(T)R.

2050. Categories 1 to 4 and 7 are types of collective investment scheme, whether based in the United Kingdom or elsewhere, which satisfy the appropriate rules of investment regulatory bodies.

2051. Category 5 is cash, so long as the cash is not held to realise a profit on selling it. Such a profit may only be realised on foreign currency.

2052. Category 6 is an investment in a policy or contract to which this Chapter applies, other than one that is, or is in any way related to, a personal portfolio bond. "Related property", a term used in *subsection (3)(c)*, in relation to any policy or contract (or the premiums paid on it), means income which derives directly or indirectly from holding the policy or contract, or investing in it. In the source legislation, this term is defined by reference to section 660A(10) of ICTA, but that provision is rewritten in Chapter 5 of Part 5 of this Act.

Section 521: The property selection conditions

2053. This section is based on regulation 4 of PPB(T)R. The commentary on section 519 applies equally here.

Section 522: Method for making annual calculations under section 515

2054. This section is based on regulation 5 of PPB(T)R. It takes a similar approach to that used in the other required calculations in this Chapter, that is, a calculation formula plus supporting method statements to find the amounts relevant to the formula.

2055. However, whereas in those other calculations the figure found by applying the formula produces the amount of the gain, *subsection (4)* sets the gain at 15% of the figure found by applying the formula.

2056. Any year in which the policy or contract was not a personal portfolio bond nevertheless enters the calculation. So the relevant premiums, previous gains under this section and excess events are those of any insurance year of the policy or contract. Where regulation 5 of PPB(T)R refers to a year in which the bond was in existence, this means a year when the policy or contract was in existence, rather than a year in relation to which the policy was a personal portfolio bond. The term "personal portfolio bond" is used in the regulation merely to identify the policy or contract in question.

Section 523: The total amount of personal portfolio bond excesses

2057. This section is based on regulation 5 of PPB(T)R.

Section 524: The total amount of part surrender gains

2058. This section is based on regulation 5 of PPB(T)R.

2059. The exclusions made by *subsections (4)* and *(5)* affect assignments. That type of transaction has frequently been used in tax planning to avoid the charge rewritten in this Chapter.

2060. Because of the change of approach mentioned in the commentary on section 510, the calculations under sections 507 and 511 are independent (albeit sharing some features). It is therefore unnecessary to rewrite paragraph 5(2B)(c) of PPB(T)R, as the provisions mentioned there contribute only to the calculation under section 511.

Section 525: Chargeable events where annual calculations show gains

2061. This section is based on regulations 5 and 6 of PPB(T)R.

Section 526: Power to make regulations about personal portfolio bonds

2062. This section is based on section 553C of ICTA. But the powers given here for the Treasury to make regulations apply only to certain aspects of the charge on gains treated as arising under section 525. See *Change 94* in Annex 1.

2063. The regulations contained in PPB(T)R, in so far as they apply to determine the amount of the gain under the special charge and how that gain is charged to income tax, are rewritten in the preceding sections. The regulations remain in place in respect of calculating and charging gains to corporation tax. The regulations also remain in place as regards the duties of insurers in sections 552 to 552B of ICTA.

2064. To the extent that the regulations are rewritten for income tax purposes in these sections, the powers in section 553C of ICTA are spent.

2065. The power given is to make regulations about the administration of this charge, which in practice means regulations in connection with the duties of insurers.

Section 527: Reduction for sums taken into account otherwise than under Chapter 9

2066. This section is based on section 547 of ICTA. It prevents a double charge to tax where a sum, which is taken into account in calculating a gain under this Chapter, also falls to be taken into account in computing another type of taxable income. For example, it might also constitute a trading receipt.

2067. This rule is provided because the process for determining when a chargeable event occurs, and how much the gain is, does not sit well with the usual procedure for ensuring that income is taxed under one charging provision only (such as the priority rules in section 366 of this Act). That is, it may be necessary for such receipts to be brought into a calculation under this Chapter before it can be determined whether a chargeable event has occurred or a gain has arisen. Section 366(4) permits inclusion of such receipts in more than one computation.

2068. Although the source legislation is in terms of an amount taxable under section 547(1) of ICTA and an "amount which is chargeable to tax" apart from that subsection, this section reduces the gain otherwise chargeable by the "amount of the receipt or other credit item" taken into account in the other calculation. "Credit item" is not a defined term, but is used in, for example, section 4of this Act. See *Change 95* in Annex 1.

Section 528: Reduction in amount charged: non-UK resident policy holders

2069. This section is based on section 553 of ICTA. In effect, it exempts the part of the gain on foreign policies that represents investment profit for the period when the policy holder was not resident in the United Kingdom. The reduction does not apply to gains arising on life annuity contracts.

2070. The reduction is proportionate to the period during the course of the policy, measured to the date the chargeable event occurred, in which the policy holder was not UK resident. This method reverses the approach in the source legislation, where the calculation produces the amount of the reduced gain, rather than the amount by which the gain is reduced.

2071. The policy holder and the person or persons liable to tax on the gain may not be the same.

2072. *Subsections (5)* and *(6)* provide a special rule for a "new policy". Under paragraph 17 of Schedule 15 to ICTA, a "new policy" is a policy which is issued in substitution for, or on the maturity of, an earlier policy (as a result of exercising an option contained in the earlier policy). Where there has been one or more replacement policies, the course of the policy is taken to run from the earliest original policy.

Section 529: Exceptions to section 528

2073. This section is based on section 553 of ICTA.

2074. Because the reduction under this section is not made if the policy is held by non-UK resident trustees, it is the unreduced gain which is taken into account for the purposes of section 740 of ICTA where section 468 applies.

2075. *Subsection (2)* applies the rules in section 110 of FA 1989, which determine when a body of trustees, one or more of whom would be regarded as resident in the United Kingdom and one or more of whom would not be so regarded, are all to be regarded as resident in the United Kingdom or not so resident.

2076. The source legislation does not take account of section 110 of FA 1989. Although section 110 of FA 1989 applies only to 1989-90 and subsequent years, it is applied here in respect of all earlier years where necessary, as it would be impractical to apply the provision using two different tests of residence status. See *Change 96* in Annex 1.

2077. See also section 546 (table of provisions subject to special rules for older policies and contracts). *Change 96* is not applied in paragraph 106 of Schedule 2 to this Act as that paragraph refers to a time wholly before the rule introduced by FA 1989 applies (see paragraph 106(3)).

Section 530: Income tax treated as paid etc.

2078. This section sets out when (subject to section 531) an income tax allowance is available to set off against the tax chargeable on the gain. It is based on section 547 of ICTA.

2079. The allowance is an amount equivalent to the lower rate of income tax on the gain (see section 1A(1B) of ICTA). It is treated as tax paid by the individual or trustees liable to tax on the gain. The allowance is not available to personal representatives who are so liable.

2080. An individual whose income is chargeable at the higher rate (see section 1(2)(b) of ICTA) will pay tax at that rate on the gain, against which the allowance can be set.

2081. The trustee or trustees of a non-charitable trust pay tax at the rate applied by section 686(1AA)(b) of ICTA, subject to the set-off of the allowance. The trustee or trustees of a charitable trust pay tax on gains at the lower rate (see section 467(7)(a)), and therefore have no net liability where the allowance is due.

2082. Taxpayers whose income is chargeable at the starting, lower or basic rates only, and non-taxpayers, have no further income tax liability when the allowance is due.

2083. *Subsection (2)* provides that the tax treated as paid is not repayable even if the individual (or the trustee or trustees) is a non-taxpayer or the allowance exceeds the tax charged on the gain.

2084. *Subsection (3)* caps the allowance when the net income chargeable to tax is reduced below the amount of the gain because of other deductions. The allowance is reduced accordingly.

2085. *Subsection (6)* ensures that the starting rate of tax (section 1(2)(aa) of ICTA) does not apply when calculating the liability to tax on a gain of an individual who is entitled to the allowance.

2086. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 531: Exceptions to section 530

2087. Broadly, this section denies the income tax allowance provided by section 530 to policies and contracts where the underlying investment profit is not subject to UK tax. Where this section applies, the tax charge for the person liable includes the starting rate of income tax (section 1(2)(aa) of ICTA) where applicable. It is based on sections 547, 553 and 553A of ICTA.

2088. This section is disregarded for the purposes of a top-slicing relief calculation (see sections 535 to 537) so that the calculation assumes there was an income tax allowance.

2089. And the income tax allowance may be available where the policy or contract is with a European Economic Area ("EEA") or other non-UK resident insurer (*subsection (2)*), or where a foreign policy of life insurance is issued by the UK permanent establishment of a non-UK resident insurer (*subsections (5)* and *(6)*). In these circumstances, the underlying investment profit has been subject to UK tax or to comparable tax in an EEA or other country.

2090. Subsection (5) refers only to policies which are foreign policies of life insurance under the first part of the definition in section 476(3), and not to policies under the second part. This preserves the intended operation of section 553(7) of ICTA for such policies despite the apparent override of that provision in section 553A(3) of ICTA for *all* foreign policies. See *Change 97* in Annex 1.

2091. *Subsection (3)* sets out the types of policies and contracts which are excepted by this section from section 530.

2092. Paragraph (a) makes clear that life annuity contracts issued by a friendly society in its tax-exempt business are within the exception, as well as life insurance policies so issued, despite the reference in the source legislation to policies only. Section 547(7) of ICTA applies to gains under both sections 541 and 543 of ICTA. Its opening words are "Where under section 541, 543 or 546C(7)(b), a gain is to be treated as arising in connection with a policy…". However, while section 541 of ICTA deals with gains on policies, section 543 of ICTA deals with gains on contracts for life annuities. Section 547(7) of ICTA therefore applies to contracts for life annuities.

2093. Paragraph (b) indicates section 530 does not apply to a gain on a foreign policy of life insurance unless the policy meets conditions which indicate that the underlying investment profit earned by the policy has borne UK tax.

Section 532: Relief for policies and contracts with European Economic Area insurers

2094. This section and the following section are based on sections 547 and 553 of ICTA. This section sets out when the income tax allowance provided by section 530 may be available for a gain on a foreign policy or contract, despite the exception in section 531. It applies where:

- a claim is made under this section;
- the insurer conditions (conditions A and B) are satisfied; and
- reinsurance of a particular type (see the definition of "excluded reinsurance contract" in *subsection (5)*) has not been made in respect of the policy or contract (condition C).

2095. In relation to "policies", the section makes clear that the relief provided extends to foreign capital redemption policies as well as to life insurance policies.

2096. *Subsection (1)* sets out that a claim under this section must simply be made, rather than made to the Inland Revenue, or (as in the source legislation) to the Board of Inland Revenue. See *Change 149* in Annex 1.

2097. The definition of "policy period" in *subsection (5)* excludes any period when the policy or contract has already been subject to UK tax on the underlying investment profit.

Section 533: Meaning of "comparable EEA tax charge"

2098. This section sets out the requirement for the purposes of section 532 that the tax charge applied to the EEA insurer is at least broadly equivalent to that applying to insurers operating in the United Kingdom. This section is based on sections 547 and 553 of ICTA.

2099. The term "insurer" in *subsection (1)* recognises that the range of bodies issuing policies or contracts in another EEA country may be different from that met in the United Kingdom, and is not necessarily equivalent to an insurance company. And for that reason, the term "insurance company" (which is defined in section 545) has not been used here.

Section 534: Regulations providing for relief in other cases where foreign tax chargeable

2100. This section is based on section 56(3) of FA 1995. It gives the Board of Inland Revenue power to make regulations which provide the same relief as does section 532 where:

- the insurer is not resident in a EEA country or territory;
- the insurer is subject to tax in that non-EEA country or territory (as described in section 532); and
- a claim for the relief is made.

2101. No regulations have been made yet under section 56(3) of FA 1995.

Section 535: Top slicing relief

2102. This section, and sections 536 and 537, are based on section 550 of ICTA. They provide a relief where the gain charged under this Chapter takes an individual's taxable income into the higher rate of tax. The relief reduces or eliminates the higher rate charge.

2103. The relief is given by reducing the amount of tax charged on the gain, or by repayment. It is given without a claim being required. See *Change 98* in Annex 1.

2104. The relief is calculated by comparing the tax chargeable on the gain (or gains) with the tax that would be chargeable on a fraction of the gain, in both cases after setting off the appropriate income tax allowance under section 530. The fraction (the "annual equivalent") is calculated by reference to the number of years the policy or contract has been in existence. The relief is the difference between the tax otherwise chargeable on the full gain and the tax that would be charged if the full gain were taxed at the rate of tax chargeable on the fraction.

2105. How to determine the fraction, and how the tax chargeable on the fraction is calculated, depends on whether the individual is taxable under this Chapter in the tax year on a gain from one chargeable event (section 536) or on gains from more than one event (section 537).

2106. *Subsection (3)* sets out how to calculate the tax on the gain(s) before any relief under this section has been given. The gain is treated as the "top slice" of the individual's total income.

2107. *Subsection (5)* ignores certain items of income in working out an individual's "total income" for these purposes. Section 835 of ICTA defines "total income", in relation to any person, as "the total income of that person from all sources estimated in accordance with the provisions of the Income Tax Acts".

Section 536: Top slicing relieved liability: one chargeable event

2108. This section is based on sections 550 and 553 of ICTA.

2109. The method employed in *subsection (1)* takes three steps. The first step determines a fraction of the gain (called the "annual equivalent"). The second calculates the net tax charge that would apply to that fraction. The third step works out the tax on the whole gain (called the "relieved liability") by multiplying the tax calculated under step 2 by the factor ("N" – see step 1) which was used to find the fraction.

2110. "N" represents the *number* of complete years the policy or contract has run before the chargeable event.

2111. *Subsections (2)* to *(8)* contain rules which modify how "N" is worked out. For example, where the gain is from a "calculation event", that is, a part surrender or assignment that gives rise to a gain, subsection (2) substitutes the number of years since the latest "calculation event" which arose on that policy or contract. (But, where the policy is a "new policy" (see subsection (5)) in relation to a replaced policy, any calculation event which arose on the replaced policy is disregarded for the purposes of subsection (2), even though the life of the "new policy" is, under subsection (4), dated from the commencement of the earlier replaced policy.)

Section 537: Top slicing relieved liability: two or more chargeable events

2112. This section is based on section 550 of ICTA. It employs the same method approach as section 536, and the same rules modifying the calculation of the factor ("N") by which each gain is to be divided for the purposes of the calculation.

2113. However, the actual method employed differs in two respects. First, the fractions (the "annual equivalent") of each gain are totalled, so that the tax calculation under step 2 is made in respect of the totalled amount.

2114. Second, the relieved liability is found by multiplying the net tax on the total annual equivalents by the aggregated gains and dividing the result by the total annual equivalents. (Roughly speaking, this gives a result based on a weighted average of "N".) This method statement expresses explicitly the calculation described in section 550(6) of ICTA for such cases.

2115. The product of this calculation is compared with the unrelieved liability on the full gains (as calculated under section 535(3)) to work out how much top slicing relief is available.

2116. For example, if an individual is chargeable on gains totalling £31,000 under this Chapter (say, gains of £6000 from one policy where "N" is four years and gains of £25,000 from another policy where "N" is ten years), and the net tax chargeable on those gains before relief (the "unrelieved liability") would be, say, £2400:

- the "total annual equivalent" is £4000 (£1500 from the first policy plus £2500 from the second);
- the "total relieved liability" on the total annual equivalent is, say, £200;
- the relieved liability is £1550 (the total relieved liability £200 multiplied by the total gains £31,000, divided by the total annual equivalent £4000);
- top-slicing relief is £850 (unrelieved liability £2400, less relieved liability £1550).

Section 538: Recovery of tax from trustees

2117. This section provides a right of recovery for an individual who, although the rights in question under the policy or contract are held by non-charitable trustees, is liable to tax on a gain or gains under this Chapter because section 465(1)(b) applies. It is based on section 551 of ICTA.

2118. *Subsection (1)(c)* defines the tax that may be recovered from the trustees. Broadly, it is the extra tax paid on the gain or gains after any top slicing relief. Where top slicing relief is available and there is more than one chargeable event in the year, with at least one gain giving liability by virtue of section 465(1)(b), *subsection (4)* provides that the relief is to be apportioned between the gains charged in working out the extra tax.

2119. *Subsection (3)* sets a cap on the amount that can be recovered from trustees, by reference to what they have derived from the relevant chargeable event.

2120. *Subsections (5)* and *(6)* allow the individual to require the Inland Revenue (rather than the Board of Inland Revenue) to certify an amount recoverable from the trustees. See *Change 149* in Annex 1.

Section 539: Relief for deficiencies

2121. Together with sections 540 and 541, this section is based on section 549 of ICTA. These sections provide a sort of "loss" relief where:

- the overall gain on a policy or contract is less than the amounts that were charged as gains on chargeable events occurring in earlier policy years; and
- the individual in question was the person liable to tax on those gains.

2122. The relief is only available to an individual. It only reduces tax charged at the higher rate or the "dividend upper rate" (the Schedule F upper rate in the source legislation).

2123. Under *subsection (1)*, the relief is only given to an individual who would have been liable on a gain, had one arisen on the chargeable event in question. For this purpose, the requirement in section 465(1), that an individual must be UK resident to be liable, is disregarded. The effect of this is that a non-UK resident individual, who is not liable under section 465(1), but is chargeable to income tax on other income, is not denied the benefit of this relief.

2124. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 540: When deficiencies arise: events following calculation events

2125. This section is based on section 549 of ICTA. Under *subsections (2)* to *(4)*, a deficiency may only arise where:

- there is a chargeable event within certain of the categories of chargeable event listed in section 484(1);
- there has previously been a gain on a "calculation event" (see section 491(4)), other than a "personal portfolio bond event", in respect of that policy or contract; and
- the calculation carried out under section 491 does not produce a gain.

2126. Although the amount of the deficiency to be relieved ignores any gains on personal portfolio bond events under section 522, the calculation under section 491 does not exclude such gains in arriving at the overall "loss".

Section 541: Calculation of deficiencies

2127. This section explains how to calculate the amount of a deficiency. It is based on section 549 of ICTA. It uses the "total benefit value" of the policy or contract, and the "total allowable deductions", in respect of the event, as calculated for section 491, to find the amount. What those terms mean in detail is shown by the calculation methods in sections 492 and 494 respectively.

2128. There are two possible amounts. Where the investor has made no overall gain, on comparing the "total benefit value" of the policy or contract and the "total allowable deductions", all earlier gains which formed part of that individual's total income are "refunded" as the amount of the deficiency. If there is a gain, but it is less than those earlier gains, the amount of the deficiency is those gains minus the net overall gain. (In determining for this purpose whether there has been an overall gain and, if so, its amount, the earlier gains are themselves disregarded.)

Section 542: Replacement of qualifying policies

2129. This section treats a qualifying policy and another qualifying policy which it replaces as a single policy for the purposes of certain sections in this Chapter (the general rules for when chargeable events occur and how gains are calculated). The commonest circumstance in which this section applies is where a life is added to or removed from a policy on marriage or divorce. It is based on paragraph 20 of Schedule 15 to ICTA.

2130. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 543: Issue time of qualifying policy replacing foreign policy

2131. This section substitutes the start date of the old policy as the start date of the new policy for a particular circumstance where one policy has been substituted for another. It is based on section 553 of ICTA.

Section 544: Application of Chapter to policies and contracts in which companies interested

2132. This section deals with the circumstance where the application of this Chapter, that is, whether there is a chargeable event and what the amount of the gain is, has to take into account anything that occurred (or may yet occur) in respect of the policy at a time when any liability may, wholly or in part, arise or have arisen under the equivalent corporation tax provisions. It is new. (Paragraph 210 of Schedule 1 to this Act inserts section 539ZA of ICTA for the equivalent corporation tax purposes.)

2133. The section makes clear that this Chapter applies in respect of any other circumstance regardless of any application of "the corporation tax provisions" at that time. For example, if there has been a chargeable event under section 509 at a time when liability on the gain arose wholly or in part under section 547(1)(b) of ICTA (so that there was also a chargeable event under, say, section 540(1)(a)(v) of ICTA), that event is taken into account in the later application of this Chapter, even if there would then be no liability under section 547(1)(b) of ICTA.

Section 545: Minor definitions

2134. This section provides minor definitions for the purposes of this Chapter.

2135. The definitions of "charitable trust", "friendly society" and "non-charitable trust" are based on section 539 of ICTA.

2136. The definition of "insurance company" is new for the purposes of this charge, although the Tax Acts provide a definition for other purposes. See *Change 99* in Annex 1. (There is no Chapter-wide definition of "insurer". Depending on the provision, that word may mean the insurer for the time being or the original insurer with whom the insurance or contract was made. Where a definition is needed, it has been provided for the purposes of the section in question (for example, see section 501)).

2137. The definition of "market value" is based on the definition provided by regulation 2(1) of PPB(T)R for the purposes of those regulations. The term is not otherwise defined in the source legislation. See *Change 100* in Annex 1.

2138. The definitions in *subsection (2)* of "premium", and in *subsection (3)* of "the amount of premiums paid" are based on the definition in regulation 2(2) of PPB(T)R. They clarify rather than replace "premium" as the term is generally understood, and are not regarded (in so far as they apply for the purposes of the Chapter rather than for the special charge on personal portfolio bonds only) as a change in the law.

Section 546: Table of provisions subject to special rules for older policies and contracts

2139. This section provides an index to the paragraphs of Parts 6 and 7 of Schedule 2 to this Act that modify the operation of certain provisions in the Chapter for older policies and contracts. It is new.

2140. The section also indicates those paragraphs in Part 5 of that Schedule that are relevant to this Chapter but depend on time factors other than the date on which the policy or contract was made.

Chapter 10: Distributions from unauthorised unit trusts

Section 547: Charge to tax under Chapter 10

2141. This section is based on sections 18(1) and (3) and section 469(3) and (4) of ICTA.

2142. This section refers to "schemes to which section 469 of ICTA applies" as a definition of "unauthorised unit trusts" would involve setting out a number of provisions used in ICTA.

2143. For the purposes of this Act unit holders liable to income tax are treated as receiving "income" rather than "annual payments". But for other tax purposes, for example sections 348 and 349 of ICTA, unit holders continue to be treated as receiving annual payments which are subject to deduction of tax. This is achieved by consequential amendment to section 469(3) of ICTA. This is a temporary measure until those provisions which impact on distributions from unauthorised unit trusts which are not rewritten in this Act are rewritten.

Section 548: Income charged

2144. This section sets out the amount of income treated as received by a unit holder from an unauthorised unit trust scheme which is charged to tax. It is based on section 469 of ICTA.

2145. *Subsection (2)* contains a method statement setting out the steps to be taken to calculate the amount of income on which the investor is charged to tax. The definition of "distribution period" in section 469(6) of ICTA has been provided in *subsection (5)* to assist in the calculation.

Section 549: Person liable

2146. This section states who is liable for any tax charged. It is based on sections 59(1) and 469(3) of ICTA.

Section 550: Income tax treated as paid

2147. This section is based on sections 348(1)(d) and 469(3) of ICTA.

2148. Where the unit trust has been treated as making annual payments under section 348 of ICTA (payment out of profits or gains brought into charge to income tax) or under section 349 of ICTA (payment not out of profits or gains brought into charge to income tax) the tax deducted will be treated as tax paid by the unit holder.

2149. Under section 348(1)(d) of ICTA tax deducted from annual payments under section 348(1)(b) of ICTA is treated as paid by the recipient. Case law extends this to tax deducted under section 348(2) of ICTA and section 349 of ICTA. In allowing all tax deducted under sections 348 and 349 of ICTA to be treated as tax paid by the unit holder section 550 fills a gap otherwise filled by case law. For more detail see the commentary on section 426.

Chapter 11: Transactions in deposits

Overview

2150. This Chapter charges profits from the disposal of deposit rights to tax. It is based on sections 56 and 56A of ICTA.

2151. Until 2003, "deposit rights" generally took the form of a "certificate of deposit". A certificate of deposit is created when money has been deposited with a person who issues a certificate containing a promise to pay a certain amount, with or without interest, to whoever holds the certificate. Such certificates are transferable. There is a paperless version of this arrangement where no certificate is issued but someone is entitled to call for its issue.

2152. What is now section 56 of ICTA was introduced by section 26 of FA 1973. The purpose of the legislation was to stop a tax avoidance device whereby certificates of deposit were sold just prior to maturity. The certificates were sold at a profit but, because the increase in value was not interest, the seller escaped tax under Schedule D Case III. Furthermore, because certificates of deposit do not constitute a debt on a security, the seller also escaped capital gains tax. Section 26 of FA 1973 stopped the avoidance by providing that, where the right to receive the amount stated in a certificate of deposit is disposed of, the gain arising is treated as an annual profit or gain charged to tax under Schedule D Case VI.

2153. Under the source legislation, paperless deposit rights (that is, those deposit rights not evidenced by a paper certificate, where the holder is nevertheless entitled to call for the issue of a certificate) are dealt with by section 56A of ICTA. That provision was introduced by section 34 of and Schedule 8 to F(No 2)A 1992. It applies the charge under section 56 of ICTA.

2154. Administration of the UK market in certificates of deposit and their paperless equivalents, and other forms of money market instrument, has become increasingly centralised and computerised. In 2001 the Treasury made regulations under section 207 of the Companies Act 1989 to facilitate the computerisation of the market (the Uncertificated Securities Regulations 2001 SI 2001/3755). The regulations introduced the concept of "units of a security to be evidenced otherwise than by a certificate and transferred otherwise than by a written instrument".

2155. After a period of preparation, existing money market instruments, including certificates of deposit, migrated to a new, wholly computerised and uncertificated system in September 2003. It remains possible, in theory at least, for a paper certificate of deposit to be issued (and a paper version of other types of money market instrument). But conventionally it is now units of an "eligible debt security" that are issued.

2156. The Treasury made regulations in June 2003, again under section 207 of the Companies Act 1989, amending SI 2001/3755 to cater for, among other things, "eligible debt securities" (the Uncertificated Securities (Amendment) (Eligible Debt Securities) Regulations 2003 SI 2003/1633 – the "2003 regulations"). That term is defined in regulation 3(h) as:

"(a) a security that satisfies the following conditions-

(i) the security is constituted by an order, promise, engagement or acknowledgement to pay on demand, or at a determinable future time, a sum in money to, or to the order of, the holder of one or more units of the security; and

(ii) the current terms of issue of the security provide that its units may only be held in uncertificated form and title to them may only be transferred by means of a relevant system;

(b) an eligible Northern Ireland Treasury Bill; or

(c) an eligible Treasury Bill.

2157. The 2003 regulations also modify numerous provisions to cater for the new type of money market instrument where legislation applies to one or other type of migrated instrument. Some of the legislation is tax provisions, including section 56 of ICTA. Paragraph 6 of Schedule 2 to the 2003 regulations deals with certificates of deposit. In an enactment to which paragraph 3 applies:

"(a) a reference to a certificate of deposit includes a reference to uncertificated units of an eligible debt security where the issue of those units corresponds, in accordance with the current terms of issue of the security, to the issue of a certificate of deposit which is a certificate of deposit for the purposes of that enactment; and

(b) a reference to an amount stated in a certificate of deposit includes a reference to a principal amount stated in, or determined in accordance with, the current terms of issue of an eligible debt security of the kind referred to in subparagraph (a).

2158. Although the modification applied by the 2003 regulations does not amend the text of the statute in question, it has the same effect as an amendment. Section 552 therefore defines "deposit rights" to encompass all types of deposit, old and new.

2159. While the vast majority of deposit rights in 2005-06 and later years will take the form of units of uncertificated eligible debt securities, there are likely to be a few extant old certificates of deposit (or the previous paperless equivalent) or new certificated deposits, and this Chapter applies to them.

2160. A number of consequential amendments in Schedule 1 to this Act add, for income tax purposes, the modification applied by the 2003 regulations (see, for example, paragraph 148 which amends section 349 of ICTA). As regards the reference to "rights" in section 398 of ICTA (which modifies loss relief under sections 392 or 396 of ICTA in relation to the disposal of deposit rights), the modification applied by the 2003 regulations is provided, for income tax purposes, through the consequential amendment in that Schedule inserting a reference to this Chapter.

2161. In so far as sections 56 and 56A of ICTA continue to apply after 2004-05 for corporation tax purposes (but see section 56(4A) and (4B) of ICTA), the modification is still provided by the 2003 regulations. For corporation tax purposes, the reference to "rights" in section 398 of ICTA is modified accordingly.

2162. For the purposes of the exemptions provided by section 56(3)(b) and (c) of ICTA, which are not rewritten in this Act, the modification is also still provided by the 2003 regulations.

2163. This Chapter does not rewrite section 56(3)(a) of ICTA, under which there is no charge in respect of a right to receive an amount stated in a certificate of deposit issued before 7 March 1973. As certificates of deposit are in practice issued for a maximum term of five years, section 56(3)(a) of ICTA is obsolescent, if not obsolete. Paragraph 92 of Schedule 2 to this Act provides a saving for extant pre-7 March 1973 certificates (if any).

Section 551: Charge to tax on profits from disposal of deposit rights

2164. This section is based on sections 56 and 56A of ICTA.

2165. As deposit rights consist of the right to receive interest and the right to the return of the principal amount, *subsection (2)* makes clear that receiving the principal amount is a disposal of rights for the purposes of the charge to tax but receiving interest is not. Such interest is taxable under Chapter 2 of this Part.

Section 552: Meaning of "deposit rights"

2166. This section is based on sections 56 and 56A of ICTA, as modified by the 2003 regulations.

2167. S*ubsection (2)* defines various terms. The definitions of terms in relation to "uncertificated eligible debt security units" are based initially on the modification provided by the 2003 regulations, although the definitions themselves are based individually on earlier regulations. The definition of a "certificate of deposit" is based on sections 56(5) and 56A(4) of ICTA. The definition of a "security" is based on section 56(5) of ICTA, which uses the definition in section 132 of TCGA. The definition of an "uncertificated right" is based on section 56A(1) of ICTA. Paragraph 93 of Schedule 2 to this Act preserves the commencement rule for this category, in so far as any pre-16 July 1992 arrangements are extant.

Section 553: Income charged

2168. This section sets out the amount of income charged to tax. It is based on section 69 of ICTA.

Section 554: Person liable

2169. This section states who is liable for any tax charged. It is based on section 59 of ICTA.

2170. Section 56(2) of ICTA, as extended by section 56A(3)(a) of ICTA, sets out in rather elaborate terms the persons whose exercise of a deposit right results in the profits being charged to tax. But section 59 of ICTA achieves the same effect by simpler means, so those parts of sections 56 and 56A of ICTA are not rewritten.

Chapter 12: Disposals of futures and options involving guaranteed returns

Overview

2171. This Chapter rewrites the provisions in Schedule 5AA to ICTA on guaranteed returns on transactions in futures and options. It taxes as income profits and gains on a disposal of a future or option which, but for this Chapter, would be taxed as chargeable gains.

Section 555: Charge to tax under Chapter 12

2172. This section charges to tax profits and gains arising on a disposal of a future or option to which the Chapter applies. It is based on paragraph 1 of Schedule 5AA to ICTA.

2173. The section refers to "profits and gains", as in the source legislation, since the profits arising may also be gains for the purposes of TCGA. There are provisions to ensure that a double charge under both this Chapter and TCGA does not arise. See new section 148A of TCGA (futures and options involving guaranteed returns) in paragraph 435 of Schedule 1 to this Act.

2174. The word "disposal" (see section 562 (when disposals of futures or options occur: general)) replaces "transaction to which this Schedule applies" since a gain can only arise on a disposal, although not all transactions are necessarily disposals.

2175. *Subsection (1)* refers to a disposal of a future or option rather than a disposal of futures or options as in paragraph 2(1) of Schedule 5AA to ICTA. A taxpayer is taxed on a disposal of a future or an option. A similar reference to a disposal of a future or option appears in sections 559 and 560 where the source legislation refers to a disposal of futures or options.

2176. *Subsection (2)* provides that profits which, but for this Chapter, would be capital profits, may be charged under this Chapter.

2177. Profits and gains from a trade, whether arising in the United Kingdom or abroad, are excluded and dealt with under Part 2 of this Act. See section 366(1) which gives the charge in Part 2 priority. That aside, the charge under this Chapter is on both UK and foreign profits and gains. See *Change 101* in Annex 1.

Section 556: Income charged

2178. This section sets out the amount charged to tax on profits and gains that arise on the disposal of a future or option. It is based on paragraph 1 of Schedule 5AA to ICTA.

2179. Schedule 5AA to ICTA provides no precise computational rules for computing the profit or gain arising on the future or option chargeable to tax. It refers only to the profits being "realised". This is rewritten by providing that the profits are the full amount of profits and gains arising when the disposal occurs. In most cases the quantum of profits will be the difference between the disposal proceeds and the acquisition cost of the future or option.

Section 557: Person liable

2180. This section states who is liable for any tax charged. It is based on paragraph 1 of Schedule 5AA to ICTA.

Section 558: Meaning of "future", "option" etc.

2181. This section explains what is meant by future and option for the purposes of this Chapter. It is based on paragraphs 4 and 4A of Schedule 5AA to ICTA.

2182. *Subsection (2)* reproduces the definition of "traded option" in section 144(8) of TCGA rather than relying on a cross-reference to that Act, as paragraph 4(6) of Schedule 5AA does. But the section does not employ the term "traded option". The distinction between a traded option and any other option is relevant only for paragraph 4(3) of Schedule 5AA to ICTA. Section 562 (when disposals of futures or options occur: general), which rewrites that paragraph, applies the substance of the definition without using the term.

2183. *Subsection (3)* has, for the sake of convenience, been introduced from TCGA.

Section 559: When disposals involve guaranteed returns

2184. This section explains for the purposes of this Chapter when a disposal involves guaranteed returns. It is based on paragraph 2 of Schedule 5AA to ICTA.

2185. *Subsection (1)* provides that where the conditions in *subsections (2)* to *(4)* are met a disposal will involve guaranteed returns. These conditions are that there must be at least one other related transaction, apart from the disposal giving rise to the charge, and that this, and the related transaction, are intended to produce a guaranteed return. (What is meant by “related transactions” is explained by section 566 (when transactions are related)). The guaranteed return should consist of the return from the disposal in question or a number of disposals of which the disposal in question is one.

2186. *Subsection (5)* explains the phrase used in the first condition “two or more related transactions designed to produce a guaranteed return”. A “main purpose test” is applied to the two or more related transactions. Considering them together, it must be reasonable to assume that their main purpose or one of their main purposes is to produce that guaranteed return.

2187. *Subsection (6)* then explains what factors may be considered in making a “reasonable assumption”. These are the same factors as in section 566 (when transactions are related).

Section 560: Production of guaranteed returns

2188. This section explains, for the purposes of this Chapter, what is meant by producing a guaranteed return from a disposal of a future or option. It is based on paragraph 3 of Schedule 5AA to ICTA.

2189. *Subsection (1)* gives the basic rule for ascertaining whether a guaranteed return is produced from a disposal of a future or option. A risk of fluctuations in the underlying subject matter (defined at *subsection (6)*) of the future or option must be eliminated or reduced so that the return on the disposal meets the two conditions in subsections (3) and (4).

2190. *Subsection (2)* supplements the rule in subsection (1) where there is more than one disposal.

2191. *Subsections (3)* and *(4)* provide two conditions that must be met for the basic rule to apply. Broadly, the return on the investment must be predictable and have more similarity to interest than to the risk expected on a future or option.

2192. *Subsection (5)* extends the circumstances in which risks are treated as eliminated or reduced. A main reason for the choice must be the expectation that the value of an asset of that nature will be liable to only minimum fluctuation.

Section 561: The return from one or more disposals

2193. In order to ascertain whether there is a guaranteed return for the purposes of this Chapter, section 559 (when disposals involve guaranteed returns) requires a consideration of “the return from one or more disposals”. This section explains what is meant by “the return from one or more disposals”. It is based on paragraph 5 of Schedule 5AA to ICTA.

2194. *Subsection (1)* contains the basic rule. The charge under section 555 (charge to tax under Chapter 12) is on a profit or gain from an individual disposal. But, in deciding whether there is a guaranteed return, more than one disposal in the scheme or arrangement can be taken into account and the overall result of that disposal or those disposals considered, that is to say the profits or gains less losses on those disposals or on all but an insignificant part of them.

2195. *Subsection (2*) provides that profits or gains or losses are to be treated as made by the same person, notwithstanding that they are realised by different persons, if they are made by persons who are associated with each other.

2196. *Subsections (3)* to *(6)* explain when persons are associated with each other. (This is quite unconnected with the associated person test in section 227 of ICTA.) All disposals must be part of the same scheme or arrangements (defined in *subsection (7)*) and all must share in the net return of all the profits and losses incurred on those disposals in a sharing arrangement agreed for that scheme or arrangements.

2197. The references in paragraph 5(3) of Schedule 5AA to ICTA to "associated companies" have not been reproduced. See *Change 102* in Annex 1.

Section 562: When disposal of futures or options occur: general

2198. Tax is charged under this Chapter on the profits and gains arising from a disposal of a future or option. This section explains when there is a disposal. It is based on paragraph 4 of Schedule 5AA to ICTA.

2199. *Subsection (1)* refers to the relevant sections of TCGA which decide whether and when a disposal occurs. Section 143(5) and (6) of TCGA treat as disposals futures contracts which are closed out by entering into another contract or which are settled by payment. Section 144 of TCGA treats as disposals grants and abandonments of options (but not the exercise of an option). Section 144A of TCGA provides that the exercise of an option which is settled by cash is treated as a disposal both in respect of the grantor of the option and the grantee. These last two sections also provide rules as to when a future or option in these circumstances has been disposed of.

2200. The assumptions that apply in interpreting subsection (1) are set out in subsections (2) to (4).

2201. *Subsection (2)* requires, for the removal of doubt, that all futures are to be considered as assets in applying the TCGA sections. (Options are already listed as chargeable assets in section 21(1) of TCGA.)

2202. *Subsection (3)* requires section 143(5) and (6) of TCGA to be read without the words "in the course of dealing in commodity or financial futures" since the range of futures transactions covered by this Chapter extends beyond commodity and financial futures as defined in section 143 of TCGA.

2203. *Subsection (4)*, by requiring references to a financial option in section 144 of TCGA to exclude only listed options, extends the provisions of that section to cover options that would otherwise be excluded under the definition in subsection 144(8) of TCGA. (Section 144 of TCGA provides for the grant and abandonment of options to be treated as disposals and for premiums to be included in the computation of the gain or loss.) These listed options are referred to as "traded options" in paragraph 4 of Schedule 5AA to ICTA. The context demands that the listing should be at the time of disposal and this has been added for clarification.

2204. *Subsection (5)* provides a cross-reference to sections 563 (timing of certain grants of options where related disposals occur later) and 564 (deemed disposal where futures run to delivery or options are exercised).

2205. Section 563 provides timing rules for deemed disposals where futures run to delivery or option contracts are exercised. Section 564 provides that futures running to delivery and options exercised are treated as disposals for the purposes of this Chapter if they would not otherwise be.

2206. This section does not rewrite paragraph 4(1) of Schedule 5AA to ICTA. That subparagraph explains that a disposal is a disposal of futures or options if it is the disposal of one or more futures or one or more options or both combined. Because a taxpayer is charged on a disposal of a future or option and more than one future or option may already be taken into account in ascertaining whether there is a guaranteed return (see section 561), it is considered that this sub-paragraph adds nothing but simply serves to confuse.

Section 563: Timing of certain grants of options where related disposals occur later

2207. This section provides that certain grants of options are to be treated as having taken place after other transactions. The purpose is to allow loss relief arising on the grant of an option to be set against a later profit. The section is based on paragraph 4 of Schedule 5AA to ICTA.

2208. *Subsection (1)* sets out the general rule. There are three conditions that must be satisfied for the rule to apply.

2209. *Subsections (2)* to *(4)* set out these three conditions. There must be a number of related transactions designed to produce a guaranteed return of which one is the grant of an option. At least one of the other transactions should be entered into after the grant and should be a disposal that is not a grant of an option.

2210. *Subsection (5)* then provides that the grant of the option is deemed to take place at the same time as the next one of the transactions referred to in subsection (4) takes place. As a result, a loss on the grant of an option will coincide with any profit arising on the later transaction. Because losses under Schedule 5AA to ICTA are allowable against Schedule D Case VI profits they may be carried forward against other Schedule D Case VI profits arising in a later year or set off against other Schedule D Case VI profits of the same year, but not carried back. Since the Schedule D Case VI set-off rule is rewritten, this section allows that later profit to be reduced by a loss which, but for this section, could arise in a later year than that profit.

2211. *Subsection (6)* consequently requires that the two timing rules in sections 144(2) and 144A(2) of TCGA, should they apply, take precedence over the timing rule in this section. But in most cases the two rules will give the same result. (Sections 144(2) and 144A(2) of TCGA treat grants of options and transactions by the grantor to fulfil his obligations as a single transaction.) The purpose of this is to allow the sum received on the grant to fall within the same capital gains computation as arises when the option is exercised, etc. Where it applies for this Chapter, the timing rules in these two sections of TCGA will generally achieve the same results as this section. But the rules in sections 144(2) and 144A(2) of TCGA will not always apply because certain transactions within this Chapter fall outside them.

Section 564: Deemed disposal where futures run to delivery or options are exercised

2212. This section provides that futures which are allowed to run to delivery and option contracts which are exercised will be treated as disposals for the purposes of this Chapter if they would not otherwise be disposals under this Chapter. Paragraph 94 of Schedule 2 to this Act ensures that these transactions are not disposals if they took place before 6 February 1998. This section is based on paragraph 4A of Schedule 5AA to ICTA.

2213. *Subsections (2)* and *(3)* provide the conditions that must apply for there to be a deemed disposal. There must be two or more related transactions (section 566 explains what is meant by a related transaction). One of these must be the creation or acquisition of a future or option and the other the running to delivery of that future or exercise of that option but which is not already a disposal for the purposes of this Chapter.

2214. Under *subsection (4)* a disposal is deemed to have taken place the moment before the future runs to delivery or the option is exercised and that disposal is deemed to be a disposal provided for in a scheme or arrangements.

2215. Both parties to the future or option are affected by the deemed disposal.

2216. Under s*ubsection (5)* the person whose rights and entitlements have a value immediately before the option is deemed to dispose of that right or those rights for their market value. Thus the same disposal proceeds are deemed to arise as if the person had disposed of the contract to another and a profit or gain had arisen in those circumstances.

2217. Under *subsections (6)* and *(7)* any other party to the future or option is deemed to have received nothing on the disposal but to have incurred costs equal to the amount the person would have been expected to pay in an arm's length transaction for the release of the person's obligations under the contract.

2218. *Subsection (8)* requires that section 144(2) and (3) of TCGA should be disregarded in applying subsections (1) to (3). This is because under these two subsections of section 144 of TCGA (applicable as a result of section 562 (when disposals of futures or options occur: general)) the grant and exercise of an option are treated as a single transaction (to enable the premium to be set against the disposal proceeds). But, in order for this section to apply, subsections (1) to (3) require *two* related transactions, the creation of the future or option and its running to completion or being exercised, so those two transactions must not be taken to be a single transaction.

Section 565: Interpretation of section 564

2219. This section provides explanations necessary to understand the previous section. It is based on paragraph 4A of Schedule 5AA to ICTA.

2220. *Subsection (3)* defines "party" in relation to the future or option in terms of rights, entitlements, obligations and liabilities, ensuring that both "grantors" and "grantees" of both futures and options fall within the definition.

Section 566: When transactions are related

2221. This section provides an explanation of what is meant by related transactions. The rules given in this section are necessary for the definition of what constitutes a guaranteed return in section 559, for the timing of disposals in section 563 and for applying the provisions on deemed disposals in section 564. This section is based on paragraph 6 of Schedule 5AA to ICTA.

Section 567: Losses

2222. This section gives some rules on losses, when they arise and how they are relievable. It is based on paragraph 1 of Schedule 5AA to ICTA.

2223. *Subsection (4)* gives a link to three sections which have been inserted into TCGA by paragraph 435 of Schedule 1 to this Act. They rewrite paragraph 4A(5) to (9) of Schedule 5AA to ICTA. The rules in these two new sections prevent gains which have been charged under this Chapter from being taxed again under TCGA and losses relieved under this Chapter from being relieved again under that Act. Because these rules are properly relevant to the capital gains regime they are rewritten as consequential amendments to TCGA.

Section 568: Special rule for certain income of trustees

2224. This section provides, with some exceptions, that profits or gains arising to trustees under this Chapter are chargeable to tax at the rate applicable to trusts in section 686 of ICTA. It is based on paragraph 7 of Schedule 5AA to ICTA.

2225. The reference in *subsection (4)* to a superannuation fund to which section 615(3) of ICTA applies has effect for the tax year 2006-07 onwards only. There is a transitional rule in paragraph 95 of Schedule 2 to this Act which gives the rules for 2005-06. Changes to the rules on superannuation funds in FA 2004 only apply from 2006-07.

2226. *Subsection (6)* qualifies the meaning of "trustees" for the purposes of this section. Paragraph 7(3) of Schedule 5AA to ICTA simply refers to section 686 of ICTA but the definition in that section is rewritten in full here.

Section 569: Anti-avoidance: transfer of assets abroad

2227. Sections 739 and 740 of ICTA provide rules to counter the avoidance of income tax by the transfer of assets abroad. They apply where income is payable to a person resident or domiciled outside the United Kingdom but which a person domiciled or resident within the United Kingdom has the power to enjoy. This section enables sections 739 and 740 of ICTA to apply to profits arising under this Chapter by ensuring that the profits or gains are treated as income payable to a person resident or domiciled outside the United Kingdom. It is based on paragraph 8 of Schedule 5AA to ICTA.

Chapter 13: Sales of foreign dividend coupons

Overview

2228. This Chapter rewrites the charge to tax in section 18(3B) to (3E) of ICTA on the proceeds of the sale of coupons and warrants attached to foreign securities and shares, where the sale is made through a bank or to a dealer in coupons and both are in the United Kingdom.

Section 570: Charge to tax under Chapter 13

2229. This section charges to tax income which is treated as arising from foreign holdings where a dividend coupon attached to the holding is (a) sold or otherwise realised by a bank in the United Kingdom or (b) sold to a coupon dealer in the United Kingdom by someone other than a bank or a coupon dealer. The term "foreign holdings" is defined in section 571. The section is based on section 18 of ICTA.

2230. *Subsection (3)* sets out the first circumstance in which income is treated as arising from foreign holdings. This is where the UK office of a bank pays over the proceeds of a sale or realisation of dividend coupons or carries those proceeds to an account. Section 18(3B)(a) of ICTA refers simply to "a bank in the United Kingdom". See *Change 103* in Annex 1.

2231. *Subsection (4)* sets out the second circumstance. This is where a person who is neither a bank nor another coupon dealer sells the dividend coupons to a coupon dealer in the United Kingdom. Section 18(3B)(b) of ICTA refers to "a dealer in coupons in the United Kingdom". See *Change 103* in Annex 1.

Section 571: Meaning of "foreign holdings" etc

2232. This section gives the meaning of "foreign holdings" and "dividend coupons" and of words used within these definitions. It is based on section 18 of ICTA.

Section 572: Income charged

2233. This section sets out the amount charged to tax on income arising from foreign holdings. It is based on section 65 of ICTA.

Section 573: Person liable

2234. This section states who is liable for any tax charged. It is based on section 59 of ICTA.

Part 5: Miscellaneous income

Overview

2235. This Part contains the rules relating to miscellaneous income. It consists of income that is charged under Schedule D Cases III, IV, V and VI and non-schedular charges in the source legislation.

2236. There is a separate Chapter for each category of income arranged as follows:

- receipts from intellectual property (Chapter 2);
- films and sound recordings: non-trade businesses (Chapter 3);
- certain telecommunication rights: non-trading income (Chapter 4);
- settlements: amounts treated as income of settlor (Chapter 5);
- beneficiaries' income from estates in administration (Chapter 6);
- annual payments not otherwise charged (Chapter 7); and
- income not otherwise charged (Chapter 8).

Structure of Chapters

2237. The basic structure of each Chapter is:

- charge to tax on income;
- the amount to be charged to tax;
- the person liable for the tax charged; and
- rules specific to that income.

2238. This Part does not contain exemption provisions. Signposts to the exemptions most likely to be relevant have been placed in the charge to tax provisions.

Part 5: Chapter 1: Introduction

Section 574: Overview of Part 5

2239. This section sets out the income charged in this Part, the approach to exempt income and where to find the priority rules. It is new.

Section 575: Provisions which must be given priority over Part 5

2240. This section provides rules which determine which Part will take priority in the case of any overlaps in the charging provisions. It is based on sections 18 and 20 of ICTA, and section 9D of TMA.

2241. *Subsection (1)* ensures that if any amount falls within a charge in Part 5 of this Act and the charge on trade profits, Chapter 2 of Part 2 of this Act will charge that amount as a trade receipt.

2242. It also reflects the decision to give effect to the Crown Option. See *Change 66* in Annex 1.

2243. *Subsection (2)* ensures that if any amount falls within a charge in Part 5 of this Act and the charge on a UK property business, Chapter 3 of Part 3 of this Act will charge that amount as a receipt of a UK property business. This reflects the priority of Schedule A over Schedule D and is based on section 18(1)(b) of ICTA and Schedule D Cases III(a) and VI.

2244. Particular types of income which, in the source legislation, are charged to tax under Schedule D Case III have been given separate charges to tax in Parts 4 and 5 of this Act. As the general annual payments charge in Chapter 7 of Part 5 of this Act takes effect only if an amount is not otherwise charged to income tax there can be no overlap between this charge and the ex-Case III charges in Part 4 of this Act.

2245. *Subsection (3)*, therefore, provides a rule where there could potentially be an overlap between Chapters within Parts 4 and 5 of this Act. It ensures that the interest charge in Chapter 2 of Part 4 takes priority over any of the charges in Part 5 that are based on Schedule D Case VI. This maintains the priority in the source legislation of Case III over Case VI which charges amounts that do not fall under any other Case of Schedule D.

2246. It also provides the priority between Chapter 3 of Part 4 of this Act (dividends etc. from UK resident companies) and Part 5 of this Act. This rewrites the effect of section 20(2) of ICTA which provides specifically for Schedule F to take priority over the other Schedules.

2247. *Subsection (4)* ensures that if any amount falls within a charge in Part 5 and any of the charging provisions in ITEPA, ITEPA has priority. This reflects the priority of ITEPA over Schedule D and is based on section 18(1)(b) of ICTA and Schedule D Case VI.

2248. The non-schedular charges rewritten in Part 5 of this Act in Chapter 5 (Settlements: amounts treated as income of the settlor) and section 656 (Beneficiaries' income from estates in administration: Income charged: UK estates) do not have the potential to overlap with Chapter 2 of Part 2 of this Act (trade profits) or Chapter 3 of Part 3 of this Act (UK property business) or any of the charges in Part 4 of this Act or ITEPA. There is therefore no need to exclude these charges from the priority rules.

Section 576: Priority between Chapters within Part 5

2249. This section provides rules which determine which Chapter will take priority in the case of any overlaps in the charging provisions within Part 5 of this Act. It is new.

2250. Usually, by their nature, the particular amounts charged in Part 5 of this Act can fall only within one Chapter so there is no need to make any special provision. In addition, as the general annual payments charge in Chapter 7 of Part 5 of this Act takes effect only if an amount is not otherwise charged to income tax there can be no overlap between this charge and the ex-Case III charges in Part 5 of this Act.

2251. This section provides the one priority rule required for this Part. Where amounts fall within Chapter 2 (receipts from intellectual property) and Chapter 3 (films and sound recordings: non-trade businesses), Chapter 3 has priority. Although both charges are based on Schedule D Case VI, priority has been given to Chapter 3 to ensure that these amounts continue to benefit from the special deductions rules set out in sections 612 and 613 of that Chapter.

Section 577: Territorial scope of Part 5 charges

2252. This section provides that income within Part 5 of this Act is only charged to tax if it is from a source in the United Kingdom or, if from a source outside the United Kingdom, it arises to a UK resident.

2253. It is based on section 18(1) of ICTA.

2254. The comments made in the commentary on section 368 of this Act on the absence of a charge to tax on income from outside the United Kingdom arising to non-residents apply here also. See in particular the specific comments on subsections (1), (2) and (3) of that section, the use of the term "source" and how it is proposed to include within that section income without a source.

2255. *Subsection (4)* serves to exclude, for example, section 587 (charge to tax on income from sales of patent rights) from the scope of this rule since that section has its own rules on territorial scope.

Chapter 2: Receipts from intellectual property

Overview

2256. This Chapter incorporates three charges to income tax in respect of intellectual property. The Chapter includes a charge to income tax on royalties and other receipts from intellectual property arising both within and outside the United Kingdom. In this context, intellectual property includes patents, trade marks, registered designs and design rights, copyright, performer's rights or plant breeder's rights. The Chapter also charges to income tax capital sums arising from the disposal of know-how in certain circumstances and capital sums from the sale of patent rights.

2257. The following are excluded from the scope of this Chapter:

- royalties or other receipts from intellectual property which form part of the profits of a trade (dealt with in Part 2 of this Act);
- capital sums from the disposal of know-how which are treated either as trading receipts or as a payment for goodwill (dealt with in Part 2 of this Act or in TCGA); or
- balancing charges for certain forms of intellectual property included in CAA.

2258. Sections 536 (taxation of royalties where owner abroad), 537 (public lending right) and 537B (taxation of design royalties where owner abroad) of ICTA are not rewritten. These provisions all relate to deduction of tax at source under section 349(1) of ICTA.

Section 578: Contents of Chapter

2259. This introductory section sets out the three income tax charges imposed by the Chapter. It is new.

2260. *Subsection (2)* contains a signpost to section 727 of this Act which provides for a limited exemption from income tax for annual payments made by individuals. So payments of royalties which are made by individuals and arise in the United Kingdom will be outside the scope of this section if the conditions in section 727 are met. This subsection also contains a signpost to section 758 of this Act which contains another exemption for certain interest and royalty payments.

Section 579: Charge to tax on royalties and other income from intellectual property

2261. This section charges to tax royalties and other income from intellectual property. It is based on section 18 of ICTA.

2262. The section sets out a new provision creating a specific charge to tax on royalties and other income from intellectual property. The source legislation uses general principles to tax such income. In the source legislation, income from intellectual property is charged:

- as annual payments under Schedule D Case III;

- as profits of a trade under Schedule D Case I;
- as annual profits or gains under Schedule D Case VI; or
- as income arising from possessions out of the United Kingdom under Schedule D Case V.

The new charge covers income charged in the source legislation under the heads mentioned above, except that trading income derived from intellectual property is to be taxed not under section 579 but under Part 2 of this Act. The rules set out in the section are not intended to widen or restrict the scope of the charges under Schedule D in the source legislation.

2263. The charge embraces royalties which are UK source annual payments (Schedule D Case III in the source legislation), overseas income from intellectual property (Schedule D Case V in the source legislation) and casual profits of an income nature from the exploitation of intellectual property outside the course of a trade (Schedule D Case VI in the source legislation). The charges relating to capital sums arising from the disposal of know-how in certain circumstances and capital sums arising from the sale of patent rights are dealt with further on in this Chapter.

2264. *Subsection (1)* contains the charge on royalties and other income from intellectual property. Royalties are mentioned specifically, even though they are covered by the words “income from intellectual property”, since most of the income within the scope of this section is likely to be royalties. However, no attempt has been made to define the term “royalties”. The source legislation does not do so. Although definitions have been suggested by the courts they are not appropriate to include here as the word “royalties” has only been used to assist the courts to determine whether a payment or receipt is of a revenue or capital nature.

2265. *Subsection (2)* defines intellectual property for the purposes of this section. Intellectual property is an area of rapid change. Because of this, it is not possible to define intellectual property by way of an exhaustive list. Subsection (2)(b) therefore charges United Kingdom source royalties and other income from rights which correspond to or are similar to those listed in subsection (2)(a). Subsection (2)(c) covers rights under foreign law which correspond to or are similar to those listed in subsection (2)(a). Also within the scope of the charge is income from any information or technique not protected by a right within subsection (2)(a), (b) or (c) of this section. So subsection (2)(d) provides the flexibility to bring within the scope of the section income derived from new types of intellectual property as changes occur in this field.

Section 580: Income charged under section 579

2266. This section sets out the amount charged to tax under section 579 in respect of royalties and other income from intellectual property. It is supplemented by the detailed calculation rules for certain income in section 582. The section is based on sections 64, 65, 68 and 69 of ICTA.

2267. *Subsection (4)* contains a signpost to section 527 of ICTA (relating to the spreading of patent royalties etc. over several years). Section 527 of ICTA deals with relief in terms of a reduction in the income tax charge. It will be rewritten together with other similar relieving provisions.

Section 581: Person liable for tax under section 579

2268. This section states who is liable for any tax charged under section 579 in respect of royalties and other income from intellectual property. It is based on section 59 of ICTA.

Section 582: Deductions in calculating certain income charged under section 579

2269. This section sets out the rules for the deduction of certain expenses from income charged under section 579 other than annual payments (charged under Schedule D Case III in the source legislation) or foreign income charged on the remittance basis in accordance with section 832 of this Act. It applies to income charged under both Schedule D Case V and Case VI in the source legislation. It is new.

2270. There is no express provision in the legislation for deductions of expenditure from Schedule D Case VI income, although it is implied by the word "profits" in section 69 of ICTA (Case VI assessments) and by section 392 of ICTA (Case VI losses). This view has been upheld by the courts (see Curtis Brown v Jarvis (1929), 14 TC 744 HC). Expenditure admissible relating to income arising in the United Kingdom within the scope of the section would not cease to be admissible in respect of the same type of income arising outside the United Kingdom. However, under section 64 of ICTA (Case III assessments) no deduction is permitted from income within the Schedule D Case III charge so this section specifically does not apply to annual payments.

2271. *Subsections (2) to (4)* contain general rules about the expenditure which may be deducted. The rules are broadly based on those for deduction of expenses in calculating trade profits. In particular subsection (2) allows only expenses wholly and exclusively incurred in generating income. The intention here is to allow expenses that would be available in computing profits under Schedule D Case V or VI, and not to widen or restrict the scope of deductible expenses.

2272. *Subsection (6)* provides that the deduction of patent expenses under section 600 is additional to the relief due under this section. But where relief is given under section 582, no relief can then be given for the same expenditure as patent expenses – see subsection (5) of section 600.

Section 583: Charge to tax on income from disposals of know-how

2273. Sections 583 to 586 all relate to consideration received for the disposal of know-how. Section 583 charges to tax the proceeds of certain disposals of know-how. It is based on section 531 of ICTA. Under the source legislation, income from disposals of know-how is charged to tax under Schedule D Case VI.

2274. Section 531(6) of ICTA, which categorises a charge under section 531(4) of ICTA as "earned income", is repealed by this Act and replaced by new section 833(5A) of ICTA (see paragraph 338(5) of Schedule 1 to this Act). The concept of "earned income" in the context of know-how will now only be relevant for the purposes of section 282A of ICTA (jointly held property).

2275. *Subsection (1)* imposes the tax charge. Subsection (1)(b) is based on section 531(8) of ICTA but the words "whether absolute or qualified" have been omitted since they are superfluous. The word "profits" has been used here as it more accurately describes the sum which, after deduction of certain expenditure, is chargeable to tax.

2276. *Subsection (5)* defines "mineral deposits" for the purposes of this Chapter. This restores, for income tax purposes, a definition of "mineral deposits" that applied before CAA was enacted. See *Change 51* in Annex 1.

Section 584: Exceptions to charge under section 583

2277. This section sets out the exceptions to the charge under section 583. It is based on section 531 of ICTA.

2278. For the purposes of subsections (4) and (5) of the section, "control" is defined (through section 878(6) of this Act) by reference to section 840 of ICTA. The ICTA definition of "control" is identical in effect to that in section 574 of CAA. But as the relevance of "control" in this Act goes wider than this Chapter, the ICTA definition is used here.

Section 585: Income charged under section 583

2279. This section sets out the amount charged to tax under section 583. It is based on sections 69 and 531 of ICTA. There is no exclusion for sums calculated under the remittance basis by section 832 of this Act because, under the source legislation, income from the disposal of know-how is charged under Schedule D Case VI (to which the remittance basis does not apply).

2280. *Subsection (3)* ensures that expenditure may be deducted only once under this section and does not permit a deduction if relief has been obtained for the expenditure elsewhere (for example, as trading expenditure or by way of an allowance under CAA).

2281. *Subsection (4)* contains a signpost to section 603 of this Act which deals with contributions to expenditure. This is necessary because section 532 of ICTA treats section 531 of ICTA as if it had been contained in CAA.

Section 586: Person liable for tax under section 583

2282. This section states who is liable for any tax charged under section 583. It is based on section 531 of ICTA. The specific rules in section 531 of ICTA override the general "person chargeable" rule for Schedule D in section 59(1) of ICTA.

Section 587: Charge to tax on income from sales of patent rights

2283. Sections 587 to 599 deal with sales of patent rights. Section 587 charges to tax capital sums from the sale of patent rights. It is based on section 524 of ICTA. The charge under this section applies equally to both traders and non-traders.

2284. Section 529 of ICTA, which categorises certain income patent rights as "earned income", is repealed by this Act and replaced by new section 833(5B) to (5E) of ICTA (see paragraph 338(5) of Schedule 1 to this Act).

2285. *Subsection (1)* taxes "profits" from sales of patent rights. The word "profits" has been used here as it more accurately describes the sum which, after deduction of certain expenditure, is chargeable to tax.

2286. *Subsection (2)* contains a special rule providing that non-UK residents are taxed only on profits from the sale of UK patent rights. UK residents are taxed on profits from the sale of patent rights granted under the laws of the United Kingdom or any other country or territory.

2287. *Subsection (3)* provides that tax is not charged where the seller is a non-UK resident company chargeable to corporation tax (for example, trading in the United Kingdom through a permanent establishment). Section 524(5) of ICTA sets out which persons are chargeable to income tax and which to corporation tax under section 524(3) of ICTA. This is necessary because sections 6 and 11 of ICTA, which generally deal with the income tax/corporation tax split, are drafted in terms of "income". Section 524(5) of ICTA explains how the split is to work in the case of the capital sums charged to tax under section 524(3) of ICTA. Subsection (3) of this section makes it clear that a non-UK resident company chargeable to corporation tax is not chargeable to income tax in respect of capital sums from the sale of patent rights.

Section 588: Income charged under section 587

2288. This section sets out the amount charged to tax on profits from the sale of patent rights under section 587. It is subject to the spreading rules in section 590 to section 594. The section is based on section 524 of ICTA.

2289. There is no exclusion for sums calculated under the remittance basis under section 832 of this Act because, under the source legislation, profits from the sale of patent rights are charged to tax under Schedule D Case VI (to which the remittance basis does not apply).

2290. *Subsection (1)* provides that the profits are the proceeds of sale less the deductible costs. The reference to "net proceeds of the sale" in section 524(3) of ICTA implies that some deduction is available, but the source legislation does not further specify which amounts are deductible. The section makes it clearer what amounts may be deducted.

2291. *Subsection (2)* defines deductible costs as the capital cost of the rights sold plus any incidental expenses of sale. The section makes it explicit that such expenses may be deducted. The types of expenses which may be allowed under this section are not listed. Incidental expenses which relate to both capital sale proceeds and other sums not chargeable to tax under section 587 are effectively apportioned under the rules about net proceeds of sale in section 606.

2292. *Subsection (5)* contains a signpost to section 603 which deals with contributions to expenditure. This is necessary because section 532 of ICTA treats section 524 of ICTA as if it had been contained in CAA. There is also a signpost here to the special rules giving relief from tax on patent income in section 600.

Section 589: Person liable for tax under section 587

2293. This section states who is liable for any tax charged under section 587. It is based on section 524 of ICTA. The specific rules in section 524 of ICTA override the general "person chargeable" rule for Schedule D in section 59(1) of ICTA.

Section 590: UK resident sellers: spreading rules

2294. This section sets out the spreading rules where the person chargeable under section 587 is resident in the United Kingdom. It is based on section 524 of ICTA.

2295. Section 524 of ICTA imposes a charge to tax where a person sells all or any part of any patent rights and the net proceeds of sale consist wholly or partly of a capital sum. There are separate charges for sellers who are resident in the United Kingdom (this section) and non-UK resident sellers of UK patent rights (sections 591 and 592).

2296. For both UK residents and non-UK residents, tax is charged (depending on whether or not an election is made) either:

- in respect of the whole sum, for the tax year in which it is received, or
- on one sixth of the sum for that year and for each of the next five tax years.

2297. A "sum" to which the above rules apply could be either the whole sale proceeds or an instalment of the proceeds. So, for instance, where a UK resident seller has not elected otherwise, any receipt of an instalment of sale proceeds charged under the source legislation (section 524(1) of ICTA) would trigger the start of a six year period over which the charge for that instalment would be spread.

2298. In this Chapter, the way in which the rules on the timing of the tax charge apply to instalments is dealt with expressly.

2299. *Subsection (3)* allows the person chargeable to elect to be taxed on the whole amount for the first tax year, subject to the time limit for the normal self-assessment filing date for the tax year concerned (see also subsection(6)).

2300. *Subsection (6)* contains the time limit for elections under this section. The source legislation refers to "an officer of the Board" and the effect of this is maintained by section 878(4) of this Act which draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to "an officer of the Board".

Section 591: Non-UK resident sellers: election for spreading

2301. This section sets out how non-UK residents are taxed on capital sums from the sale of patent rights where the sale proceeds are not received in instalments. It is based on sections 69 and 524 of ICTA.

2302. *Subsection (1)* provides that the whole amount chargeable is taxed for the tax year in which the proceeds are received. This is subject to an election for spreading in subsection (2).

2303. *Subsection (2)* enables the person chargeable to elect to be taxed over six tax years beginning with the tax year in which the proceeds of sale are received. This has been brought into line with section 590 which covers UK residents. Section 524(3) of ICTA provides that if a non-UK resident chargeable to tax makes an election, the proceeds received are *treated* as if they were chargeable to tax over six years and the liability is calculated *as though* the sum were spread over six years. But the effect is the same and there is no reason why the wording in these two sections should not be consistent. However, the source legislation would have been interpreted in this way so this clarification does not amount to a change in the law.

2304. *Subsection (3)* sets out the time limit for making an election under subsection (2) to the Inland Revenue. The reference in section 524(4) of ICTA to "the Board" has not been reproduced. Section 878(4) of this Act draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to "an officer of the Board". See *Change 149* in Annex 1.

2305. Section 524(10) of ICTA is not rewritten. Section 524 of ICTA prescribes particular tax treatments with alternatives available by election. Section 524(10) of ICTA requires claims for relief under that provision to be made to the Board. The claim referred to in subsection (10) relates to capital sums received from the sale of patent rights to be spread over six years for the purposes of charging the sum to tax. As spreading is automatic for UK residents, the claim can only be relevant to non-UK residents. However, section 524(1) of ICTA refers to "a claim" and section 524(4) of ICTA, which deals with "spreading" rules for non-UK residents, refers to "the election". Section 524(10) of ICTA is, therefore, superfluous.

Section 592: Further provision about elections for spreading: instalments

2306. This section sets out how non-UK residents are taxed on capital sums from the sale of patent rights where the sale proceeds are received in instalments. It is based on sections 69 and 524 of ICTA.

2307. *Subsection (2)* sets out the rule for making an election for spreading where sale proceeds are received in instalments. This makes explicit in the section what was implicit in the source legislation.

2308. *Subsection (3)* contains the time limit for making an election under subsection (2). The reference in section 524(4) of ICTA to "the Board" has not been reproduced. Section 878(4) of this Act draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to "an officer of the Board". See *Change 149* in Annex 1.

Section 593: Death of seller

2309. This section deals with the case where a seller of patent rights dies before the end of the six year spreading period under sections 590, 591 or 592. It is based on section 525 of ICTA.

2310. *Subsection (2)* provides that personal representatives may elect for a reduction in the tax charged under subsection (1) based on "the lifetime tax years". The term "personal representatives" is now defined in section 878(1) of this Act.

2311. *Subsection (3)* defines "the lifetime tax years" for the purposes of subsection (2). The subsection also deals with sale proceeds which are received in instalments. This makes explicit in the section what was implicit in the source legislation.

2312. *Subsection (4)* contains the time limit for making an election under subsection (2). The reference in section 525(2) of ICTA to "the inspector" has not been reproduced. Section 878(4) of this Act draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to "an officer of the Board". See *Change 149* in Annex 1.

2313. The time limit in section 525(2) of ICTA has been changed to fit in with the normal self-assessment filing date for the year in which the death occurs. See *Change 104* in Annex 1.

Section 594: Winding up of a body corporate

2314. This section deals with a body corporate which is chargeable to income tax under section 587 where the body corporate commences to be wound up. It is based on section 525 of ICTA.

2315. The section applies where, for example, a company not resident in the United Kingdom (and not trading in the United Kingdom through a permanent establishment) disposes of UK patent rights, makes an election for spreading under section 591 or section 592 and is subsequently wound up before the expiry of the six year spreading period.

2316. *Subsection (2)* also deals with amounts arising to the corporate body in a fiduciary or representative capacity (for example, corporate trustees) which would have been chargeable to income tax for later tax years under section 590(2) or (4).

Section 595: Deduction of tax from payments to non-UK residents

2317. This section contains rules relating to the deduction of tax from payments to non-UK residents where a charge arises under section 587 on profits from the sale of the whole or any part of any patent rights. It is based on section 524 of ICTA.

2318. *Subsection (2)* provides that the capital costs in section 588 shall not affect the amount of income tax to be deducted under section 349(1) of ICTA and assessed under section 350 of ICTA. The reference in section 524(9) of ICTA to "section 349(1) and (3)" was clearly intended to read "sections 349(1) and 350". This has been corrected in the consequential amendment which inserts section 349ZA into ICTA (see paragraph 149 of Schedule 1 to this Act).

2319. *Subsection (3)* provides that sections 349ZA and 350 of ICTA are not affected by any election under this Chapter for spreading provisions to apply. The reference to instalments makes explicit in the section what was implicit in the source legislation.

Section 596: Adjustments where tax has been deducted

2320. This section contains rules relating to adjustments which may be necessary where tax has been deducted from payments to a non-UK resident under subsection (2) of section 595. It is based on section 524 of ICTA.

2321. *Subsection (2)* provides that, where an election for spreading has been made, the necessary adjustments are to be made by treating one sixth of the sum deducted from the proceeds of sale or instalment as income tax paid for each of the six years. The reference to instalments makes explicit in the section what was implicit in the source legislation.

Section 597: Licences connected with patents

2322. This section provides some definitions connected with patents which extend the meaning of patent rights for the purposes of section 587 to section 596 . The definitions relate to licences and are based on section 533 of ICTA.

Section 598: Rights to acquire future patent rights

2323. This section deals with the sale of rights to acquire patent rights in the future, before the patent has been granted. It is based on section 533 of ICTA.

2324. *Subsection (1)* provides that a sum paid to obtain an option to acquire future patent rights is to be treated as the purchase of patent rights in the hands of the payer and a sale of patent rights in the hands of the recipient. Any capital sum received is therefore chargeable under section 587 on the recipient and the payer may obtain relief for the expenditure under section 588 when the rights acquired are disposed of.

2325. The section makes it more explicit than the source legislation that there is a deemed sale of patent rights where an option to acquire future patent rights is sold or granted and also clarifies the position regarding the costs of such options. However, the section does not change the law since the source legislation would have to be read in this way.

Section 599: Sums paid for Crown use etc. treated as paid under licence

2326. This section provides that sums paid for Crown use, or by a government of a country outside the United Kingdom, in certain circumstances are to be treated as having been paid under a licence. It is based on section 533 of ICTA.

2327. *Subsection (1)* sets out the conditions under which sums paid in respect of an invention which is the subject of a patent and used in the service of the Crown, or the government of a country outside the United Kingdom, are be treated as having been paid under a licence. The treatment of licences connected with patents is dealt with in section 597.

2328. The reference in section 533(4) of ICTA to "sections 46 to 49 of the Patents Act 1949" has not been reproduced in this section. This is because patents granted under these provisions have ceased to have effect so it is unnecessary to reproduce this reference. The removal of this unnecessary material follows the line adopted in section 482 of CAA.

2329. The words "used" and "use" in this section (which correspond with the relieving legislation in section 482 of CAA) are intended to be read widely and cover "make" and "sell".

Section 600: Relief for expenses: patent income

2330. This section provides relief for certain expenditure in connection with patents. The section sets out the nature of the expenditure for which relief may be given under section 601. It is based on sections 526 and 528 of ICTA. The deduction is on the basis of expenses incurred. This relaxes any requirement in the source legislation that fees have to be paid before a deduction can be made.

2331. *Subsection (2)* defines "inventor's expenses" for the purpose of this section. To the extent that relief is not given elsewhere (for example, as a deduction, where appropriate, in calculating trade profits) a claim may be made under this section for such expenses to be relieved against income from patents.

2332. The word "net" in "the net amount of any expenses" in section 526(2) of ICTA has not been reproduced. This word is superfluous having regard to subsection (6) of the section which contains a signpost to section 603 (contributions to expenditure).

2333. *Subsection (3)* defines "patent application and maintenance expenses" for the purposes of this section. Relief for such expenses is excluded from the scope of this section if the expenditure is incurred for the purposes of a trade carried on by the payer. This is because there is a similar provision in section 89 for trading expenses connected with patents.

2334. *Subsection (5)* excludes from the scope of this section expenditure for which relief is given elsewhere. Section 526(2) of ICTA applies this rule only to expenditure incurred by the inventor and now covered by subsection (1)(a) of this section. Section 526(2) of ICTA provides that relief could not be given more than once for expenditure incurred in devising an invention for which a patent has been granted. There is no such explicit double deduction prohibition in section 526(1) of ICTA which deals with expenditure incurred in the grant, extension etc of a patent. To avoid any possible confusion, however, the section prevents a double allowance in respect of all relevant expenditure. This makes clear the implicit rule that the legislation does not enable such expenses to be relieved twice.

2335. *Subsection (6)* contains a signpost to section 603 which deals with contributions to expenditure. This is necessary because section 532 of ICTA treats section 526 and 528 of ICTA as if those provisions had been contained in CAA.

Section 601: How relief is given under section 600

2336. This section sets out how relief is to be given where a claim is made under section 600 for patent expenses to be set against patent income. It is based on sections 526, 528 and 533 of ICTA.

2337. *Subsection (2)* allows relief for expenditure against patent income in the tax year in which the expenditure is incurred. However, if the expenses exceed the patent income in the tax year, the surplus expenses cannot be used to create a loss under this section.

2338. *Subsection (3)* provides that the excess of eligible expenses over income in a tax year is carried forward and set off against patent income in the next tax year and so on until the expenses have been fully relieved. The carry forward to future years is automatic and no additional claim needs to be made.

2339. *Subsection (5)* reproduces the ordering rule in section 528(3A) of ICTA. This requires the deduction or set-off of any capital allowances under section 479 of CAA in calculating “income from patents” for the purposes of subsection (4) of this section.

Section 602: Payments received after deduction of tax

2340. This section deals with the position of an individual receiving royalties or other income within this Chapter from which tax has been deducted. It is based on sections 348 and 349 of ICTA. Under section 348(1)(b) of ICTA “a sum representing the amount of income tax thereon” may be deducted from certain annual payments.

2341. The section reproduces the effect of section 348(1)(d) of ICTA, under which the sum is treated as income tax paid by the person to whom the payment is made. The payer is entitled, but not obliged, to deduct this sum representing tax, which is treated as tax paid by the recipient. The tax treated as paid by the recipient of the annual payment is taken into account, along with any other tax paid by deduction at source and any tax credits, in calculating the tax payable for the tax year.

2342. In so far as this section covers payments which are not annual payments within section 348(1) of ICTA, the scope of the provision has been made more explicit. Section 348(1)(d) of ICTA applies, in terms, only to annual payments from which any deduction is made under section 348(1)(b) of ICTA, but case law effectively extends it to payments under sections 348(2) and 349 of ICTA. See commentary on section 426 of this Act.

Section 603: Contributions to expenditure

2343. This section restricts expenditure allowable under section 585, section 588 and section 600 to the extent that the expenditure is met by a public body or someone other than the claimant. It is based on section 532 of ICTA and section 532 of CAA.

2344. Section 532 of ICTA provides that sections 524, 526 and 531 of ICTA are to be treated as if those provisions had been contained in CAA.

2345. *Subsection (3)* excludes this section from applying to incidental expenses incurred by the seller of patent rights (see section 588(2)(b)). This is because section 524 of ICTA only bites in the first place on the net proceeds of a sale.

Section 604: Contributions not made by public bodies nor eligible for tax relief

2346. This section provides that contributions not made by public bodies may still be eligible as deductible expenditure in certain circumstances. The section is based on section 532 of ICTA and section 536 of CAA. It qualifies the general rule in section 603.

Section 605: Exchanges

2347. This section provides an extended definition of sale to include exchange. It is based on section 532 of ICTA and section 572 of CAA.

2348. Section 532 of ICTA provides that section 524 of ICTA (dealing with the sale of patent rights) and section 531 of ICTA (dealing with the disposal of know-how) are to be treated as if they had been contained in CAA.

Section 606: Apportionment where property sold together

2349. This section provides for the apportionment of sale proceeds and expenditure on a just and reasonable basis where property within the scope of this Chapter is sold or disclosed together with other property. It is based on section 532 of ICTA and section 562 of CAA.

2350. Section 532 of ICTA provides that section 524 of ICTA (dealing with the sale of patent rights) and section 531 of ICTA (dealing with the disposal of know-how) are to be treated as if they had been contained in CAA.

Section 607: Questions about apportionments affecting two or more persons

2351. This section contains a signpost to section 563 of CAA which sets out the body of Commissioners responsible for determining any question about the way in which a sum is to be apportioned under section 606 where the relevant apportionment affects two or more persons. It is based on section 532 of ICTA and section 563 of CAA.

2352. Section 532 provides that section 524 of ICTA (dealing with the sale of patent rights) and section 531 of ICTA (dealing with the disposal of know-how) are to be treated as if those provisions had been contained in CAA.

Section 608: Meaning of "capital sums" etc.

2353. This section contains a signpost to section 4 of CAA which defines "capital expenditure" and "capital sums". It is based on section 532 of ICTA and section 4 of CAA.

2354. Section 532 of ICTA provides that sections 524 to 529 and 531 to 533 of ICTA are to be treated as if those provisions had been contained in CAA.

Chapter 3: Films and sound recordings: non-trade businesses

Overview

2355. This Chapter deals with income arising from the exploitation of films and sound recordings – and the special allocation rules available to the producers and acquirers of films and sound recordings – where the activities carried on do not amount to a trade.

2356. The special allocation rules rewritten in Chapter 9 of Part 2 of this Act for trades apply also to businesses. So this Chapter is needed to cater for businesses which fall short of a trade.

2357. There are no specific charging provisions for income from non-trade film and sound recordings businesses in ICTA. Such income is chargeable under Schedule D Case VI for UK sources and Schedule D Case V for foreign sources under the source legislation. The new charge has been carved out of a general charging provision and dealt with – together with the special allocation rules – in a separate charging Chapter. The new Chapter will apply to both UK source and foreign source businesses.

Section 609: Charge to tax on films and sound recordings businesses

2358. This section charges to tax income from businesses involving the exploitation of films and sound recordings where the activities fall short of trading. It is based on section 18 of ICTA .

2359. *Subsection (1)* imposes a charge on UK or foreign businesses involving the exploitation of films or sound recordings where the activities do not amount to a trade. Reclassifying the income according to its nature makes sense. The special allocation rules for films and sound recordings in sections 40A to 40D of F(No 2)A 1992 (and sections 41 to 43 of F(No 2)A 1992 for films) apply to both trades and businesses. The creation of a new charge and Chapter for this income provide a convenient link with the special allocation rules for films and sound recordings businesses (where the activities fall short of trading) which might otherwise be missed.

2360. The new charge on income from non-trading film or sound recordings businesses has been carved out of the general sweep up charge (see section 687) of this Act and included in a separate Chapter together with a signpost to the special allocation rules for expenditure relating to such activities.

Section 610: Income charged

2361. This section sets out the amount charged to tax under this Chapter. It is based on sections 65 and 68 of ICTA.

2362. *Subsection (3)* provides that this section is subject to the special rules for foreign income in Part 8 of this Act. The special allocation rules for films and sound recordings can apply to businesses carried on outside the United Kingdom as well as to businesses carried on in the United Kingdom.

Section 611: Person liable

2363. This section states who is liable for any tax charged under this Chapter. It is based on section 59 of ICTA.

Section 612: Calculation of income

2364. This section contains calculation rules for income charged under section 609. It is new.

2365. Where a particular type of income is carved out of what would otherwise be a general charge, this Act explicitly sets out the calculation rules applicable to that income. This approach has been extended to foreign source income charged under Schedule D Case

V in the source legislation. This section sets out expenses that would, in practice, be deductible in calculating profits and does not widen or restrict the scope of deductible expenses.

2366. There is no express provision in the legislation for deductions of expenditure from Schedule D Case VI income, although it is implied by the word "profits" in section 69 of ICTA (Case VI assessments) and by section 392 of ICTA (Case VI losses). This view has been upheld by the courts (see Curtis Brown v Jarvis (1929), 14 TC 744 HC). Expenditure admissible relating to income arising in the United Kingdom within the scope of the section would not cease to be admissible in respect of the same type of income arising outside the United Kingdom.

2367. *Subsection (4)* precludes expenditure which would not have been allowed had a trade been carried on. So expenses precluded by Chapter 4 of Part 2 of this Act are not deductible here.

Section 613: Application of trading income rules to non-trade businesses

2368. This section provides that Chapter 9 of Part 2 of this Act – the special allocation rules for trades – apply to non-trade businesses as those rules apply to trades (with certain modifications). It is new.

Chapter 4: Certain telecommunication rights: non-trading income

Overview

2369. This Chapter imposes a charge on profits derived from certain telecommunication rights not held for trading purposes. It also sets out how the profits are to be calculated. The Chapter is based on Schedule D Cases III, V and VI of ICTA and Schedule 23 to FA 2000. The rights dealt with in the Chapter are certain telecommunications licences and capacity on telecommunications cable systems, known as indefeasible rights to use (IRU).

2370. Schedule 23 to FA 2000 does not impose a charge to tax on the income derived from the rights. The main purpose of Schedule 23 to FA 2000 is to allow a taxpayer who acquires qualifying rights a revenue deduction for expenditure that would otherwise be treated as capital for tax purposes. It does this by providing that the income tax treatment follows the treatment in the accounts provided the accounts are prepared in accordance with generally accepted accounting practice. This rule applies not only to the acquisition but also to revaluations and disposals.

2371. In most cases it is likely that the rights will be acquired for use in a trade. For this reason Schedule 23 to FA 2000 is rewritten as Chapter 10 of Part 2 of this Act. But the Schedule applies for all income tax purposes. This Chapter rewrites the charge if the assets are not acquired for the purposes of a trade.

2372. The Chapter applies only to IRUs acquired on or after 21 March 2000. See the transitional rules in paragraphs 130 and 131 of Schedule 2 to this Act. No telecommunications licences to which this Chapter applies were acquired before that date.

Section 614: Charge to tax on certain telecommunication rights of a non-trader

2373. This section charges to tax income from telecommunication rights arising to a non-trader. It is based on Schedule D Cases III, V and VI, section 18(1) and (3) of ICTA, and paragraph 1 of Schedule 23 to FA 2000.

2374. If the rights are acquired for pure investment purposes and the licensor does not undertake to provide any extra services, ICTA charges the profits to tax under Schedule D Case III as an annual payment (or under Schedule D Case V in the unlikely event that the source is outside the United Kingdom).

2375. If the licensor undertakes to provide services that do not amount to a trade, ICTA charges the profits under Schedule D Case VI (or under Schedule D Case V if the source is outside the United Kingdom).

Section 615: Income charged

2376. This section sets out the amount charged to tax. It is based on sections 64, 65, 68 and 69 of ICTA and Schedule 23 to FA 2000.

Section 616: Person liable

2377. This section states who is liable for any tax charged. It is based on section 59 of ICTA.

Section 617: Deductions in calculating certain income charged

2378. This section sets out how to calculate the income charged to tax if the taxpayer provides services that do not amount to a trade. It is based on section 69 of ICTA and Schedule 23 to FA 2000.

2379. In the source legislation this income would be charged under Schedule D Case VI (or under Schedule D Case V if the source is outside the United Kingdom). The rules set out in this section deal with two aspects of the calculation of this income. First, the general deduction rules that apply to income taxed under Schedule D Case VI. Second, the particular rules that apply to income from telecommunication rights.

2380. There is no express provision in the legislation for deductions of expenditure from Schedule D Case VI income, although it is implied by the word "profits" in section 69 of ICTA (Case VI assessments) and by section 392 of ICTA (Case VI losses). This view has been upheld by the courts (see Curtis Brown v Jarvis (1929), 14 TC 744 HC). Expenditure admissible relating to income arising in the United Kingdom within the scope of the section would not cease to be admissible in respect of the same type of income arising outside the United Kingdom. However, under section 64 of ICTA (Case III assessments) no deduction is permitted from income within the Schedule D Case III charge so this section specifically does not apply to annual payments.

2381. Schedule 23 to FA 2000 set out a particular set of rules that apply to income from telecommunication rights. Because they are most likely to apply to trading income this section merely cross-refers to the rewrite of those rules in sections 147 and 148 of this Act.

Section 618: Payments received after deduction of tax

2382. This section deals with the position of an individual receiving income within this Chapter from which tax has been deducted. It is based on sections 348 and 349 of ICTA.

2383. Under section 348(1)(b) of ICTA "a sum representing the amount of income tax thereon" may be deducted from certain annual payments. The section reproduces the effect of section 348(1)(d) of ICTA, under which the sum is treated as income tax paid by the person to whom the payment is made. The payer is entitled, but not obliged, to deduct this sum representing tax, which is treated as tax paid by the recipient. The tax treated as paid by the recipient of the annual payment is taken into account, along with any other tax paid by deduction at source and any tax credits, in calculating the tax payable for the tax year.

2384. In so far as this section covers payments which are not annual payments within section 348(1) of ICTA, the scope of the provision has been made more explicit. Section 348(1)(d) of ICTA applies, in terms, only to annual payments from which any deduction is made under section 348(1)(b) of ICTA, but case law effectively extends it to payments under sections 348(2) and 349 of ICTA. See commentary on section 426 of this Act.

Chapter 5: Settlements: amounts treated as income of settlor

Overview

2385. This Chapter rewrites the settlements legislation in Chapters 1A and 1B of Part 15 of ICTA. This legislation prevents the avoidance of tax where a person (the settlor) arranges for his or her income to be received by someone who is either chargeable to tax at a lower rate than the settlor, or not chargeable to tax at all. The legislation operates by treating the income as if it were the settlor's. The legislation operates where:

- the settlor retains an interest in property but the income from that property is received by another;
- payments from a settlement set up by the settlor are made to a minor child of the settlor; or
- payments are made to the settlor from the settlement in the form of capital rather than income.

Section 619: Charge to tax under Chapter 5

2386. This section charges to tax payments, whether income or capital, which are deemed to be the income of the settlor under this Chapter. It also provides that the part which represents distributions attracts the dividend ordinary rate. It is based on sections 660C and 677 of ICTA.

2387. *Subsection (1)* charges to tax the income and capital payments which are treated as the income of the settlor under this Chapter. It rewrites the charges under sections 660C and 677(7) of ICTA. Section 660C(1) of ICTA, which charges income treated as the settlor's because he or she retains an interest in the settlement or because of payments etc to a minor child, imposes a Schedule F charge on distributions and a charge under Schedule D Case VI on other income. Section 677(7) of ICTA, which charges capital payments treated as the settlor's income, imposes a Case VI charge on all such payments. The listing in this subsection of the amounts treated as income acts as an introduction to the Chapter and explains the nature of the charge under the Chapter.

2388. *Subsection (3)* lists the income that is to be treated under *subsection (2)* as within section 1A(2)(b) of ICTA. The income is all distribution income or income treated as such. The effect of this provision is that this income is charged at the dividend ordinary rate (the Schedule F ordinary rate). The income within section 660C(1A), which this subsection rewrites, is included here as follows:

- (1A)(a) is rewritten at (3)(a);
- (1A)(b) is rewritten at (3)(b) and (e);
- (1A)(f) is rewritten at (3)(c); and
- (1A)(g) is rewritten at (3)(d).

2389. Section 660C(1A)(c) to (e) has not been listed because it is unnecessary. The income within section 233(1), (1A) and (1B) of ICTA is already included within section 660C(1A)(a) as "income chargeable under Schedule F". Such income is included within subsection (3)(a) of this section since Chapter 3 of Part 4 of this Act rewrites the Schedule F charge.

2390. Section 660C(1A)(b) of ICTA includes income to which section 1A of ICTA applies "by virtue of it being equivalent foreign income falling within subsection (3)(b) [of section 1A of ICTA] and chargeable under Case V of Schedule D". The "equivalent foreign income" within that subsection is dividends or other distributions of a non-UK resident company which would be chargeable under Schedule F if that company were resident in the UK. Because Chapter 4 of Part 4 of this Act charges foreign dividends and not foreign *distributions*, *subsection (4)* provides that any such foreign distributions falling outside that Chapter are included within section 619(3)(e) because they would, if the company were UK resident, fall within Chapter 3 of that Part. Chapter 3 of Part 4 of this Act rewrites the Schedule F charge on both dividends *and* distributions of a UK resident company.

Section 620: Meaning of "settlement" and "settlor"

2391. This section explains the meaning of "settlement" and "settlor" for the purposes of this Chapter. It is placed in this part of the Chapter to help the reader by giving an early indication of the nature of the charge under this Chapter. It is based on sections 660G and 677 of ICTA.

Section 621: Income charged

2392. This section sets out the amount charged to tax. It is based on sections 69, 660C and 677 of ICTA.

2393. All the income and capital payments which are to be treated as the settlor's income are chargeable to tax.

2394. The income to be treated as the settlor's income under section 624 is the income arising under the settlement. The meaning of income arising under a settlement is given in section 648. Subsection (1) of that section provides that income arising under a settlement includes income chargeable to income tax by deduction or otherwise and, in the case of income from outside the United Kingdom, income which would be chargeable if received by a UK resident. In consequence the appropriate measure of income chargeable and the tax year of charge are provided by the charging sections of other Chapters of this Act (or the appropriate sections of the Income Tax Acts).

2395. Section 648(2) provides that where the settlor is non-domiciled etc and the settlement is entitled to income which would not be chargeable on the settlor if he or she made a claim for the remittance basis to apply, it is excluded from income arising under a settlement and is therefore not chargeable on the settlor.

2396. The amount of income arising under a settlement which is treated as the settlor's income under section 629 and the year of charge are given in subsection (1) of that section.

2397. The amount to be treated as the settlor's income under section 633 and the year of charge are given in subsection (1) of that section.

Section 622: Person liable

2398. This states who is liable for any tax charged. It is based on sections 660A, 660B and 677 of ICTA.

2399. Section 660A(1) of ICTA provides that income charged on the settlor is not treated as the income of any other person. Since that person could be a company, and outside the scope of this Act, new section 660C(4) of ICTA (see paragraph 272(4) of Schedule 1 to this Act) ensures that a charge cannot be made on a company in respect of that income.

Section 623: Calculation of income

2400. This section allows the settlor the same deductions and reliefs as if he had received as income the amount on which he is chargeable. As a result of this the settlor is charged to tax as if he had received the income arising under the settlement directly. It is based on sections 660C and 677 of ICTA. Section 660C(3) of ICTA is not rewritten in this Act.

Section 624: Income where settlor retains an interest

2401. This is the first of the rules under which income is treated as the settlor's. Where the settlor retains an interest in settled property the income arising under the settlement is treated as the settlor's. The section is based on section 660A of ICTA.

Section 625: Settlor's retained interest

2402. This section explains when a settlor is treated as having an interest in property for the purposes of section 624 and exceptions to this. It is based on section 660A of ICTA.

2403. *Subsection (1)* explains what is meant by a settlor having an interest in property. The interests may also be those of the settlor's spouse.

2404. *Subsections (2)* and *(3)* give occasions where a settlor does not have an interest in property. The exceptions cover instances when the settlor may by inadvertence or circumstances likely to be outside his or her control have an interest in property which he or she has settled or an interest in property derived from that property. These circumstances include bankruptcy, where the settlor may obtain an interest in property as a result of the bankruptcy of another person who has an interest in that property. This might occur where the beneficiary of a settlement, who is also the creditor of the settlor, becomes bankrupt and the debt is settled by a payment of settlement income from the bankrupt's estate.

2405. The settlor is also excluded from having an interest in property as long as someone under the age of 25 years is alive during whose lifetime that property cannot be payable to the settlor other than in a bankruptcy or by assigning or charging the individual's interest in the property. While there is no requirement that the person under 25 years should have an interest in that property it may generally be expected that they will.

2406. *Subsection (5)* provides the meaning of "related property" ("derived property" in section 660A(10) of ICTA). When this clause was drafted the House of Lords' decision in West v Trennery (2005), TL 3747[16] on the interpretation of "derived property" in section 77(8) of TCGA was not available. The definition of "derived property" in that section is the same as in section 660A(10) of ICTA. In consequence the section closely follows the source legislation.

Section 626: Exception for outright gifts between spouses

2407. This section provides an exception to the rule in section 624 for an outright gift of property between spouses which gives rise to income. Such gifts are within the exclusion as long as the property gifted is more than simply a right to income and the right to income is a right to the whole of the income. The section is based on section 660A of ICTA.

Section 627: Exceptions for certain types of income

2408. This section provides that section 624 does not apply to certain income between former parties to a marriage and to commercial and charitable payments and pension contributions. It is based on section 660A of ICTA.

2409. *Subsection (1)* enables a person to make a settlement that benefits a former or separated spouse without that income being treated as income of the settlor.

2410. *Subsection (3)(c)* refers to regulations made under the Welfare Reform and Pensions Act 1999 and its equivalent in Northern Ireland although section 660A(11)(c) of ICTA (inserted by paragraph 28 of Schedule 35 to FA 2004) simply refers to regulations made by the Secretary of State. See *Change 105* in Annex 1.

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2411. Subsection (3) applies for the tax year 2006-07 onwards and rewrites the changes to section 660A(11) of ICTA introduced by FA 2004. A transitional rule is found in paragraph 132 of Schedule 2 to this Act which gives the rules for "approved pension arrangements" for 2005-06. The FA 2004 changes to pension provisions only apply from 2006-07.

Section 628: Exception for gifts to charities

2412. This section provides that certain charitable donations will not be treated as the settlor's income under section 624. It is based on section 44 of FA 2000.

2413. Section 44 of FA 2000 applies to the charge under both sections 660A and 660B of ICTA (settlor-interested trusts and payments to a minor child of the settlor). Section 44 of FA 2000 is rewritten in two places in this Chapter, once as an exemption from the charge under section 624 and secondly as an exemption from the charge under section 629. (A payment may, for example, be made by trustees to a charity which benefits a minor child of the settlor.) *Subsection (3)(b)*, which includes within the sum paid to a charity sums for which the exemption in section 630 applies, covers the possibility, unlikely though it may be, of a trust changing its nature during a tax year whereby it is no longer a settlor-interested trust and thus one to which section 630 might apply. (A charge under that section will not apply if a charge under section 624 applies.) Any charitable payments exempted from a charge on the settlor under section 629 must be included to give the correct result.

Section 629: Income paid to unmarried minor children of settlor

2414. This section provides the second charge under this Chapter. Income paid to or for the benefit of an unmarried minor child of the settlor or income which is treated as that child's income is charged as income of the settlor if it does not already fall within section 624. The section is based on section 660B of ICTA.

2415. *Subsection (1)* sets out the basic rule. Subsection (1)(b) ensures that avoidance cannot arise by using a bare trust arrangement where a child is a beneficiary of the trust, although no income is paid to or for the child's benefit.

2416. *Subsection (2)* provides that a charge under section 624 will always take precedence over a charge under this section.

2417. See paragraph 133 of Schedule 2 to this Act for the application of this section in relation to income arising under a settlement made before 9 March 1999 or from funds provided before that date.

2418. Section 660B(1) of ICTA provides that income charged on the settlor is not treated as the income of any other person. Since that person could be a company, and outside the scope of this Act, new section 660C(4) of ICTA (see paragraph 272(4) of Schedule 1 to this Act) ensures that a charge cannot be made on a company in respect of that income.

Section 630: Exceptions for gifts to charities

2419. This section provides that certain charitable donations will not be treated as the settlor's income under section 629. This exemption might apply in the unusual circumstances of a charity benefiting the minor child of a settlor, that is to say that payments out of the settlement to the charity were paid to or applied for the benefit of the settlor's minor child. The section is based on section 44 of FA 2000.

2420. See the commentary on subsection (3)(b) of section 628 as to how subsection (2)(b) of this section applies.

Section 631: Retained and accumulated income

2421. This section applies the rule in section 629 where payments are made to or for the benefit of a minor child of the settlor out of a settlement under which income is retained or accumulated. It is based on section 660B of ICTA.

2422. *Subsection (1)* provides the general rule. The payment must be made in connection with the settlement out of a trust under which income may be retained or accumulated. The distinction in trust law between "retained" and "accumulated" income (income the trustees have resolved to treat as capital) has been retained.

2423. *Subsection (2)* provides that such payments are treated as payments of income even though out of capital as long as there is sufficient accumulated or retained income available to make the payment in question.

2424. *Subsection (4)* sets out what is meant by available retained or accumulated income in subsection (2). Income that has arisen under the settlement must exceed the amounts set out in *subsection (5)*. These are amounts that have been paid out in expenses or already treated as the income of the settlor or another person, including a minor child of the settlor.

2425. *Subsections (6)* and *(7)* provide the computation for income subject to income tax of a minor child of the settlor for the purposes of subsection (5)(d). One first computes a figure for the whole of the child's income from all sources less allowances and deductions and then compares that with the sums treated as the child's income under the settlement. If the income less allowances is sufficient to include the child's income from the settlement then that income is deemed to have been subject to tax, ie the settlement income is treated as the top slice of the child's income.

Section 632: Offshore income gains

2426. This section provides that gains under the offshore funds legislation are deemed to be paid to a minor where they would have been considered as his or her income were it not for his or her minority. (Section 761(1) of ICTA provides that where there is a disposal in an offshore trust the gain is treated as income of the person disposing of it.) The section is based on section 660B of ICTA.

Section 633: Capital sums paid to settlor by trustees of settlement

2427. This section provides the third charge under this Chapter. It treats as income of the settlor capital sums paid or lent to the settlor by the trustees of the settlement where those payments are matched by undistributed income within the settlement. It is based on section 677 of ICTA.

2428. *Subsection (1)* and *(2)* provide the basic rule that capital payments to the settlor are treated as his or her income where there is sufficient available income within the settlement up to the end of that tax year to cover that payment.

2429. *Subsection (3)* deals with the situation where there is insufficient available income up to the end of the year in which the loan is made. One then takes into account the available income for the following year to the extent that it has not been treated as the settlor's income following a capital payment made in that year. If there is still insufficient available income one takes into account the available income for the year after that and so on.

2430. *Subsection (4)* allows the rule in subsection (3) to run for up to 10 years subsequent to the capital payment.

Section 634: Meaning of "capital sum" and "sums paid to settlor"

2431. This section provides the meaning of two terms used in section 633. It is based on section 677 of ICTA.

2432. *Subsection (1)* explains what is meant by "capital sum". It includes sums paid as a loan, loans repaid or sums paid to the settlor or his or her spouse (see *subsection (7)*) in excess of the market value of goods or services. Settlors cannot therefore avoid tax by extracting income from a settlement in the form of a capital payment by the receiving of loans from the settlement, by the making of loans which are invested by the trustees and then receiving repayment of those loans, or by selling to the trustees of the settlement an item in excess of market value.

2433. *Subsection (3)* excludes sums from being treated as capital sums which are broadly outside the control of the settlor (see commentary on section 625(2)).

2434. *Subsection (5)* prevents a settlor from avoiding a charge under this section by arranging for the trustees to pay a capital sum to a third party from which the settlor may benefit.

Section 635: Amount of available income

2435. This section explains what is meant by available income for the purposes of section 633. It is based on section 677 of ICTA.

2436. *Subsections (2)* and *(3)* give the rules for ascertaining available income. It is the income arising under the settlement which has not been distributed, less sums which have already been taken into account under this rule as a capital payment in a previous year or which have been treated as the settlor's income under sections 624 or 629 or which represent an amount of tax paid on undistributed settlement income.

2437. Section 677(2) of ICTA, on which subsection (3) is based, excludes from the measure of available income such income as has been treated as income of the settlor in tax years before 1995-96 under provisions which have been repealed. These paragraphs of section 677(2) of ICTA are rewritten in paragraph 134 of Schedule 2 to this Act.

Section 636: Calculation of undistributed income

2438. This section explains for the purposes of section 635 what is meant by income arising under a settlement that has not been distributed. It is based on section 682 of ICTA.

2439. *Subsection (1)* provides the basic rule with the detail in the remaining subsections. The amounts which may be set against the income arising are classified under three headings which are set out in *subsections (2)*, *(4)* and *(6)*.

Section 637: Qualifications to section 636

2440. This section gives special provisions that apply to payments made by the trustees in section 636(2) to (6) and which would otherwise be available to reduce the undistributed income within the settlement. It is based on section 682 of ICTA.

2441. *Subsection (1)* disapplies section 636(2) for payments of interest or payments to connected bodies corporate or other settlements. Such payments are not therefore to be treated as sums which have been distributed under that section.

2442. The purpose of *subsections (2)* to *(7)* is to prevent certain payments of interest that would not be allowable against tax from reducing the undistributed income. Interest payments that are allowable for tax purposes will already have been allowed in arriving at the income arising under the settlement.

2443. Disallowable interest payments should not be available to reduce the income treated as the settlor's income. Without special rules loan interest payable by the trustees, which would not be allowed for tax purposes, could reduce the undistributed income and hence the amount chargeable on the settlor.

2444. Interest can only reduce the amount available for distribution to the extent that it represents an expense against income payments to persons other than the settlor. The formula in *subsection (5)* apportions the interest paid on these lines. The resulting sum represents the interest paid in respect of income payments made by the settlement to the settlor and that resulting figure is unavailable to set against the undistributed income.

2445. *Subsection (6)* removes from the computation interest that has been paid to the settlor or spouse of the settlor since tax will already have been borne on that interest and, but for this, double taxation would arise on those sums.

Section 638: Capital sums paid by way of loan or repayment of loan

2446. This section gives the rules that apply where the capital sums in section 633 are loans or repayments of loans. It is based on section 677 of ICTA.

2447. *Subsections (1)* provides that if a capital loan is repaid no part of it is treated as the settlor's income under section 633 for any year following the year of repayment.

2448. *Subsections (2)* and *(3)* provide that where a second loan is made to the settlor after repayment of the original loan, that loan is only treated as the settlor's income to the extent that it exceeds a previous loan which has been treated as the settlor's income. This is because no repayment of tax is made to the settlor in respect of the repayment of the first loan. He or she has effectively already paid tax on the new amount outstanding.

2449. *Subsections (4)* and *(5)* provide that, where a settlor has made a subsequent loan to the settlement following the repayment of an earlier loan, no part of the repayment on the first loan is treated as the settlor's income after the tax year in which the subsequent loan to the settlement is made, as long as it is not less than the amount of the first loan. The second loan here is treated as a repayment of the capital sum paid out of the settlement as repayment of the first loan.

Section 639: Loans to participators in close companies

2450. This section serves to avoid a double taxation charge as a result of the application of Chapter 6 of Part 4 of this Act. Under that Chapter loans made by a company to a participator and then written off are treated as income net of tax at the dividend ordinary rate on UK distributions. The rule is that where a charge potentially arises under both this section and under Chapter 6 of Part 4 of this Act this section will take precedence, but if a charge under Chapter 6 of Part 4 of this Act has already been made, then the charge under this Chapter on the settlor is reduced by a corresponding amount. See section 418 of this Act (relief where borrowers liable as settlors) which rewrites section 421(3) of ICTA. The section is based on section 677 of ICTA.

Section 640: Grossing-up of deemed income

2451. This section explains the grossing-up procedure for capital sums treated as the settlor's income and the tax allowed against the settlor's liability. It is based on section 677 of ICTA.

2452. S*ubsection (1)* provides that the settlor is taxed on the grossed up amount of the capital sum treated as his income. Section 877 of this Act explains how sums are grossed up.

2453. *Subsection (2)* then allows a set-off of tax against the settlor's tax liability with the result that only higher rates of tax are chargeable on the settlor. The amount that the settlor may set off against his liability is given in the following subsections.

2454. *Subsection (3)* explains the amount ("the deductible amount") that can be set against the settlor's liability. This is the lesser of the tax at which the capital sum is grossed up at for the tax year (the rate applicable for trusts) or the amount of tax the trustees are deemed to have paid on the available income (irrespective of the fact that the capital sum is grossed up at the rate applicable to trusts for the tax year in which the loan is treated as the settlor's income). This allows for the fact that where available income to cover the capital sum (see section 633(2)) arose in earlier years, that income may have been charged at different rates to those in the tax year in which the capital sum is treated as the settlor's income.

2455. *Subsections (4)* to *(7)* provide that, in order to ascertain the appropriate rates of tax for subsection (3)(c), the capital sum is matched against available income arising in earlier years before later years and the given rates of tax are applied for each tax year in which the available income representing the grossed-up sum arose. This includes a nil rate of tax where the available income would not have been subject to UK tax because the available income arose outside the United Kingdom to a non-UK resident. Subsection (6)(b) reflects the change in the rate applicable to trusts in FA 2004. The net effect of these subsections is that the credit available against the tax charge broadly represents the tax paid on the available income which represents the grossed-up capital sum. The nil rate applies in relation to any income in any tax year which falls within subsection (6)(a)(i) and (ii).

2456. Subsection (5) provides for grossing-up at the appropriate rate, that is to say the rates given in subsection (6), in order to ascertain the tax credit to set against the settlor's income (the "deductible amount"). This is a separate grossing-up exercise to that in subsection (1), which provides that the charge on the settlor's income is always on the amount grossed up at the rate applicable to trusts.

Section 641: Capital sum paid to settlor by body connected with settlement

2457. This section provides a variation on the preceding rule. It ensures that capital sums paid by a corporate body connected with the settlement are treated as income of the settlor where the payment of that capital sum can be identified with a payment made to the corporate body by the settlement. Thus payments of capital from the settlement to the settlor but dog-legged through a connected third party will not avoid a tax charge on the settlor. The section is based on section 678 of ICTA.

2458. Under *subsections (1)* and *(2)* where a capital sum is paid to the settlor by a body corporate connected with the settlement and an associated payment is made directly or indirectly to that body corporate by the trustees, the capital sum paid by the body corporate is treated, to the extent that it falls within the associated payment, as if it were paid directly by the trustees to the settlor and section 633 applies accordingly.

2459. Where an associated payment is made in the year following the year in which the payment is made by the corporate body to the settlor, the capital sum is treated as the settlor's income for that tax year and so on, up to the amount covered by the associated payment, for each subsequent year (*subsections (4)* to *(6)*).

2460. See the entry in paragraph 135 of Schedule 2 to this Act for the application of this section in respect of payments to the settlor made before 1995-96 by a body corporate connected with the settlement.

Section 642: Exception for certain loans or repayments of loans

2461. This section provides time limits for section 641. Where the capital sum paid to the settlor is repaid within 12 months or loans made to the settlor by a body corporate connected with the settlement are not outstanding for more than 12 months in five years, the capital sum is not treated as the settlor's income. The section is based on section 678 of ICTA.

Section 643: Interpretation of sections 641 and 642

2462. This section provides definitions of and further information on terms used in sections 641 and 642. It is based on section 678 of ICTA.

2463. *Subsection (1)* provides the same tests as section 633 in ascertaining whether a capital sum has been paid to a settlor.

2464. *Subsection (4)* widens the meaning of payments made by or to another body corporate. It enables sections 641 and 642 to apply where the body corporate making the payment to the settlor is a different body corporate to that receiving the payment from the trustees, whether directly or indirectly, but where both bodies corporate are associated.

Section 644: Application to settlements by two or more settlors

2465. This section explains how the provisions of this Chapter apply where there is more than one settlor. It is based on sections 660E and 682A of ICTA.

2466. The Chapter is written in terms of a single settlor and the rules in *subsections (2)* to *(5)* allow the property originating from each settlor to be considered in isolation.

Section 645: Property or income originating from settlor

2467. This section explains what is meant by property or income originating from a settlor for the purposes of section 644. It is based on sections 660E and 682A of ICTA.

2468. *Subsection (1)* rewrites section 660E(5) of ICTA. Section 660E(5) of ICTA provides under paragraph (c) that property originating from a settlor means property that represents property provided by the settlor and other property as, on a just apportionment, represents the property so provided. This is rewritten as "on a just and reasonable apportionment". See *Change 14* in Annex 1.

Section 646: Adjustments between settlor and trustees etc.

2469. This section enables a settlor to recover from the trustees or others tax which has been charged on him or her under sections 624 or 629 as well as requiring him to repay to the trustees any tax repayment which would not have arisen to him or her apart from the charge under these two sections. The section is based on section 660D of ICTA.

2470. *Subsection (1)* enables the settlor to recover from the trustees, or whoever else has received the settlement income, the tax payable by the settlor as a result of a charge under sections 624 or 629. Since the settlor has not in fact received the income it is considered inequitable that he or she should have to pay the additional tax. The net effect where such a recovery is made is that the trustees or beneficiary of the settlement effectively pay the tax on the income but at the settlor's highest tax rate.

2471. *Subsection (2)* enables the settlor to request a certificate of tax paid from the Inland Revenue which is conclusive, under *subsection (3)*, of the facts in it.

2472. Section 660D(1)(b) refers to "an officer of the Board". Similar references have been replaced in this Act by the term "Inland Revenue" to achieve a more consistent approach. This is not a change in the law since section 878(1) of this Act defines "the Inland Revenue" as "any officer of the Board of Inland Revenue".

2473. *Subsections (4)* and *(5)* require a repayment of tax to the trustees or other persons receiving the settlement income which a person would not have received but for a charge under sections 624 and 629. This is most likely to arise where the income charged on the settlor has had tax deducted at source and a repayment of tax is made to the settlor because there is a surplus of allowances or reliefs to set against that income. The repayment may be apportioned where the settlement income was received by more than one person.

2474. Section 660D(2) of ICTA refers to “a person” obtaining a repayment of income tax. This is rewritten here as “a settlor”. The person referred to can only be the settlor and the use of “person” simply reflects the language of FA 1922, on which that section is based, which refers to the settlor as “a person making a disposition”.

2475. *Subsection (8)* ensures that a charge on settlement income in respect of settlor-interested settlements and settlements in respect of minor children of the settlor may still be made on the trustees as recipients of the income.

Section 647: Power to obtain information

2476. This section allows the Inland Revenue to require parties to a settlement to provide them with information within a specified time limit. It is based on section 660F of ICTA.

2477. Section 660F refers to “an officer of the Board”. Similar references have been replaced in this Act by the term “Inland Revenue” to achieve a more consistent approach. This is not a change in the law since section 878(1) of this Act defines “the Inland Revenue” as “any officer of the Board of Inland Revenue”.

Section 648: Income arising under a settlement

2478. This section explains what is meant by income arising under a settlement. It is based on section 660G of ICTA.

2479. *Subsection (1)* includes all income chargeable to tax on a UK resident from sources within or outside the United Kingdom.

2480. *Subsections (2) to (5)* apply where the settlor is either not resident in the United Kingdom or not domiciled or not ordinarily resident here. In that case any foreign source income is excluded unless it is remitted to the United Kingdom and the settlor would be chargeable to tax in respect of it if it were his own income. In that case it is included in the income arising under a settlement in the year of remittance.

2481. The net effect of this section is to include all UK source income within income arising under a settlement but to exclude foreign source income if the settlor is non-UK resident. If the settlor would have been charged on an amount calculated by reference to section 832 (relevant foreign income charged on the remittance basis) had he or she been entitled to the income, then that foreign source income is charged only to the extent that it is remitted here.

Chapter 6: Beneficiaries’ income from estates in administration

Overview

2482. This Chapter charges to income tax income paid or payable by personal representatives to residuary beneficiaries from estates in administration. The Chapter rewrites sections 695 to 698 and 699 to 702 of ICTA. Section 698A of ICTA (which deals with rates of tax) and section 700(4), (5) and (6) of ICTA (which deal with administrative matters) have not been rewritten in this Chapter. These provisions will be rewritten together with other provisions dealing, respectively, with rates of tax and administrative matters.

2483. Personal representatives are taxable only at the basic rate, lower rate or the dividend ordinary rate (Schedule F ordinary rate in the source legislation) on any income they receive during the administration period. When the income which arises to the personal representatives is paid to the residuary beneficiaries, it is treated as having borne tax at those rates. So this Chapter ensures that beneficiaries liable at the higher rate are chargeable at the higher rate or, as appropriate, the dividend upper rate (Schedule F upper rate in the source legislation), as well as allowing beneficiaries liable at the lower rate, or not liable to income tax, to reclaim some or all of the tax paid by the personal representatives.

Section 649: Charge to tax on estate income

2484. This section charges estate income to tax. It is based on sections 695, 696, 698 and 701 of ICTA.

2485. The approach of Part 16 of ICTA is to deem sums to have been paid as income for all tax purposes. In the case of UK estates, the income is not charged under a particular Schedule or Case and it is implicit that tax is charged on those sums. For foreign estates, a charge is imposed under Schedule D Case IV. This section applies to both UK and foreign estates. And it has now been made explicit that the charge to tax applies to all estate income which is treated as arising under the Chapter from a deceased person's estate.

2486. *Subsection (2)* provides a definition of "estate" and "estate income". It provides that the charge under this section applies to all estate income. This includes income from both UK and foreign estates.

2487. *Subsection (3)* ensures that estate income is treated as income for income tax purposes. Without the rules in this Chapter (and Part 16 of ICTA for corporate beneficiaries within the charge to corporation tax), payments by personal representatives to residuary beneficiaries would, in law, be payments of capital.

2488. *Subsection (4)* recognises that an estate may be divided into different parts with different residuary dispositions. Where, for instance, a proportion of an estate is subject to different dispositions from the remainder and each set of dispositions involves there being a residue, each part of the estate should be treated for the purposes of this Chapter as if they were separate estates. While this subsection applies where the testator has property abroad which he or she disposes of by a separate will, it can also apply to dispositions in the same will. For example, a testator could leave a limited interest in half his or her residuary estate to one child and half to the other with the capital comprising each half share to their respective issue. This would be treated, for the purposes of this Chapter, as two separate estates.

Section 650: Absolute, limited and discretionary interests

2489. This section defines the three types of interest in the whole or part of the residue of an estate. It is based on sections 698 and 701of ICTA.

2490. *Subsection (1)* defines an absolute interest in the whole or part of the residue of an estate. Subsection (1)(a) refers to the capital being properly payable to the person with the interest if the residue had been ascertained. This simply reflects the fact that the amount of any residue, and the income from it, can only be an estimate until the residue has been ascertained.

2491. *Subsection (2)* defines a limited interest in the whole or part of the residue of an estate. Subsection (2)(b) mirrors subsection (1)(a) of this section.

2492. *Subsection (3)* defines what is referred to as a "discretionary interest" in the whole or part of the residue of an estate for the purposes of this Chapter. The income has to be properly payable to the person with the discretionary interest "if the residue had been ascertained at the beginning of the administration period". Effectively, this imposes a working assumption that there will be sufficient income from the residue to make the discretionary payments when the residue has been ascertained.

2493. *Subsection (4)* covers the following four situations:

- income/capital properly payable directly to the person with the interest;
- income/capital properly payable to the person with the interest indirectly through a trustee or other person;

- income/capital properly payable for the benefit of the person with the interest to another person in that person's right, and that income/capital is paid directly to that other person; and

- income/capital properly payable for the benefit of the person with the interest to another person in that person's right, and that income/capital is paid indirectly through a trustee or other person.

2494. An amount is only treated as properly payable to a person if it is "properly payable to the person, or to another in the person's right, for the person's benefit". This makes it clear that, whether the amount is properly payable to the beneficiary or to another in the beneficiary's "right", it must still be payable for the beneficiary's benefit (eg where a payment is made to a person having a power of attorney for a beneficiary). An example of a situation in which this condition is not met is where the residuary beneficiary is in bankruptcy. The income/capital would not be properly payable to the residuary beneficiary but would be payable to the trustee in bankruptcy in his or her right. But any payments would not be made for the benefit of the trustee in bankruptcy as the trustee receives them in a fiduciary capacity.

2495. *Subsection (5)* deals with the situation where personal representatives would have an absolute or limited interest in the residue of another deceased person's estate if a right they have as personal representatives were vested in them for their own benefit. In these circumstances they are treated as having that interest. The term "personal representatives" is defined in section 878(1) of this Act.

2496. *Subsection (6)* makes it clear that for the purposes of subsection (4) it does not matter whether the payment is made directly to the beneficiary by the personal representatives or through a trustee or other person. For example, the payment may be made to the guardian of a child or to whoever is appointed to look after the finances of a mentally incapacitated adult.

Section 651: Meaning of "UK estate" and "foreign estate"

2497. This section defines "UK estate" and "foreign estate" for the purposes of this Chapter. It is based on sections 699A and 701 of ICTA. The definitions in this section underpin the whole of this Chapter.

2498. *Subsections (2), (3)* and *(5)* contain the conditions which determine whether an estate is a UK estate for a tax year. A "foreign estate" is an estate which is not a "UK estate" for the tax year.

Section 652: Estate income: absolute interests in residue

2499. This section sets out the basis on which estate income is treated as arising in a tax year in the case of absolute interests in residue. It is based on section 696 of ICTA.

2500. *Subsections (2)* and *(3)* set out the relevant conditions. A payment need not be made in the final tax year because the net amount of estate income in that year is always equal to the assumed income entitlement for that year. Under section 696(5) of ICTA, taxing a person with an absolute interest in a residuary estate depends on whether the person receives payments and, in the final year of administration, on a fictional payment under that section. The same effect is achieved in this section by determining the liability by considering the assumed income entitlement in all years. Assumed income entitlement is dealt with in section 665.

Section 653: Meaning of "the administration period" and "the final tax year"

2501. This section defines "the administration period" and "the final tax year". It is based on sections 695, 701 and 702 of ICTA.

2502. *Subsection (1)* defines "the administration period" for the purposes of this Chapter. The reference to "the period commencing on the death" in section 695(1) of ICTA suggests that the actual time of death could be important in determining whether income arose before or after death. In general, this will not be the case because income such as earnings, rent, interest and dividends does not arise at a particular time of the day. If such income arises on the date of death, it will be deemed to be income passing to the deceased immediately on the commencement of that day.

2503. But the administration period has not been defined in this Act as beginning the day after the date of death. This is because the possibility cannot be excluded that income will arise after the death, but on the same date, as a result of the efforts of the personal representatives and this should properly be regarded as income of the estate.

2504. *Subsection (2)* defines when the administration of the estate is completed for Scotland. A full definition for Scotland is required because the completion of the administration of an estate would otherwise have no meaning under Scottish law (although the definition has been updated by replacing the archaic expression "for behoof of"). In contrast, there are cases under English law which have established that the administration is complete when the residue of the estate is ascertained and is ready for distribution. Case law explains what this means in particular circumstances (see, for example, R v Special Commissioners ex parte Dr Barnardo's Homes (1921), 7 TC 646 HL, Daw v CIR (1928), 14 TC 58 HC and CIR v Sir Aubrey Smith (1930), 15 TC 661 CA).

2505. *Subsection (3)* defines "the final tax year" to avoid repeating the full meaning throughout the Chapter.

Section 654: Estate income: limited interests in residue

2506. This section deals with estate income relating to limited interests. It is based on section 695 of ICTA.

2507. The section sets out the basis on which estate income is treated as arising in a tax year for limited interests in residue. The section reflects the need to deal with tax years before the final tax year. Also, a limited interest might cease on the death of the beneficiary before the final tax year so that situation has to be provided for.

Section 655: Estate income: discretionary interests in residue

2508. This section deals with estate income relating to discretionary interests in residue. It is based on section 698 of ICTA.

2509. The section sets out the basis on which estate income is treated as arising in a tax year for discretionary interests in residue. Estate income is treated as arising if a payment is made in the tax year in exercise of the discretion in favour of the person with the discretionary interest.

Section 656: Income charged: UK estates

2510. This section sets out the amount charged to tax under section 649 for income from UK estates. It is based on sections 695, 696 and 698 of ICTA.

2511. As there are fundamental differences between the basis of charge for income from UK and foreign estates, the rules for foreign estates have been dealt with in a separate section (section 657).

2512. *Subsection (2)* provides that income from a UK estate is charged on the gross amount of the estate income arising in the tax year. This is the basic amount of the income grossed up at the applicable rate. "Basic amount" is a new term. This avoids confusion with the term "net amount" since it is the "net amount" which is actually charged to tax in the case of a foreign estate (except where section 680 (income treated as bearing income tax) applies).

Section 657: Income charged: foreign estates

2513. This section sets out the amount charged to tax under section 649 for income from foreign estates. It is based on sections 65, 68, 695, 696, 698 and 699A of ICTA.

2514. *Subsection (5)* provides that, so far as the income is not within section 680, the charge is on the basic amount of that income. Where the income is within section 680, the charge is on the gross amount of the income calculated in accordance with section 663.

Section 658: Special rules for foreign income

2515. This section is based on sections 695, 696 and 698 of ICTA. It indicates that estate income arising outside the United Kingdom may be subject to the special rules for foreign income in Part 8 of this Act.

2516. *Subsection (2)* provides that the special rules in Part 8 of this Act for "relevant foreign income" only apply to foreign estates. This preserves the effect of the source legislation under which those special rules only apply to income charged under Schedule D Cases IV or V. And under the source legislation, only income from foreign estates is charged under Schedule D Case IV.

Section 659: Person liable

2517. This section states who is liable for any tax charged under section 649. It is based on sections 695, 696 and 698 of ICTA.

2518. The person who is liable will very much depend on the nature of the interest held by the beneficiary. The various interests are set out in the section together with the person liable for each of those interests.

Section 660: Basic amount of estate income: absolute interests

2519. This section explains how to calculate the basic amount of estate income for absolute interests. It is based on section 696 of ICTA.

2520. For years before the final tax year, the basic amount is the total of all sums paid in the tax year in respect of the interest or the person's assumed income entitlement, whichever is the lower. Surplus payments are excluded because an absolute income beneficiary may receive sums which comprise both capital and income but the section taxes only the income element. For the final tax year, it is the person's assumed income entitlement for that year which is taxed.

2521. This section removes all the deeming of amounts to have been paid in Part 16 of ICTA. Instead, it looks at either amounts actually paid or the assumed income entitlement. It then catches all previously untaxed income due to the absolute interest holder by taxing the assumed income entitlement in the final year. This avoids the two stage process inherent in section 696(5) of ICTA.

2522. *Subsection (3)* introduces a new rule allowing excess estate deductions in the final tax year to be set off against the basic amount of estate income for that year. See *Change 106* in Annex 1.

Section 661: Basic amount of estate income: limited interests

2523. This section explains how to calculate the basic amount of estate income for limited interests. It is based on section 695 of ICTA.

2524. Essentially, the basic amount of estate income is all the sums referred to in section 654 falling within a particular tax year added together. It is impossible for there to be sums within both section 654(3)(c) and (4)(c) in the same tax year.

Section 662: Basic amount of estate income: discretionary interests

2525. This section identifies the basic amount of estate income relating to discretionary interests. It is based on sections 695 and 698 of ICTA.

Section 663: The applicable rate for grossing up basic amounts of estate income

2526. This section provides for basic amounts of estate income to be grossed up, as appropriate, for the purposes of the income charged sections (section 656for UK estates and section 657 for foreign estates) by reference to the rate at which tax is borne by the aggregate income of the estate. The aggregate income of the estate is defined in section 664. Section 663 is based on sections 699A and 701 of ICTA

Section 664: The aggregate income of the estate

2527. This section explains what is meant by the "aggregate income of the estate" for a tax year. It is an important definition of general application. Essentially, the aggregate income is all the taxable income of the personal representatives plus certain sums which are treated as having borne income tax at particular rates. The section is based on sections 249, 421, 547, 701 and 702 of ICTA.

2528. *Subsection (2)* defines the income and amounts within the aggregate income of the estate. Subsection (2)(a) brings in income chargeable to UK income tax. Subsection (2)(b) brings in foreign source income.

2529. *Subsection (4)* provides that the amount of income falling within subsection (2)(b) takes account of any deductions which would have been available if it had been subject to UK income tax. So subsection (4) brings foreign source income into line with UK source income.

2530. *Subsection (5)* provides that two types of income are excluded from the aggregate income of the estate. This subsection excludes income from property devolving on the deceased's personal representatives otherwise than as assets for payment of the deceased's debts. The subsection also excludes from the aggregate income of the estate income to which any person may become entitled under a specific disposition. This second exclusion is new to the definition of the aggregate income of the estate although it is similar to section 697(1)(b) of ICTA which deals with amounts which are deductible from the aggregate income in calculating the residuary income of the estate.

2531. It does not seem appropriate for income from specific dispositions or income from contingent interests to be treated as part of the aggregate income of the estate. See *Change 107* in Annex 1.

2532. Section 698(1) of ICTA deals with the position where the deceased person ("A"), whose estate is being administered by personal representatives, had an absolute or limited interest in the residue of the estate of another deceased person ("B"). Section 698(1) of ICTA deems the personal representatives to have the same interest as "A" "notwithstanding that that right is not vested in them for their own benefit". The substance of this is rewritten in section 650(5). Section 698(1) of ICTA also deems any income in respect of such an interest to be part of the aggregate income of A's estate. This part of the source legislation is not rewritten because such income will fall within the definition of the aggregate income of the estate anyway, once the personal representatives are deemed to have the interest, because it will be the income of the deceased's personal representatives as such. It is immaterial for this purpose that that right in relation to the estate of another deceased person "is not vested in them for their own benefit".

2533. It is not considered necessary to expand on the two types of excluded income mentioned in subsection (5) of this section (with the exception of *subsection (6)* of this section) since it will be clear when such income arises. Consequently, section 701(6) and (7) of ICTA are not rewritten.

Section 665: Assumed income entitlement

2534. This section explains the new concept of the "assumed income entitlement". It is based on section 696 of ICTA.

2535. The concept of "assumed income entitlement" has been introduced as a tool for calculating the basic amount of estate income for absolute interests. It is similar to the "aggregated income entitlement" in section 696 of ICTA but applies in a more straightforward way.

2536. *Subsection (1)* sets out the steps to be considered to determine whether a person has an assumed income entitlement for a tax year. The assumed income entitlement is the amount by which the absolute holder's share of residuary income (after, in the case of UK estates, deduction of tax at the applicable rate) for tax years up to and including the tax year in question exceeds the total of the basic amounts for which he is chargeable for all previous tax years. Thus, for example, if the beneficiary receives his share of the residuary income in each tax year up to the year in question, then the assumed income entitlement is the basic amount of his share of the residuary income for that year.

2537. Step 4 in subsection (1) deals also with situations where a corporate beneficiary liable to income tax was, at some earlier point during the administration period, chargeable to corporation tax. It also deals with other situations where a non-UK resident beneficiary becomes UK resident, when the estate is a foreign estate.

Section 666: The residuary income of the estate

2538. This section explains how the residuary income of the estate is calculated. Beneficiaries with absolute interests need to know the residuary income of the estate for a tax year in order to work out their assumed income entitlement. The section is based on section 697 of ICTA.

2539. *Subsection (2)* lists the "allowable estate deductions". This is a new label for the items which may be deducted from the aggregate income of the estate. Subsection (2)(a) refers to "all interest paid in that year by the personal representatives …". Section 697(1)(a) of ICTA refers to "the amount of any annual interest, annuity or other annual payment for that year which is a charge on residue …". The requirements that interest must be annual and also a charge on residue have not been reproduced. See *Change 108* in Annex 1.

2540. In practice, the Inland Revenue allow income from specific dispositions to be deducted from the aggregate income of the estate in calculating the residuary income of the estate in the year of assent and later years. But it is considered simpler for it merely to be excluded from what counts as the aggregate income and not be deducted from it. See *Change 107* in Annex 1.

2541. Subsection (2)(b) deals with annual payments. Because of the restricted meaning given to annual payments, much of the wide definition in section 701(6) and section 702(d) of ICTA is otiose. Any liabilities which are annual payments will now have to meet only the requirement that they are properly payable out of residue and this is also a requirement of section 701(6) of ICTA. Omitting the remainder of the definition removes unnecessary material. As a consequence of the change, section 701(7) of ICTA, which limits the meaning of "charges on residue" in relation to specific dispositions, does not need to be rewritten either.

2542. The section does not contain an ordering rule for allocating allowable estate deductions against different categories of income. It is not considered appropriate to state explicitly that the taxpayer may choose whichever allocation is most advantageous. This is implicit in the section.

Section 667: Shares of residuary income of estate

2543. This section is based on section 696 of ICTA. It explains the rules for determining the share of residuary income treated as arising from a person's absolute interest in the whole or part of the residue of an estate.

Section 668: Reduction in share of residuary income of estate

2544. This section provides that the share of the residuary income of the estate of a person with an absolute interest is reduced at the end of the administration period in certain circumstances. It is based on sections 4 and 697 of ICTA.

2545. This is beneficial to a person with an absolute interest because a lower share of the residuary income results in a lower (or no) assumed income entitlement. The section ensures that the beneficiary is not charged to tax on more income than he or she actually enjoys. The reduction may apply where, for example, the debts of the estate exceed the amount ultimately realised from the capital assets available for their payment and so part of the income received from the assets is also used, leaving only part available for the residuary beneficiary.

2546. *Subsection (2)* and *(3)* provide that if there is an excess within *subsection (1)*, that excess is available to reduce the person's share of the residuary income in the final tax year. If that share is reduced to nil then any remaining excess is available to reduce the share of the residuary income in the previous tax year and so on.

2547. *Subsection (5)* provides that, for the purposes of subsection (1)(b), a sum paid during the administration period is grossed up by reference to the basic rate for the tax year in which it was paid in the case of UK estates. And it provides that a sum payable at the end of the administration period is grossed up by reference to the basic rate for the final tax year in the case of UK estates. Section 4(1) of ICTA provides that any provision requiring, permitting or assuming the deduction of income tax shall be construed as referring to deduction or payment of income tax at the basic rate. This has been made explicit in subsection (5) itself.

Section 669: Reduction in residuary income: inheritance tax on accrued income

2548. This section deals with the case where an absolute interest holder is a higher rate taxpayer and income accruing before death has been taken into account both in calculating the residuary income and for inheritance tax purposes. The section is based on section 699 of ICTA.

2549. The overlap in the two tax charges may arise where income has accrued before death but is received after death. The section provides for a reduction in the residuary income in such circumstances.

2550. *Subsections (1)* and *(2)* explain the basic principle. The reduction applies when pre-death income (as defined) is taken into account both in calculating the residuary income of the estate for a tax year and in determining the value of the deceased's estate for inheritance tax purposes.

2551. *Subsection (4)* sets out a method statement for calculating the reduction in three steps. For liabilities to be deductible from pre-death income, they have to have affected both the value of the estate for inheritance tax purposes and the residuary income of the estate for the tax year. In the latter case, they might have been deducted in calculating the aggregate income of the estate or have been deducted from the aggregate income in calculating the residuary income.

2552. *Subsections (7)* and *(8)* are administrative provisions. They provide that the amount of inheritance tax chargeable and the value of the estate cannot be reopened once agreed or settled in proceedings. The reference to "the Board" in section 699 of ICTA has been replaced in this section by "the Inland Revenue" which is defined in section 878(1) of this Act. See *Change 149* in Annex 1.

2553. Section 699(6)(b) of ICTA, which provides that references to inheritance tax include references to capital transfer tax, is not rewritten; it is spent.

Section 670: Applicable rate for determining assumed income entitlement (UK estates)

2554. This section sets out the calculation of the applicable rate for the purposes of calculating income tax to be deducted from the residuary income in step 2 of section 665(1). The section is based on section 701 of ICTA.

Section 671: Successive absolute interests

2555. This section explains the position where two or more absolute interests in the residue of an estate are held successively by different people. It is based on sections 697 and 698 of ICTA.

2556. In each tax year in which a payment is made in respect of an absolute interest, it is necessary to calculate the beneficiary's assumed income entitlement. The assumed income entitlement works on a cumulative basis, so the share of the residuary income of the absolute interest holder and the basic amounts of previous tax years are taken into account. In order to give a true picture of the assumed income entitlement of someone who has an absolute interest in succession to another person, the position of the previous holder needs to be brought into the calculations. Otherwise, in certain circumstances, an element of the residuary income might escape taxation.

2557. *Subsections (1)* and *(2)* apply where successively there are different persons with absolute interests in the residue of an estate of a deceased person or in parts of such a residue. They apply primarily for situations where one absolute interest is succeeded by another. This might occur where, for example, an absolute interest holder dies or there is a deed varying the will so that the interest passes for income tax purposes to another beneficiary from the date of the deed etc.

2558. *Subsection (3)* contains an ordering rule to ensure that all determinations under subsection (2) or section 672(2) are made in relation to the person with the earlier interest before the person with the later interest. This subsection has been inserted to make explicit what is already implicit in the source legislation.

2559. *Subsection (4)* provides a special rule where there are two or more absolute interests in the final tax year. It is intended to ensure that it is the last absolute interest which is charged to tax on the assumed income entitlement, which will comprise all the residuary income, in the final year. This is because the last absolute interest holder will receive the capital of the residue (and also all outstanding income in respect of it).

2560. *Subsections (5)* and *(6)* contain special rules where section 668 (reduction in share of residuary income of estate) applies and there are successive absolute interests. These subsections provide that the calculation under section 668(1)(a) and (b) is to be made by reference to all the absolute interests taken together. Then, after applying the reduction to the last absolute interest under section 668(1) and (2), any remaining excess is applied to the previous absolute interest holders working backwards from the beginning of the last interest. See *Change 109* in Annex 1.

Section 672: Successive interests: assumed income entitlement of holder of absolute interest following limited interest

2561. This section (and section 673) explains the position of the absolute interest holder where successive limited and absolute interests in the residue of an estate are held by different people. It is based on section 698 of ICTA.

2562. The section only applies where the later interests arise or are created on the cessation of the previous interest otherwise than by death (the position of limited interests which cease on the death of the holder before the final tax year are dealt with in section 654(4)). All sums paid or remaining payable in respect of that interest after the tax year of death are treated as estate income arising in the tax year of death.

2563. Examples of situations, in relation to limited interests, that are covered by the section include:

- the disclaiming of a life interest which accelerates an existing interest under the will; and
- an interest which is only held until marriage or attaining a certain age.

2564. *Subsections (3)* and *(4)* contain the two rules introduced by *subsection (2)*. They deal with the limited interest which ceases otherwise than on death. They also explain how such an interest is brought into the calculation of whether the person with the absolute interest has an assumed income entitlement and, if so, its amount. The assumed income entitlement works on a cumulative basis, so the share of the residuary income of the absolute interest holder and the basic amounts of previous years are taken into account.

Section 673: Successive interests: payments in respect of limited interests followed by absolute interests

2565. This section covers the position where the absolute interest holder is entitled to receive payments in respect of a preceding limited interest which has ceased otherwise than on death. It is based on section 698(1A) and (1B) of ICTA.

2566. *Subsection (2)* deals with such payments while the absolute interest holder still has the absolute interest. It provides that a payment made to the absolute interest holder in respect of the limited interest is treated as paid in respect of the absolute interest (and not the limited interest). Thus, such payments may form part of the basic amount of estate income in tax years before the final tax year.

2567. *Subsection (3)* deals with the position where the holder's absolute interest has itself ceased (but the administration period continues). The approach here is to treat any such sum paid in these circumstances as a payment in respect of the earlier limited interest. The result is that such payments are treated as estate income under the limited interests provisions. But *subsection (6)* provides that the payments are treated as paid or payable in respect of the absolute interest for the purposes of section 668 (reduction in share of residuary income of estate).

2568. The taxation of successive interests in the residue of an estate is dealt with in section 698(1A) to (2) of ICTA. Section 698(1B) of ICTA deals with the case where there were successive interests in an estate which ceased otherwise than on death and the earliest or one of the earlier interests was a limited interest (see section 698(1A) of ICTA).

2569. Section 698(1B)(a) of ICTA provides that Part 16 of ICTA applies as if all the interests were the same interest ("the deemed single interest"), so that none of them is to be treated as having ceased on being succeeded by any of the others. Section 698(1B)(b) of ICTA then determines who had the deemed single interest. It is either the person in respect of whose interest or previous interest the payment was made (section 698(1B)(b)(i) of ICTA) or a person who has or had an interest and is entitled to receive the payment (section 698(1B)(b)(ii) of ICTA). So a beneficiary who does not give up his or her entitlement to income which is unpaid at the time the interest ceases is taxable on the payment, rather than the person holding the successive interest at the time when the payment is made. However section 698(1B)(b) of ICTA is made subject to section 698(1B)(c) of ICTA. Section 698(1B)(c)(i) of ICTA provides that, so far as a later interest is an absolute interest, it is to be treated as having always existed and the earlier interest or interests as having never existed for the purposes of the provisions dealing with absolute interests in section 696(3A) to (5A) of ICTA.

2570. In rare circumstances the later absolute interest may itself have ceased at the time the payment is made. For example, A has a limited interest which is succeeded by absolute interests held first by B and then by C, and a payment is received by B in respect of A's earlier limited interest after B's own interest has ceased but before the end of the administration period. As a result of section 698(1B)(b)(ii) of ICTA, Part 16 of ICTA applies to the payment as if B had the deemed single interest. So section 696(3) of ICTA deems the sum to be paid to B as income in the year in which it is actually paid. That is a tax year in which C had the absolute interest. Under section 698(1B)(c)(i) of ICTA for the purposes of section 696(3A) to (5) of ICTA, Part 16 of ICTA is to apply as if the later interest of C had always existed and the earlier interests had never existed. Section 698(1B)(c)(ii) and (iii) of ICTA then provides that sums paid as income in respect of the earlier interests are deemed to be sums paid in respect of the later interest of C.

2571. The relationship between these particular provisions, where the later interest has itself ceased at the time the payment is made but the administration period continues, is difficult to work out. It would seem that the payment in the above example should be taxed on B because of section 696(3) of ICTA. The payment is then brought into account when the payments made in respect of C's interest are compared to his aggregated income entitlement (in making the final year calculation under section 696(5) of ICTA in respect of C's interest to determine whether any amount should be treated as having been paid to C immediately before the end of the administration period). So although section 698(1A) and (1B) of ICTA operate in a very convoluted way in the above circumstances, the end result appears to be that B, the person with the absolute interest who receives the payment, is taxed on it, but it does not affect B's aggregated income entitlement.

2572. In order to spell out how a payment made in these circumstances should be treated, section 673(3) and (4) provide that where such a payment is made, this Chapter applies as if the earlier limited interest had continued to subsist while the later absolute interest subsisted and had been held by the holder of the later absolute interest. The result is that payments to that holder are treated as estate income under the provisions about limited interests.

2573. Sums to which that holder is entitled that remain payable at the end of the administration period are treated in the same way. They will be basic amounts arising from the limited interest in the tax year in which the absolute interest ceases and are dealt with by sections 654 and 661. The effect of this on later absolute interests is then determined by the successive absolute interests provisions in section 671. Under subsection (6) of section 673, however, these sums are to be treated as paid or payable in respect of the absolute interest for the purposes of the provisions about the reduction in shares of residuary income under section 668.

Section 674: Successive interests: holders of limited interests

2574. This section explains the position of a limited interest holder where successive interests in the residue of an estate are held by different people and the earlier, or if there are more than two, the earliest of the interests is a limited interest. It is based on sections 695 and 698 of ICTA.

2575. The section only applies where the later interests arise or are created on the cessation of the previous interest otherwise than by death.

2576. *Subsections (3) to (5)* cover three sets of circumstances described as "cases" where the estate income in respect of successive limited interests is treated as arising. The cases are the equivalent for successive limited interests of the three cases for single limited interests in section 654. But the section recognises that there may be more than one limited interest in the chain of succession, so references are made to "one of the interests" and subsection (5) refers to "the last of the successive interests".

2577. There is also an additional sub-paragraph in each case providing that a limited holder (as defined) is entitled to receive the payment. This reflects the fact that the person who receives the payment in these circumstances is not always the person in respect of whose interest the payment is made. For example, on disclaiming a life interest, a beneficiary may also disclaim any entitlement to income accrued in respect of that interest but not yet paid.

2578. The section does not make it explicit that a new chain of succession begins with the first limited interest (and a previous absolute interest is ignored) for the purposes of this provision. Nor does the section make it explicit that two limited interests which are preceded by a limited interest which ceased on the death of the beneficiary are covered by the section. These conclusions are implicit in the section.

Section 675: Basic amount of estate income: successive limited interests

2579. This section explains how to calculate the net amount of estate income for successive limited interests. It is based on sections 695 and 698 of ICTA.

2580. The section is the equivalent provision to section 661 for limited interests that are not successive. Essentially, the basic amount of estate income is all the sums referred to in section 674 falling within a particular tax year added together. It is impossible for there to be sums within both section 674(4)(c) and (5)(c) in the same tax year.

Section 676: Apportionments

2581. This section applies where successive interests apply to only part of the residue. In other words, the residuary estate is divided up and one or more of the successive interests provisions apply to a part or parts of that estate. It also applies where one of the interests covers the whole estate and the other interest covers part of it.

2582. In such circumstances, it is possible that a subsequent interest does not cover exactly the same part of the residuary estate as the interest which preceded it. For example, a limited interest holder may give up half his or her interest, thus accelerating the interest of the absolute interest holder. Only half the share of the residuary income and half the net amounts of the limited interest holder would be needed for the calculation of whether the absolute interest holder has an assumed income entitlement in accordance with section 672(2). The section provides for just and reasonable apportionments to be made in these circumstances.

2583. The section is new. See *Change 110* in Annex 1.

Section 677: Relief where UK income tax borne by foreign estate: absolute interests

2584. This section provides for relief if income, which has borne UK tax, arises to a person with an absolute interest in the residue of a foreign estate. It is based on section 696 of ICTA. The relief has been expressed as a formula to make it easier to compute.

2585. *Subsection (2)* contains the formula for calculating the relief where a claim is made. The labels in section 696(7)(a) and (b) of ICTA – "the deemed income" and "the aggregate income" respectively – were added as explanatory aids in the course of the 1988 consolidation. These labels are not retained.

Section 678: Relief where UK income tax borne by foreign estate: limited and discretionary interests

2586. This section provides for relief if income, which has borne UK tax, arises to a person with a limited or discretionary interest in the residue of a foreign estate. The section is based on sections 695 and 698 of ICTA. The relief has been expressed as a formula to make it easier to compute.

2587. *Subsection (2)* provides for a reduction to be made from the tax charged on the person following a claim for relief. The tax is to be reduced by an amount equal to the appropriate fraction of that tax. The fraction here (based on section 695(5) of ICTA) is slightly different to the fraction used for absolute interests (based on section 696(7) of ICTA). The labels in section 695(5)(a) and (b) of ICTA – "the deemed income" and "the aggregate income" respectively – were added as explanatory aids in the course of the 1988 consolidation. These labels are not retained.

2588. Section 695(6) of ICTA is not rewritten. The meaning of this provision, which was introduced when surtax was still charged, is now obscure and it is difficult to see how it could operate in the context of Self Assessment. See *Change 111* in Annex 1.

Section 679: Income from which basic amounts are treated as paid

2589. This section sets out the rules for determining from which part of the aggregate income of the estate a basic amount is treated as paid. It is based on sections 699A and 701 of ICTA.

2590. Personal representatives may receive such income from a number of sources. And different rates of tax apply to different types of income. Some of the income is taxed in the hands of the personal representatives at "the applicable rate" (the basic rate, the lower rate or the dividend ordinary rate; see section 680).

2591. The basic amounts of estate income do not always correlate precisely with the income received by the personal representatives. It is therefore necessary to attribute payments out of the residuary estate in the form of basic amounts to particular types of income received by the personal representatives.

2592. *Subsections (4)* to *(6)* deal with situations where some of the aggregate income of the estate is income treated under section 680 as bearing tax. In such circumstances, a third assumption is introduced. That third assumption is to be applied before the two assumptions referred to in *subsections (2)* and *(3).*

Section 680: Income treated as bearing income tax

2593. This section deals with income which is treated as bearing income tax. It is based on section 699A of ICTA.

2594. For certain types of income (for example, stock dividend income) the amounts treated as received by individuals are gross amounts on which they are treated as having paid tax at the dividend ordinary rate (the Schedule F ordinary rate in the source legislation) or the lower rate (as appropriate). They may then be chargeable to tax at the dividend upper rate or the higher rate on that income. Where such income forms part of the aggregate income of the estate (as a result of section 664(2)), this section treats the income as having borne tax at either the dividend ordinary rate or the lower rate (as appropriate) for certain provisions within the Chapter.

2595. *Subsection (1)* sets out the provisions within the Chapter affected by the section. The provisions in question all affect the aggregate income of the estate (see section 664).

2596. *Subsection (5)* provides that no repayment shall be made of any income tax which is treated as having been borne under section 656(3) or section 657(4) so far as the basic amount comes from sums within this section.

2597. Section 699A(1)(b) of ICTA is not rewritten in this Act. This provision provides that the sums to which section 699A(1)(a) of ICTA applies must be sums in respect of which the personal representatives are not directly assessable to UK income tax. Of the income referred to in section 699A(1)(a) of ICTA to which section 699A(1)(b) of ICTA applies, none appears to be directly assessable. So section 699A(1)(b) of ICTA serves no useful purpose.

2598. Section 699A(6) of ICTA is not rewritten in this Act. It deals with deduction of tax at source and will be rewritten together with the rewrite of sections 348 and 349 of ICTA. The purpose it achieves is served by the new subsection (4)(e) in the consequential amendment to section 348 of ICTA.

Section 681: Transfers of assets etc. treated as payments

2599. This section is concerned with the appropriation of assets by personal representatives to themselves, any other transfer of assets and the set off or release of a debt. The section is based on section 701 of ICTA.

2600. *Subsections (1)* and *(2)* provide that the relevant events are treated as payments when they occur.

2601. *Subsections (3)* and *(4)* provide that where the relevant events have not happened by the end of the administration period, amounts equal to the value of the assets or debt are treated as payable.

Section 682: Assessments, adjustments and claims after the administration period

2602. This section deals with adjustments after the end of the administration period. It is based on section 700 of ICTA.

2603. *Subsections (1)* and *(3)* deals with adjustments where the person previously appeared to be chargeable to either a greater or lesser amount.

2604. *Subsections (2)* and *(4)* make provision for all necessary adjustments and repayments to be made (and where a person has been allowed too much relief, for tax to be charged). They also make provision for the person to be assessed and taxed (and where, for example, the beneficiary is a charity, for relief or additional relief to be allowed).

Chapter 7: Annual payments not otherwise charged

Overview

2605. The Chapter rewrites the part of section 18(3) Schedule D Case III (a) of ICTA which deals with annual payments and the parts of Schedule D Cases IV and V which deal with foreign annual payments.

2606. Under section 18(3) of ICTA there are no individual charges on income from different types of source within the Schedule D Case IV or V charge. The system of identifying and classifying income by Schedule and Case is replaced by individual charges on types of income, which previously would have fallen under a general Schedular/Case charge. In the context of income which would have previously been charged under Case IV or V, as appropriate, the charge is being fully integrated with the equivalent income arising from a UK source.

2607. This Chapter sets out the charge to income tax on any annual payments that are not charged to tax by any other provision of this Act or any other legislation. Annuity payments made under purchased life annuities and distributions from unauthorised unit trusts (which in the source legislation are treated as annual payments) are generally regarded as investment income. So the charge to tax for this income is in Part 4 of this Act. Royalties which are annual payments are generally regarded as income from intellectual property and are therefore taxed alongside other intellectual property income under Chapter 2 of Part 5 of this Act. Annual payments derived from telecommunication rights are also taxed under a separate Chapter, Chapter 4 of Part 5 of this Act. So, as the annual payments charge in Chapter 7 of Part 5 of this Act takes effect only if an amount is not otherwise charged to income tax, there is no overlap between the charge under this Chapter and the ex-Case III charges elsewhere in this Act.

2608. The charge to tax is in the penultimate Chapter of Part 5 of this Act to emphasise that it is a residual charge.

2609. The exemptions from the charge to income tax on annual payments are in Part 6 of this Act.

2610. The phrase "annual payment" is retained but not defined. The phrase is not defined in the source legislation. Instead it derives its meaning from an extensive body of case law. That case law illustrates that the phrase has a meaning for tax purposes far different from its natural one. Replacing that phrase risks breaking the link to case law without making the law any clearer or easier to understand. Because of the volume and complexity of the case law, defining "annual payment" comprehensively in this Act is impracticable and also risks changing the law.

2611. But it is possible to derive from the case law the main characteristics of an annual payment.

2612. For example, Jenkins L.J., in Commissioners of Inland Revenue v Whitworth Park Coal Company (1959), 38 TC 531 HL (at pages 548 to 550) regarded the following propositions as established:

(i) "To come within the Rule as an "other annual payment" the payment in question must be ejusdem generis with the specific instances given in the shape of interest of money and annuities (Hill v Gregory 6 TC 39; Earl Howe v Commissioners of Inland Revenue 7 TC 289)…;

(ii) The payment in question must fall to be made under some binding legal obligation as distinct from a being a mere voluntary payment (Smith v Smith 1923)…;

(iii) The fact that the obligation to pay is imposed by an Order of the Court and does not arise by virtue of a contract does not exclude the payment from Rule 1(a) of Case III (Smith v Smith 1923; CIR v Corporation of London (as Conservators of Epping Forest) 34 TC 293) …;

(iv) The payment in question must possess the essential quality of recurrence implied by the description "annual" (Smith v Smith 1923) …;

(v) The payment in question must be in the nature of a "pure income" profit in the hands of the recipient (Earl Howe v CIR 7 TC 289).

2613. The value of the first proposition is not without doubt. Not only has Parliament changed the genus from that considered in Hill v Gregory and Earl Howe, but the Court of Appeal in R - v - Special Commissioners of Income Tax ex parte Shaftesbury Homes and Arethusa Training Ship (1922), 8 TC 367 CA, in construing "any yearly interest or other annual payment" held that the expression "other annual payment" could not be construed eiusdem generis with the expression "any yearly interest".

Section 683: Charge to tax on annual payments not otherwise charged

2614. This section is based on section 18(1) and (3) (Schedule D Case III (a) and Cases IV and V) of ICTA. *Subsection (1)* charges residual annual payments to tax.

2615. The charge to tax in the source legislation is in respect of "any annuity or other annual payment". The reference to "any annuity or other" is omitted because most annuities are not charged to tax under Chapter 7 of Part 5 of this Act but under Part 4 of this Act or ITEPA. Including a reference to annuities might therefore be misleading.

2616. Likewise the examples of annual payments in Schedule D Case III (a) are omitted on the basis that including these risks misleading the reader either by excluding a right which may give rise to an annual payment or by including rights which may not.

2617. The words "whether such payment is payable within or out of the United Kingdom" in Schedule D Case III (a) are also omitted. See the commentary on section 369 of this Act.

2618. The charge to tax in the source legislation excludes "any payment chargeable under Schedule A". It is not necessary to rewrite this as the priority rules (see section 575 (2)) ensure that property income is taxed under Part 3 of this Act and not under any other Part.

2619. *Subsection (2)* ensures that any exemption from other charges to income tax is not reversed by the charge under this Chapter. It protects an exemption, whether provided by Part 6 of this Act or other legislation.

2620. *Subsection (3)* rewrites "or whether the same is received and payable half-yearly or at any shorter or more distant periods".

Section 684: Income charged

2621. This section sets out the amount charged to tax, which is the full amount of the annual payments (*subsection (1)*). It is based on sections 64 and 65(1) of ICTA.

2622. The words "without any deduction" in section 64 of ICTA are omitted. It is unnecessary to reproduce this phrase because one of the defining characteristics of an annual payment is that the recipient may make no deductions for expenses from it. See also the commentary on section 370 of this Act.

2623. *Subsection (2)* makes subsection (1) subject to the rules in Part 8 of this Act. Part 8 sets out the special rules which apply to foreign income including allowable deductions from foreign income and the remittance basis (see further the commentary on Part 8).

2624. *Subsection (3)* signposts the tax provision in ICTA which deals with the position of a person who receives income from a discretionary trust.

Section 685: Person liable

2625. This section states who is liable for any tax charged and is based on section 59(1) of ICTA. The phrase "receiving or entitled to" is retained because it is generally understood and has been widely interpreted by the courts. See further the commentary on section 371 of this Act.

Section 686: Payments received after deduction of tax

2626. *Subsection (1)* confirms that if income tax has been deducted by the payer of the annual payment, the recipient is treated as having paid that income tax. It is based on sections 348(1) and 349(1) of ICTA. The gap otherwise filled by case law (see Allchin v Corporation of South Shields (1943), 25 TC 445 HL, particularly Viscount Simon LC on page 461, Stokes v Bennett, (1953) 34 TC 337 HC, and Grosvenor Place Estates Ltd v Roberts (1960), 39 TC 433 CA) has been expressly rewritten. See further the commentary on section 426 of this Act.

Chapter 8: Income not otherwise charged

Overview

2627. This Chapter charges to tax any income that is not charged by any other income tax provision, whether elsewhere in this Act or in any other part of the Tax Acts, including ITEPA. It is based on section 18 of ICTA.

2628. Schedule D is the residual Schedule into which income falls for income tax purposes if neither ITEPA nor another Schedule of ICTA applies to it. Section 18(1)(a) of ICTA charges "annual profits or gains arising or accruing… from any kind of property whatever…". Section 18(1)(b) of ICTA charges "…other annual profits or gains not charged under Schedule A or under ITEPA 2003 as employment income, pension income or social security income, and not specially exempted from tax". Schedule F (rewritten in Chapter 3 of Part 4 of this Act) has sole charging rights over the amounts within its scope. Tax is charged under Schedule D Case VI "in respect of annual profits or gains not falling under any other Case of Schedule D and not charged by virtue of Schedule A or by virtue of ITEPA 2003 as employment income, pension income or social security income".

2629. Case VI is itself the residual Case under Schedule D. Schedule D Case V includes an identical function for "relevant foreign income" (see the definition in section 830) of this Act. The scope of Case V is "tax in respect of income arising from possessions out of the United Kingdom not being employment income, pension income or social security income on which tax is charged under ITEPA 2003". Case law has established the comprehensive scope of Case V in relation to "income from possessions out of the United Kingdom" (see the commentary on the overview to Part 8 of this Act). So far as any amount is "income from possessions out of the United Kingdom", Case V is the "last resort" charging provision, not Case VI. And a corollary of that rule is that income charged by Case VI (other than amounts which are directed to be taxed under Case VI) can only derive from a source in the United Kingdom.

2630. So far as is practicable, income charged by the source legislation under Schedule D Cases IV to VI is the subject of separate charges in this Act. See, for example:

- Chapter 4 of Part 4 of this Act, taken from Case V, which deals with dividends from non-UK resident companies;
- Chapter 3 of Part 5 of this Act, taken from Cases V and VI, which deals with films and sound recordings (non-trade businesses); and
- Chapter 4 of Part 5 of this Act, partly taken from Cases V and VI, which deals with certain telecommunication rights (non-trading income).

2631. This Chapter brings together the "sweep up" functions of Cases IV to VI. And it contains the charge to tax on two types of income where, in most cases, income will be wholly covered by relief. See section 688(2)(a) and (b).

2632. The charge under this Chapter is restricted to amounts that are "income" on first principles. That is, they are "annual profits or gains" under section 18(1) of ICTA, as that phrase has been interpreted by case law, and are not profits or gains of a capital nature (although some amounts of that nature have been treated as income charged to income tax, whether under a Case of Schedule D or otherwise). This is indicated by the use in section 687(1) of the words "from any source" and by the disapplication of the definition of "income" in section 878(1) of this Act by section 687(4). (For the significance of the reference to "any source", see the commentary on the overview to Part 8 of this Act on recent judicial remarks on "source".)

2633. Although some charges to income tax, whether in ICTA or elsewhere in the Tax Acts, are not rewritten in this Act or ITEPA, none of them overlaps with the charge under this Chapter. Nor is there any overlap with any other charges which themselves are limited to income not otherwise chargeable.

2634. Under the source legislation, Case VI losses may be set against Case VI profits or gains (see section 392 of ICTA). Paragraph 168 of Schedule 1 to this Act amends that section so that, in conjunction with section 836B to ICTA (inserted by that Schedule), where a loss arises in circumstances that, had there been income rather than a loss (other than relevant foreign income) the income would have been charged under this Chapter, the same loss relief applies. The only equivalent loss relief for relevant foreign income is under section 391 of ICTA. But this relief is restricted to losses from a trade, profession or vocation carried on wholly abroad. Any income from such a source would be charged under Part 2 of this Act. Section 391 of ICTA does not, therefore, apply to losses from a source where any income would be charged by this Chapter.

Section 687: Charge to tax on income not otherwise charged

2635. This section is based on section 18 of ICTA. Schedule D Cases IV and V charge tax in respect of *income*, whether from securities or possessions out of the United Kingdom. Schedule D Case VI charges tax in respect of *annual profits or gains*. The scope of all three cases is derived from section 18(1) of ICTA, which refers to "annual profits or gains". Case law does not indicate a difference, in the context of section 18 of ICTA, in the meaning of "annual profits and gains" and "income". The choice of term appears to be dictated (although not consistently) by the degree to which a calculation of profit or loss is relevant to the calculation of the income charged.

2636. The section uses *income* rather than *(annual) profits or gains*. There is nothing known which is "income" within the usual meaning of the term and therefore caught by this section but which would not be caught under Schedule D Cases V or VI.

2637. *Subsection (2)* ensures that section 683 (charge to tax on annual payments not otherwise charged) has the exclusive right to charge any annual payments not falling within any other charge.

2638. *Subsection (3)* protects an exemption, whether provided by Part 6 of this Act or other legislation.

2639. *Subsection (5)* lists some exemptions which apply particularly to this charge. Other exemptions may (exceptionally) apply: for example, see section 771 of this Act (relevant foreign income of consular officers and employees).

Section 688: Income charged

2640. This section is based on sections 65, 68 and 69 of ICTA. The rules in sections 65(1) and 68(1) of ICTA, for income chargeable under Schedule D Cases IV and V, and under section 69 of ICTA, for income chargeable under Schedule D Case VI, are broadly similar. But there is a difference in terms used (*income* in sections 65 and 68 of ICTA, *profits or gains* in section 69 of ICTA). For the reasons set out in the commentary on the preceding section, that difference has no significance here.

2641. As regards any income within this charge which is relevant foreign income (defined in section 830 of this Act), Part 8 of this Act applies. That Part rewrites the calculation rules in sections 65 and 68 of ICTA, for income charged under Schedule D Cases IV and V, setting out all the material differences between those rules and those in section 69 of ICTA for income charged under Schedule D Case VI. Chapter 4 of Part 8 of this Act contains rules that apply to income arising outside the United Kingdom, whether or not it is relevant foreign income.

2642. See also paragraph 159 of Schedule 2 to this Act. This paragraph provides that such case law guidance as there is on the calculation of income under this and other charges, as regards deductions allowed and not allowed, continues to apply. In respect of income that was formerly within Schedule D Case VI, this ensures that the guidance in, for example, Curtis Brown Ltd v Jarvis (1929), 14 TC 744 HC remains applicable. (The effect of that guidance is spelt out in the sections mentioned in that paragraph.)

2643. See also Chapter 2 of Part 10 of this Act for further rules that affect the calculation of income under this section.

Section 689: Person liable

2644. This section is based on section 59 of ICTA.

Part 6: Exempt income

Overview

2645. This Part groups all of the sections which provide exemption for income otherwise charged to income tax by this Act. A signpost in each charging section points the user to the main exemptions from that particular charge contained in this Part.

2646. For the most part each Chapter in this Part relates to a particular type of income but there are also Chapters that deal with exemptions relevant to certain types of annual payment and to miscellaneous other income.

2647. The exemptions, where relevant, apply to both United Kingdom and foreign income unless one of these kinds of income is expressly excluded in the section.

2648. The wording of the exemption sections follows the "no liability approach" adopted in ITEPA.

Chapter 1: Introduction

Section 690: Overview of Part 6

2649. This section lists the Chapters in this Part. These provide for exemption from income tax for:

- National savings income (Chapter 2);
- Income from individual investment plans (Chapter 3);
- SAYE interest (Chapter 4);
- Venture capital trust dividends (Chapter 5);
- Income from FOTRA securities (Chapter 6);
- Purchased life annuity payments (Chapter 7);
- Other annual payments (Chapter 8); and
- Other income (Chapter 9).

2650. *Subsection (3)* explains the purpose of Chapter 10 (general). This Chapter provides that any exemption in this Part, unless there is specific provision to the contrary, is disregarded for all income tax purposes.

2651. S*ubsection (4)* indicates that there are exemptions in other Acts relating to particular categories of person which could be relevant to the charges in this Act. For example see section 505 of ICTA which provides a general exemption for charities.

2652. *Subsection (5)* explains that the exemptions in this Act may apply, where relevant, to charges outside this Act.

Chapter 2: National savings income

Overview

2653. This Chapter deals with the exemptions from income tax relating to National Savings Bank ordinary account interest and income from savings certificates (including Ulster Savings Certificates).

Section 691: National Savings Bank ordinary account interest

2654. This section is based on section 325 of ICTA, which exempts from income tax the first £70 of interest on National Savings Bank ordinary account deposits arising in a tax year.

The exemption, which is not available for interest on National Savings Bank investment account deposits, applies only to interest of individuals. Although the interest is exempt from income tax, certain returns of information may need to be made in respect of it (for example, information returns by the National Savings Bank under section 17 of TMA – see section 783(2) of this Act).

2655. It has not been possible to open a National Savings Bank ordinary account since 28 January 2004. And since 31 July 2004, existing ordinary account customers will not be able to transact on their accounts, unless it is to close the account or transfer into an Easy Access savings account. Even though the ordinary account has closed, any money which is left dormant in these accounts will continue to earn interest. The first £70 of interest for each tax year will still be tax free and customers will be able to come forward at any time to claim their money. So the tax exemption contained in this section will be needed for the foreseeable future.

2656. Two minor changes have been made to the wording of section 325 of ICTA. These are:

- to remove the reference to "total income" (which dates back to the days of surtax) as it is no longer relevant to this particular section; and
- to remove the reference to investment accounts and make it clearer that the exemption applies only to ordinary account interest.

2657. *Subsection (2)* makes it clear that a charge to income tax does apply where the interest exceeds £70 in a tax year. But the charge is only on the excess of the interest over £70 in the tax year.

Section 692: Income from savings certificates

2658. This section provides an exemption for income from savings certificates, provided that the holding of savings certificates is within specified limits. Income from any certificates purchased or held in excess of these limits is chargeable to tax. The section is based on section 46 of ICTA (excluding section 46(2) of ICTA which relates to Tax Reserve Certificates and is dealt with in section 750 of this Act).

2659. Most income from savings certificates would otherwise be taxable under the charge to tax on interest. However, income from certain savings certificates falls within the charge on profits from deeply discounted securities. This exemption therefore applies to income chargeable under both Chapters 2 and 8 of Part 4 of this Act.

2660. The detailed rules governing these certificates, including the maximum holding limits, are in regulations. The source legislation refers to the limits in terms of purchase by, or on behalf of, an individual. This could be confusing for situations such as joint ownership or inheritance, where special regulations apply. Also, the regulations are written in terms of a holding limit, but in practice this translates into a prohibition on purchasing in some situations.

2661. *Subsection (2)* avoids this confusion by using "acquisition" rather than purchase and by referring to the regulations as limiting a person's holding, in line with the way the regulations are written.

2662. Although section 46 of ICTA was simply written in terms of certificates, it is possible to purchase multiple certificates. The regulations say that a multiple certificate is to be treated as a number of unit certificates for the purposes of determining whether the holding limit has been exceeded. On a strict reading of section 46 of ICTA none of the income from a multiple certificate which is partially outside the permitted limit would be exempt. The section introduces the words "so far as" in subsection (2) to clarify that the exemption is available for the income from the permitted part of a multiple certificate. In practice section 46 of ICTA was applied in this way. See *Change 112* in Annex 1.

2663. *Subsection (3)* defines savings certificates. It is not possible to define savings certificates by reference to their characteristics; indeed, some savings certificates are not even called savings certificates. The only way of providing a completely accurate definition is by reference to the provisions under which the certificates are issued.

2664. *Subsection (4)* excludes Ulster Savings Certificates from the general definition of savings certificates, and then signposts the special rules for such certificates in section 693. Ulster Savings Certificates have been dealt with in a separate section, so that holders of other savings certificates do not have to work through material which is not relevant for their type of certificate.

Section 693: Income from Ulster Savings Certificates

2665. This section provides an exemption for income from Ulster Savings Certificates, for holdings within specified limits. Income from any certificates purchased or held in excess of these limits is chargeable to tax. The section is based on section 46 of ICTA, which also deals with savings certificates generally (see section 692).

2666. The basic provisions for Ulster Savings Certificates are the same as those for other types of savings certificate, but there are some additional rules. Although Ulster Savings Certificates have not been issued since March 1997, there are still holdings which have not been redeemed. Consequently it is necessary to rewrite this provision to ensure that interest continuing to be paid in respect of these holdings is exempt from income tax.

2667. *Subsections (2)* to *(4)* set out the residence conditions, one of which has to be satisfied in order for the income to qualify for exemption. Subsection (4) enacts ESC A34, which extends the exemption to a repayment made after the death of a holder who had been resident and ordinarily resident at the time the certificates were purchased. See *Change 113* in Annex 1.

2668. *Subsection (5)* uses “acquisition” rather than purchase and refers to a person’s holding, in line with the way the regulations are written. In the case of Ulster Savings Certificates, the regulations which limit a person’s holding are made by the Department of Finance and Personnel in Northern Ireland, rather than by the Treasury.

2669. Although section 46 of ICTA was simply written in terms of certificates, it is possible to purchase multiple certificates. The regulations say that a multiple certificate is to be treated as a number of unit certificates for the purposes of determining whether the holding limit has been exceeded. On a strict reading of section 46 of ICTA none of the income from a multiple certificate which is partially outside the permitted limit would be exempt. The section introduces the words “so far as” in subsection (5) to clarify that the exemption is available for the income from the permitted part of a multiple certificate. In practice section 46 of ICTA was applied in this way. See *Change 112* in Annex 1.

2670. *Subsection (6)* does not specify that the claim for exemption is to be made to the Board. Section 46(5) of ICTA requires such a claim to be made to the Board but it is not considered necessary for a claim to be made at this level. Section 878(4) of this Act draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require claims to be made to “an officer of the Board”. See *Change 149* in Annex 1.

2671. *Subsection (7)* is based on section 832(1) of ICTA, which provides some general definitions. As these certificates are not mentioned elsewhere in this Act, it is more helpful to incorporate a definition in this section rather than have a general definition elsewhere which applies to the whole Act.

Chapter 3: Income from individual investment plans

Overview

2672. This Chapter gives the powers for regulations on individual investment plans – better known as PEPs and ISAs – to exempt income from tax. The regulations made so far are Personal Equity Plan Regulations (SI 1989/469) and Individual Savings Account Regulations (SI 1998/1870).

Section 694: Income from individual investment plans

2673. This section contains the general powers for the Treasury to make regulations providing for the income of individuals from certain types of investment plan to be exempt from income tax and defines the scope of the exemption. It is based on section 333 of ICTA.

Section 695: Investment plans

2674. This section contains the powers under which regulations may be made to provide rules about the form of the investment plans in which investments are held and about the investments which may be held in them. It is based on section 333 of ICTA.

2675. *Subsections (3)* and *(4)* provide for approval and registration by the Board of Inland Revenue respectively. References to "the Board of Inland Revenue" (rather than to the Inland Revenue) must remain as the power to make regulations is conferred on the Board under the Inland Revenue Regulation Act 1890 and not on the Inland Revenue or its officers.

Section 696: Plan managers

2676. This section contains the powers under which regulations may be made to provide rules for the investments to be held by plan managers on behalf of investors. It is based on section 333 of ICTA.

Section 697: Special requirements for certain foreign managers

2677. This section contains the powers under which regulations may be made to provide rules for foreign institutions to be plan managers if they fulfil certain requirements. It is based on section 333A of ICTA.

2678. *Subsection (2)* defines "foreign institution". Subsection (2)(c) includes non-UK resident insurance companies within the definition. Non-resident insurance companies are now included here rather than in a rewrite of section 333B(4) of ICTA, which provides for regulations to be made about non-resident insurance companies appointing United Kingdom tax representatives. See *Change 114* in Annex 1.

Section 698: Requirements for discharge of foreign institution's duties

2679. This section contains the requirements which have to be fulfilled for a "foreign institution" in section 697 to be a plan manager. It is based on section 333A of ICTA.

Section 699: Non-entitlement to exemption

2680. Under section 694(3) regulations may specify "the description of individuals who may invest" in a plan. This section contains the powers under which regulations may be made to provide rules for an investor in a plan ceasing to be entitled to the exemption from income tax. It is based on section 333 of ICTA.

Section 700: Information

2681. This section contains the powers under which regulations may be made to provide rules for documents and information to be provided within specified time limits to the Inland Revenue by the investor or the plan manager. It is based on section 333(4) of ICTA.

Section 701: General and supplementary powers

2682. This section contains some general powers under which regulations may be made to provide administrative rules. The regulations may specify how the exemption is to be claimed, either by the investor or by the plan manager on behalf of the investor. It is based on section 333 of ICTA.

Chapter 4: SAYE interest

Overview

2683. This Chapter rewrites the exemption for interest arising under certain contractual savings schemes, commonly known as SAYE schemes. The sections are based on section 326 of and Schedule 15A to ICTA and on Schedule 12 to FA 1995.

2684. An eligible employee who is granted options under a *SAYE option scheme* must agree to enter into a *linked savings arrangement* operated either by the National Savings Bank or by an authorised financial institution. Where the Treasury are satisfied that the arrangement is a linked savings arrangement, and meets any appropriate conditions, they certify it. Such an arrangement is called a “certified SAYE savings arrangement”.

2685. For the meaning of “SAYE option scheme”, see section 516 of and Schedule 3 to ITEPA.

2686. Under a linked savings arrangement, the employee agrees to save a specific amount each month, which may be between £5 and £250. At the end of the contract period (three, five or seven years) the contributions made will be repaid to the employee together with a bonus (based on the length of the contract and the level of contributions made). The employee may then use the money to exercise his or her share options under the SAYE option scheme. If the employee does not complete the contract, the contributions made are repaid together with interest (where this is due). In both cases, providing the institution operating the linked savings arrangement is authorised (where necessary), and the scheme complies with any Treasury requirements regarding certification, the bonus and interest payments are exempt from income tax.

2687. Exemption was also available for interest and bonuses paid under “ordinary” SAYE schemes, which are not share option linked, where the contract was entered into before 1 December 1994. But any contract entered into before that date will have run its course before 2005-06. The transitional provisions in paragraph 7(1) of Schedule 12 to FA 1995 have therefore not been rewritten in this Chapter.

2688. The exemption from tax is set out in section 702. The remainder of the Chapter defines terms and sets out the administrative requirements for linked savings arrangements and for providers of arrangements.

Section 702: Interest under certified SAYE savings arrangements

2689. This section is based on section 326 of ICTA. It introduces the key term “certified SAYE savings arrangement”. The definition of that term in section 703 introduces both the various conditions to be met by the savings schemes (and the financial institutions who provide them) and the certification machinery.

2690. *Subsection (3)* qualifies the exemption by reference to:

- the rules in section 707 for authorisation of institutions providing arrangements; and

- a provision in FA 1988 in respect of building societies.

2691. Schedule 12 to FA 1988 contains provisions which apply when the business of a building society is transferred to a company in accordance with the Building Societies Act 1986 (that is, when a building society turns itself into a bank). Paragraph 7 of Schedule 12 to FA 1988 ensures that any interest payable after the transfer continues to be eligible for exemption, notwithstanding the fact that the transfer means the savings arrangement ceases to be a certified SAYE savings arrangement.

2692. *Subsection (4)* defines "interest" for the purposes of the Chapter. Although section 326(1) of ICTA refers to "any terminal bonus, or interest or other sum", in practice only bonuses and interest are payable under SAYE schemes.

2693. It is not clear why the source legislation refers to "other sum". The only other sums involved are contributions returned to the employee. But these are deposits - capital - being returned to an investor and are not themselves taxable. The words "other sum" add nothing to the provision (indeed, they might cause confusion) and are not rewritten.

2694. All bonuses are computed by reference to the level of contribution made by the employee and to the length of the savings contract. Despite the expression "terminal bonuses", a bonus is interest for tax purposes. A separate reference to the terminal bonus might put beyond doubt that the bonus is exempt from tax. But such a reference might also cast doubt on whether the bonus is in fact interest. That would in turn create uncertainty as to how the bonus would be taxed if the SAYE scheme should lose the status necessary for the income from it to qualify for the exemption in section 326 of ICTA. The section therefore simply uses "interest" throughout as including "bonus".

2695. Paragraphs 184(2) and 445(3) of Schedule 1 to this Act follow suit in amending section 477A(4) of ICTA (building societies: regulations for deduction of tax) and section 271(4) of TCGA (other miscellaneous exemptions), both of which refer to the source legislation for these sections.

Section 703: Meaning of "certified SAYE savings arrangement"

2696. This section is based on section 326 of and Schedule 15A to ICTA. It introduces the term "linked savings arrangement", defined in subsection (2). The source legislation refers to "contractual savings schemes" but this is only one of a number of names by which these arrangements are known. As any arrangement entered into since 1994 must be linked to a SAYE option scheme, "linked savings arrangement" reflects the present position.

2697. *Subsection (2)* introduces the various types of arrangement (set out in section 704) and the required link between the savings arrangement and the SAYE option scheme. Paragraphs 139 to 141 of Schedule 2 to this Act preserve the commencement rules for the amendments to this relief introduced by Schedule 12 to FA 1995. Those paragraphs affect what is or is not a certified SAYE savings arrangement.

2698. The definitions in *subsection (3)* are based on terms used and definitions provided by Schedule 15A to ICTA.

Section 704: Types of arrangements and providers

2699. This section sets out what types of arrangement may be linked savings arrangements. It provides definitions of each type of arrangement. These definitions are based on section 326 of and Schedule 15A to ICTA.

2700. *Subsection (1)* indicates that linked saving arrangements are either a "national savings arrangement" (defined in*subsection (2)*), or an "institutional arrangement", that is, one provided by a financial institution (defined in*subsections (3)* to *(6)*). The main distinction between a national savings arrangement and an institutional arrangement is that the provider of an institutional arrangement must be authorised (see section 707). The Treasury may also impose requirements on an institutional arrangement before they certify it under section 705.

Section 705: Certification of arrangements

2701. This section sets out the administrative provisions for the certification by the Treasury of linked savings arrangements. It also provides the powers for the Treasury to impose further requirements on an institutional arrangement. In practice, this means that arrangements must correspond to the Treasury model scheme for these arrangements. It is based on section 326 of and Schedule 15A to ICTA.

2702. In the source legislation, the power to impose further requirements is in respect of requirements "for the purposes of" section 326 of ICTA. But Schedule 15A to ICTA has "effect for the purposes of section 326" (paragraph 1 of that Schedule), so that the section must be read with the Schedule. This Chapter incorporates both the section and the Schedule, so this section applies the power in respect of requirements for the purposes of the Chapter.

Section 706: Withdrawal and variation of certifications and connected requirements

2703. This section is based on Schedule 15A to ICTA.

Section 707: Authorisation of providers

2704. This section is based on section 326 of and Schedule 15A to ICTA.

Section 708: Withdrawal and variation of authorisations

2705. This section is based on Schedule 15A to ICTA.

Chapter 5: Venture capital trust dividends

Overview

2706. This Chapter rewrites the provisions exempting from income tax dividends from Venture Capital Trusts ("VCTs"). The sections are based on section 332A of and Schedule 15B to ICTA.

2707. The VCT scheme is one of three venture capital schemes (the other two being the Enterprise Investment Scheme and the Corporate Venturing Scheme).

2708. The VCT scheme is aimed at encouraging individuals to invest indirectly in unquoted trading companies. VCTs are companies listed on the London Stock Exchange and are a special type of investment trust approved for the purpose of the VCT scheme by the Inland Revenue.

2709. The exemption from income tax on dividends is one of the benefits of investing in a VCT. Schedule 15B to ICTA sets out the tax relief available on the investment in a VCT and sections 151A and 151B of and Schedule 5C to TCGA give certain reliefs from capital gains tax.

Section 709: Venture capital trust dividends

2710. This section is based on paragraphs 7 and 8 of Schedule 15B to ICTA and sets out the conditions that have to be met in order for a VCT dividend to be exempt from income tax.

2711. Paragraph 7(3)(a) refers to " … a dividend (including a capital dividend) …". This is rewritten simply as "a dividend". Section 209(2) of ICTA, which sets out the meaning of "distribution", also refers to "any dividend paid by the company, including a capital dividend" (see section 209(2)(a) of ICTA). However, the charging provision in the source legislation (see section 20(1) paragraph 1 of ICTA) refers simply to "all dividends and other distributions … which are not specifically excluded from income tax … however they fall to be dealt with in the hands of the recipient". Likewise the rewritten charging provision charges to tax "dividends and other distributions …" (see section 383 of this Act). Given that the charging provision does not specifically refer to capital dividends and an investor is unlikely to know that he or she is receiving a capital dividend, the reference to capital dividends is omitted.

2712. The conditions for exemption relate first to the dividend (*subsection (2)*), then to the investor (*subsection (3)*) and then to the circumstances surrounding the investment (*subsections (4)* to *(7)*).

2713. The exemption applies only to dividends paid on ordinary shares acquired within the annual acquisition limit of £200,000 (see *subsection (4)*). The value applied is market value as defined in section 272 and 273 of TCGA (see *subsection (8)*).

2714. The condition contained in subsection (6) is based on paragraph 7(3)(a)(ia) of Schedule 15B to ICTA which was inserted by FA 1999. The condition applies only to acquisitions made on or after 9 March 1999 (see *subsection (1)(b)*). Subsection (7) confirms that shares not acquired for genuine commercial reasons are not treated as using part of the annual acquisition limit whether those shares were acquired before or after 8 March 1999. Prior to the FA 1999 amendments, such shares were not "relevant acquisitions". Following the FA 1999 amendments, dividends paid on such shares cannot qualify for exemption and therefore the shares are disregarded for the purposes of determining whether the annual acquisition limit has been exceeded.

Section 710: Treatment of shares where annual acquisition limit exceeded

2715. This section is based on paragraph 8 of Schedule 15B to ICTA and provides an ordering rule to determine which shares are treated as within the annual acquisition limit (referred to as "exempt shares") if that limit is exceeded in a tax year.

2716. *Subsection (2)* provides the basic rule, that shares are treated as exempt shares if immediately after their acquisition the annual limit is not exceeded.

2717. *Subsection (4)* deals with the situation where the limit is exceeded on a day in which shares of different descriptions are acquired. In that case the appropriate proportion of shares of each description are treated as exempt shares.

Section 711: Identification of shares after disposals

2718. This section is based on paragraph 8 of Schedule 15B to ICTA and sets out the share identification rules for disposals of shares in a VCT.

2719. The first rule (*subsection (1)*) provides the assumption that non-VCT shares are disposed of before VCT shares.

2720. The second rule (*subsection (2)*) applies if the annual acquisition limit is exceeded and some shares are disposed of. Clearly an investor will want to know whether the shares falling within the annual acquisition limit are disposed of or whether the other shares (referred to as "excess shares") are disposed of. The section sets out the assumptions to apply. Shares acquired on an earlier day are treated as disposed of before shares acquired on a later day (see *subsection (3)*). If the shares are acquired on the same day, excess shares are treated as disposed of first (see *subsection (4)*).

2721. *Subsection (5)* is based on section 60 of TCGA, incorporating the rule relating to acquisitions and disposals by a person's nominee, and acquisitions and disposals between a person and his nominee.

Section 712: Identification of shares after reorganisations etc.

2722. This section deals with the identification of shares following a reorganisation etc, for example, where there has been a bonus issue of shares or where there has been an issue of shares falling within section 135 or 136 TCGA. It is based on paragraph 8(3) and (4) of Schedule 15B to ICTA and sets out three rules.

2723. The first rule (*subsection (2)*), is that any "new shares" acquired as a result of the reorganisation etc. are treated as satisfying the conditions for exempt shares set out in section 709(4) and, if relevant, section 709 (6), if the "old shares" satisfied those conditions. Dividends paid in respect of the new shares therefore qualify for the income tax exemption under this Chapter.

2724. The condition in section 709(6) relates to shares acquired on or after 9 March 1999. If the "old shares" were acquired before 9 March 1999 the new shares do not need to satisfy the condition in section 709(6). The source legislation refers only to the new shares being treated as satisfying the annual acquisition condition. See *Change 115* in Annex 1.

2725. The second rule (*subsection (3)*) is that if only a proportion of the "old shares" met the condition about the annual acquisition limit or the commercial reasons test then only the corresponding proportion of the "new shares" are treated as doing so. It follows that the remainder of the new shares are treated as not doing so. So dividends paid in respect of those shares would not qualify for the income tax exemption under this Chapter.

2726. The source legislation is silent as to whether "new shares" in excess of that corresponding proportion ("excess new shares") get another chance to qualify as exempt shares if any of the current year's annual acquisition limit remains available.

2727. For example, in the tax year in which the "new shares" are issued (say with a value of £150,000 of which £100,000 qualify under the corresponding proportion rule) further shares are acquired to a value of say £100,000. The issue is whether the £50,000 new shares which did not qualify under the corresponding proportion rule can be treated as falling within the annual acquisition limit because £100,000 of the current year's annual acquisition limit remains available.

2728. Paragraph 8(4)(a) of Schedule 15B to ICTA ensures that the excess new shares are disregarded in determining whether acquisitions, made during the same tax year as the excess new shares are issued, come within the annual acquisition limit. The position of the excess new shares is dealt with solely under paragraph 8(4)(b) of Schedule 15B to ICTA. That sets out the extent the new shares are to be treated as acquired within the permitted maximum by reference to the status of the shares from which they are derived, that is, the proportionate basis. If they do not qualify under that provision, they do not qualify at all.

2729. It is not thought to be the intention of the legislation that excess new shares should have a second chance of being treated as falling within the permitted maximum. So subsection (3) provides explicitly that the remaining new shares are not treated as meeting the conditions to qualify for the income tax exemption. This is implied but not expressly stated in the source legislation.

2730. The third rule (s*ubsection (4))* provides that the new shares are ignored in determining whether other shares acquired in the same tax year qualify for the income tax exemption.

Chapter 6: Income from FOTRA securities

Overview

2731. This Chapter provides for exemption from income tax in respect of United Kingdom government securities which are beneficially owned by persons who are not resident in the United Kingdom. Such securities are described as being "Free of Tax to Residents

Abroad" or "FOTRA securities". The sections are based on section 154 of FA 1996 and section 161 of FA 1998.

2732. The beneficial owner of a FOTRA security may be entitled to an exemption from income tax in any of the following three situations:

- a person holding the security as an investment may be exempt from tax on the interest arising on the security;
- a dealer holding the security in circumstances where a profit on sale would be regarded as a trading receipt may be exempt from tax on the interest arising on the security; or
- a dealer holding the security in circumstances where a profit on sale would be regarded as a trading receipt may be exempt from tax on the profit arising from a purchase and sale of the security.

2733. It is not intended to rewrite section 22(1) of F(No 2)A 1931, section 60(1) of FA 1940 or section 154(1) of FA 1996. These provisions all concern the Treasury's powers to issue securities. The first two provisions were left untouched in the 1952, 1970 and 1988 consolidations. (Section 47 of Finance (No 2) Act 1915 was repealed in 1927, but in terms to the effect that the repeal did not affect income tax exemptions attaching to securities previously issued.)

Section 713: Introduction: securities free of tax to residents abroad ("FOTRA securities")

2734. This section sets out the scope of the Chapter. It is based on section 154(8) of FA 1996 and section 161 of FA 1998.

2735. *Subsection (2)* sets out the three different classes of FOTRA securities. Each class of FOTRA security has its own distinct rules.

2736. *Subsection (3)* to *(6)* define the term "the exemption condition" used in this Chapter. There are different definitions for each of the three classes of FOTRA securities in subsection (2).

Section 714: Exemption of profits from FOTRA securities

2737. This section sets out the conditions that must all be met if the exemption is to apply. It is based on section 154 of FA 1996. As the exemption can apply, in certain circumstances, to trading income as well as to interest (see overview to this Chapter), the general word "profits" has been used in *subsection (1)* rather than a more limited word such as "interest".

2738. *Subsection (6)* deals with two exceptions from the general exemption in subsection (1). These exceptions apply whatever the exemption condition relating to the FOTRA security provides.

Section 715: Interest from FOTRA securities held on trust

2739. This section reflects an Inland Revenue practice to regard the interest from a FOTRA security held in trust as exempt (and the beneficial ownership test in the exemption condition as satisfied) where none of the beneficiaries of the trust is ordinarily resident in the United Kingdom at the time when the interest arises. See *Change 116* in Annex 1. It is new. The section refers to "interest" and not "profits" because this reflects the Inland Revenue practice. It is not likely that trading profits or any other kind of income (apart from interest) could arise in respect of FOTRA securities held in trust.

Section 716: Restriction on deductions etc. relating to FOTRA securities

2740. This section prevents a deduction relating to a FOTRA security being taken into account for income tax purposes where the beneficial owner is exempt from tax. It is based on section 154(6) of FA 1996.

Chapter 7: Purchased life annuity payments

Overview

2741. This Chapter rewrites the purchased life annuity provisions in sections 656 to 658 of ICTA.

2742. Early case law established that the whole of an annuity payment received by an annuitant is chargeable to income tax (see, for example, the speech of the Lord President (Inglis) in Coltness Iron Co v Black (1881), 1 TC 287, 308, HL, which was cited with approval by Lord Wilberforce in CIR v Church Commissioners for England (1976), 50 TC 516, 566) HL. So there was a contrast between income tax law (where the whole of the payment is regarded as taxable income) and the commercial world (where a part of the payment is regarded as a return of capital).

2743. In 1954 the Report of the Committee on the Taxation Treatment of Provisions for Retirement (Cmd. 9063) recommended changing the law so that only the income element in an annuity payment should be charged to income tax. Sections 27 and 28 of FA 1956 therefore provided for purchased life annuities to be regarded as containing both an income element (chargeable to income tax) and a capital element (not chargeable to income tax). The 1956 legislation, with subsequent amendments, appears in the source legislation as sections 656 to 658 of ICTA.

2744. Section 656(1) of ICTA provides:

> "…a purchased life annuity shall, for the purposes of the provisions of the Tax Acts relating to tax on annuities and other annual payments, be treated as containing a capital element and, to the extent of that capital element, as not being an annual payment or in the nature of an annual payment; but the capital element in such an annuity shall be taken into account in computing profits or gains or losses for other purposes of the Tax Acts in any circumstances in which a lump sum payment would be taken into account.

2745. The purpose of treating the annuity payment as containing a capital element and then treating that capital element as not being an annual payment, is to ensure the capital element is not charged to income tax. These propositions are rewritten as an exemption from income tax (see section 717). Additionally, as the annuity payment is not treated as an annual payment or is not in the nature of an annual payment, that part of the payment is outside the scope of the deduction of tax at source rules (sections 348 and 349 of ICTA). This element of section 656(1) of ICTA is dealt with by the general disregard (see section 783).

2746. The purpose of the second limb of section 656(1) of ICTA is to ensure that a trader for whom the annuity would represent a trading receipt cannot exclude the capital element from the trader's Schedule D Case I tax computation. This is dealt with for traders liable to income tax by the combined effect of the priority rule for trading income (see section 366(1) which gives Part 2 of this Act charging priority over Part 4 of this Act) and *subsection (1)* of section 717. Section 717(1) only exempts from income tax annuity payments charged to tax under Chapter 7 of Part 4 of this Act. So if the annuity payments are not charged to tax under Chapter 7 of Part 4 they cannot benefit from the exemption in Chapter 7 of Part 6 of this Act.

2747. The annuity payments made under a purchased life annuity are generally regarded as investment income in the recipient's hands and are therefore charged to tax under Chapter 7 of Part 4 of this Act. This Chapter deals with the exemption from income tax in respect of annuity payments charged under that Chapter. Annuities taxed under another part of the Act such as Chapter 7 of Part 5, or under other legislation are outside the scope of this Chapter.

Section 717: Exemption for part of purchased life annuity payments

2748. This section is based on section 656 of ICTA and sets out the extent of the exemption.

2749. *Subsection (1)* sets out the exemption and makes it clear that an annuity payment is only exempt to the extent provided in section 719.

2750. *Subsection (2)* makes it clear that not all annuity payments made under a purchased life annuity are exempt and signposts section 718 which sets out the excluded annuities.

2751. The Inland Revenue does not interpret "annual payment" in section 656(1) of ICTA as restricted to annual payments chargeable under Schedule D Case III. So the exemption is not dependent on the source of the annuity payment. Foreign annuity payments may therefore benefit from the exemption.

2752. *Subsection (3)* indicates that a claim needs to be made for the exemption to apply but does not specify to whom that claim is made. Section 878(4) draws attention to the rules in the TMA, which apply for the purposes of this Act. Those rules require claims to be made to "an officer of the Board." See *Change 149* in Annex 1.

2753. The requirement for a claim is not in the source legislation but is in secondary legislation supporting sections 656 to 658 of ICTA (see regulation 4 of the Income Tax (Purchased Life Annuities) Regulations 1956 SI 1956/1230, as amended) ("the 1956 Regulations"). The claim provision has been promoted to primary legislation. That will change the status of the provision as it will no longer be possible to change it or revoke it through further regulations. See *Change 117* of Annex 1.

Section 718: Excluded annuities

2754. This section rewrites section 657(2) of ICTA, which sets out the annuities to which section 656 of ICTA does not apply. Not all of the annuities listed in section 657(2) of ICTA are specified. Some of the annuities referred to in section 657(2) of ICTA are excluded from the exemption in section 717 by the combined effect of the priority provisions (see section 366(3) which gives ITEPA charging priority over Part 4 of this Act) and *subsection (1)* of section 717. Section 717(1) only exempts from income tax annuity payments charged to tax under Chapter 7 of Part 4 of this Act. So if the annuity payments are not charged to tax under Chapter 7 of Part 4 of this Act they cannot benefit from the exemption in this Chapter. It follows that the annuity payments made under the annuities set out in section 657(2) of ICTA which are not charged to tax under Chapter 7 of Part 4 of this Act do not need to be mentioned. Section 718 therefore lists only those annuity payments made under annuities excluded by section 657(2) of ICTA and charged to tax under Chapter 7 of Part 4 of this Act.

2755. Additionally, section 657(2)(a) of ICTA is not rewritten. That section provides that section 656 does not apply to:

"any annuity which would, apart from that section, be treated for the purposes of the provisions of the Tax Acts relating to tax on annuities and other annual payments as consisting to any extent in the payment or repayment of a capital sum.

2756. Section 657(2)(a) appears to be designed to exclude "annuity" payments which, on the analysis in Perrin v Dickson (1924), 14 TC 608 CA, represent interest together with capital repayments. This case concerned a contract under which, in return for a series of annual premiums, an assurance society undertook to pay an "annuity" for seven years if a named individual should live that long. In the event of the individual's death the total amount of the premiums paid, without any interest, less any amount paid by way of "annuity", was to be repaid. The individual survived and it was held in the Court of Appeal that the payments received did not constitute an annuity for income tax purposes. Tax was chargeable only on so much of the payments as constituted interest on the original payments.

2757. On a proper analysis, however, the payments are not really "annuity" at all, even if that is what they were called. And if contracts of the type considered in Perrin v Dickson do not give rise to annual payments it is difficult to see what purpose section 657(2)(a) of ICTA is intended to serve.

2758. No true annuity which would need to be excluded in this way from the relief provided by section 656 has been discovered. Section 656(2)(a) of ICTA is otiose and has therefore been dropped.

Section 719: Extent of exemption under section 717

2759. This section sets out the rules to work out the method of calculating the amount that is exempt from tax. The method varies according to the type of purchased life annuity involved. Sometimes a constant proportion of the annuity payment is exempt and sometimes a constant fixed sum is exempt.

2760. By definition (see section 423 of this Act) the term of every purchased life annuity is dependent on the duration of a human life. The amount of the annuity payment may also be dependent on the duration of a human life. However, either might also be dependent on some other contingency.

2761. *Subsections (1)* and *(2)* set the scene by explaining that the method of calculating the amount that is exempt is determined by two factors: the amount of the annuity payments and the term of the annuity.

2762. The first step is to determine whether a constant proportion of each annuity payment is exempt or whether a constant sum is exempt. This depends on whether or not the amount of the annuity payments depends solely on the duration of a human life or lives (see s*ubsection (2)(a)*).

2763. If the amount of the annuity payments does depend solely on the duration of a human life or lives, *subsection (3)* provides that a constant proportion of the annuity payment is exempt. This has been called the "exempt proportion".

2764. If the amount of the annuity payments does not depend solely on the duration of a human life or lives (in other words the amount depends additionally on a non-life contingency) *subsection (4)* provides that a constant sum is exempt (assuming the period covered by each payment is the same). This has been called the "exempt sum".

2765. Under the type of purchased life annuity covered by subsection (4) it is possible for the exempt sum to exceed the amount of a particular annuity payment. ESC A46 deals with this by allowing the excess of the exempt sum over the gross annuity payment to be carried forward and added to the exempt part of the next payment. *Subsection (5)* legislates ESC A46. See *Change 119* in Annex 1. Special provision has also been included in Schedule 2 (see paragraph 144) to deal with the carry forward of excess capital elements which accrued before 6 April 2005.

2766. The next step is to work out the exempt proportion or the exempt sum. This depends on whether or not the term of the annuity depends solely on the duration of a human life or lives.

2767. If the term of the annuity does depend solely on the duration of a human life or lives, s*ubsection (7)* points the way to the two provisions containing the formulas for calculating the exempt proportion or the exempt sum. Under virtually all purchased life annuities, the term of the annuity depends solely on the duration of a human life or lives.

2768. But if the term of the annuity also depends on a non-life contingency, *subsection (8)* explains that the exempt proportion or the exempt sum is calculated on a just and reasonable basis. In making this calculation, account must also be taken of the additional contingencies and the relevant formula. Although the source legislation refers to a "just" basis of calculation, just and reasonable is used in subsection (8) in line with the approach which has been adopted throughout the Act that all apportionments are on a just and reasonable basis. See *Change 14* in Annex 1.

2769. If both the amount of the annuity payment and the term of the annuity (in addition to depending on the duration of human life) depends on a non-life contingency, section 656(3)(b) and (e) of ICTA provide for the exempt capital element of each payment to be computed as a constant proportion. But, as section 656(2) of ICTA recognises, actuarial techniques do not provide any mechanism for calculating the (exempt) capital element as a constant proportion if the amount of the annuity payment is dependent on a non-life contingency. So section 719(4) provides for the exempt sum method to apply in this case. See *Change 118* in Annex 1. And, as it will be possible for the exempt sum to exceed the annuity payment, ESC A46 has been extended so that it too applies. See *Change 119* in Annex 1.

Section 720: Exempt proportion: term dependent solely on duration of life

2770. This section sets out the formula for calculating the exempt proportion of an annuity payment for the most common type of annuity, that is, an annuity whose term and the amount of the annuity payments, depend solely on the duration of a human life or lives.

2771. Under this type of annuity the amount of the annuity payment may change, but only in a pre-determined way. For example, the amount may increase by a fixed percentage at set intervals or, if written on two lives, may reduce on the first death. The method of calculation calculates the exempt part as a constant proportion of each annuity payment and thus caters for increases and decreases in the amount of the annuity payments.

2772. The source legislation does not set out how the actuarial value is to be calculated. However, the source legislation ensures a consistent approach is adopted by setting out when the value is to be calculated (see section 656(4)(c) of ICTA rewritten as *subsection (3)*) and requiring (see section 656(4)(c) and (7)(b) of ICTA rewritten as *subsection (4)*) that:

- the same tables of mortality are always used (the tables prescribed by the regulations are those comprised in Table A8 set out in Appendix A on pages 113 to 115 of the booklet entitled "Continuous Mortality Investigation Reports Number 10" published by the Institute of Actuaries and the Faculty of Actuaries in 1990 (regulation 6 of the 1956 Regulations));
- the age of the person during whose life the annuity is payable is taken as a whole number of years; and
- no discount is given in arriving at the present value of a future payment.

2773. Subsection (4)(b) reflects Inland Revenue practice (which follows actuarial practice). See *Change* 120 in Annex 1.

Section 721: Exempt sum: term dependent solely on duration of life

2774. This section sets out the formula for calculating the exempt sum where:

- the term of the annuity does not depend on any contingency other than the duration of a human life or lives; but
- the amount of the annuity payments does depend on some contingency other than the duration of a human life or lives.

2775. Under this type of annuity the amount of the annuity payment may change in an unpredictable way. As changes in the amount of the annuity payments are unpredictable, any actuarial valuation of them would be virtually impossible. So the exempt part of each annuity payment is calculated as a constant sum.

2776. An example of an annuity of this type is an index-linked annuity where the amount of the annuity fluctuates with movements in the Retail Prices Index. Initially the return under this type of annuity is low and the annuity payments may fall short of the amount of the exempt sum. With inflation the amount of the annuity payments is likely to rise and in due course to overtake the amount of the exempt sum.

2777. The term of the annuity can only be predicted by an actuarial calculation. Again, a consistent approach to that calculation is ensured by *subsections (3)* and *(4)* (see further the commentary on section 720(3) and (4)).

Section 722: Consideration for the grant of annuities

2778. This section contains rules to deal with the case where the purchase of the annuity is part of a composite transaction. It is based on section 656(4) of ICTA.

2779. For example, capital protected annuities, which provide for the return on death of the purchase consideration less the annuity payments made to date, could be regarded as a composite of an annuity and a life insurance. However, under *subsection (2)* the consideration given for a capital protected annuity is treated as given for the annuity alone.

2780. *Subsections (3)* and *(4)* provide for the consideration to be apportioned on a just and reasonable basis. Although the source legislation refers to apportionment on a "just" basis, just and reasonable is used in subsections (3) and (4) in line with the approach which has been adopted throughout the Act that all apportionments are on a just and reasonable basis. See *Change 14* in Annex 1

Section 723: Determinations

2781. The exemption requires a claim to be made. This allows the Inland Revenue to determine whether an annuity is a purchased life annuity and the amount of any annuity payment which is exempt. This section deals with those questions and the consequences for the payer so far as deduction of tax at source is concerned. It is based on section 658 of ICTA.

2782. *Subsection (1)* provides that such questions are to be determined by the Inland Revenue. See *Change 149* in Annex 1. *Subsection (2)* provides for appeals against determinations to go to the Special Commissioners.

2783. Under *subsection (3)* the payer of an annuity payment is entitled to rely on a determination, made and notified by the Inland Revenue, in determining how much income tax it may or must deduct from the annuity payments. But the words "and has not been notified of any alteration of that decision" in section 656(5) make little sense unless the payer is entitled to rely on that notification. *Subsection (4)* clarifies the position by making it clear that that notification is itself a determination.

2784. Special transitional provisions have been included in Schedule 2 (see paragraphs 143 and 145) to deal with determinations made before 6 April 2005 and to make it clear which provision applies if a false statement or representation is made either before or on or after 6 April 2005.

Section 724: Regulations

2785. This section contains powers for the Board of Inland Revenue to make regulations for dealing with purchased life annuities. It rewrites equivalent provisions in sections 656 and 658 of ICTA.

2786. *Subsection (1)* covers three general matters:

- prescribing the procedures to be used;
- applying provisions of the Income Tax Acts (modified if appropriate); and

- prescribing the tables of mortality.

Section 725: Annual payments under immediate needs annuities

2787. This section is based on section 580C of ICTA. It exempts from income tax certain annual payments made under a contract for an immediate needs annuity.

2788. *Subsections (2)* and *(3)* define an immediate needs annuity. "Annuity" here refers to a contract, as is made clear in the section, rather than payments made or received. Because purchased life annuities payments have their own charge within this Act the definition of a "relevant annual payment" in section 580C(2) of ICTA which places these payments within Schedule D Case III or V can be omitted.

Section 726: Meaning of "care provider"

2789. This section defines "care provider" for the purposes of section 725(1). It is based on section 580C of ICTA.

2790. *Subsection (3)* is drafted slightly differently from the wording on which it is based, namely section 580C(4)(b) of ICTA, which refers to "care which is registered under the relevant enactment". The section reflects the fact that it is the service of care that is registered under that Act, rather than "care".

Chapter 8: Other Annual Payments

Overview

2791. This Chapter sets out the exemptions from income tax for income which would otherwise be taxable as annual payments.

Section 727: Certain annual payments by individuals

2792. This section is based on the parts of section 347A of ICTA which exempt from income tax annual payments made by individuals.

2793. See the commentary on Chapter 7 of Part 5 of this Act for an explanation of the phrase "annual payment".

2794. *Subsection (1)* gives the general exemption: annual payments made by individuals which would otherwise be taxable under Part 5 of this Act are exempt from income tax in the hands of the recipient. Section 347A of ICTA applies to annual payments which would otherwise be within the charge to tax under Schedule D Case III, that is, annual payments arising within the United Kingdom. This requirement is in subsection (1)(b).

2795. *Subsection (3)* is based on section 347A(3) of ICTA and applies the exemption to any payment made by an individual's personal representative if the exemption would have applied had the individual not died. "Personal representatives" is defined in section 878.

2796. In contrast with an English partnership, a Scottish partnership is a separate legal entity. *Subsection (4)* therefore defines "individual" as including a Scottish partnership so that the taxation treatment of English and Scottish partnerships is the same.

2797. Section 347A of ICTA applies to all payments falling due on or after 6 April 2000 and also to certain payments falling due before that date but on or after 16 March 1988. Although unlikely, it is possible for payments to fall due at a time when section 347A did not apply but to be paid after 6 April 2005. Paragraph 146 of Schedule 2 to this Act contains a transitional provision which determines whether the exemption in section 727 and the exemption in section 730 apply in these circumstances.

Section 728: Commercial payments

2798. This section provides an exception to the exemption in section 727. It is based on section 347A(2)(c) of ICTA and provides that annual payments made for commercial reasons in connection with the individual's trade, profession or vocation are not exempt from tax in the recipient's hands.

Section 729: Payments for non-taxable consideration

2799. This section also provides an exception to the exemption in section 727. It is based on section 347A(2)(d) of ICTA which provides that a payment to which section 125(1) of ICTA applies is not exempt from income tax.

2800. However, to work out whether this exception to the exemption applies, the reader has to work out whether section 125(1) of ICTA applies and this is not straightforward.

2801. Section 125(1) of ICTA applies to any payment which is an annuity or other annual payment (other than interest) taxable under Schedule D Case III and which is made in return for consideration which is not taxable in the payer's hands. But that section does not apply to:

(a) payments which (in the recipient's hands) are income within section 660A(8) or (9)(a) of ICTA (certain payments on divorce or separation);

(b) payments made to an individual in consideration of the surrender, assignment or release of an interest in settled property to or in favour of a person having a subsequent interest;

(c) any annuity granted in the ordinary course of a business of granting annuities; and

(d) any annuity charged on an interest in settled property and granted at any time before 30 March 1977 by an individual to a company whose business at that time consisted wholly or mainly in the acquisition of interests in settled property or which was at that time carrying on life assurance business in the United Kingdom.

2802. In other words, if the payment falls within paragraphs (a) to (d), it will not fall within section 125(1) of ICTA and the payment therefore falls within the exemption.

2803. Section 729 rewrites section 347A(2)(d) of ICTA by incorporating the relevant propositions of section 125(1) of ICTA rather than cross-referencing to that section and leaving the reader to work out if it applies. So, if the payment is made for non-taxable consideration (as defined in *subsection (2)*), the payment is exempt in the recipient's hands if either condition B or condition C is met. *Subsection (3)* is based on section 125(3)(a) of ICTA and *subsection (4)* is based on section 125(3)(b) of ICTA.

2804. Section 125(3)(c) of ICTA is not rewritten as an individual would not be authorised to grant annuities in the ordinary course of a business of granting annuities (and if an individual could do so, such a payment would fall within section 728).

2805. Subsections (3)(d) and (5) of section 125 of ICTA are not rewritten in section 729 but have been included in the transitionals Schedule (see paragraph 147 of Schedule 2 to this Act).

Section 730: Foreign maintenance payments

2806. This section is based on section 347A(4) of ICTA and exempts from income tax certain maintenance payments which arise outside the United Kingdom but which would be exempt from income tax if the payments had arisen in the United Kingdom.

2807. *Subsection (2)* explains what is meant by a maintenance payment. Section 347A(4) of ICTA defines a maintenance payment as a periodical payment "(not being an instalment of a lump sum)" and refers to the conditions in section 347B(5)(a) and (b) of ICTA.

The words "(not being an instalment of a lump sum)" are not rewritten. The wording of the exemption makes them redundant. Additionally, section 347B(5) of ICTA was repealed by FA 1999 in relation to a payment falling due after 5 April 2000. But the conditions in *subsection (3)* and *(4)* are rewritten on the basis of the authority in A-G v Lamplough (1878), 3 Ex D 214.

Section 731: Periodical payments of personal injury damages

2808. This section provides an exemption from income tax for periodical payments in respect of damages for personal injury. It is based on sections 329AA and 329AB of ICTA as amended by section 100(2) of the Courts Act 2003.

2809. Section 329AA of ICTA exempts periodical payments awarded under the provisions listed in subsection (6) of that section. However, it was never intended to limit the scope of the exemption to particular provisions. The policy is that all periodical payments in respect of personal injury damages should be exempt. As the policy does not rely on the specific statutory references under which the damages are awarded, the statutory references are not rewritten. See *Change 121* in Annex 1.

2810. By omitting the specific statutory references, and particularly the reference to the Fatal Accidents Act 1976 and the Fatal Accidents (Northern Ireland) Order 1977, it would not be clear on the face of the legislation that references to personal injuries includes death from personal injury. *Subsection (4)* therefore makes this explicit. See *Change 121* in Annex 1.

Section 732: Compensation awards

2811. This section exempts from income tax annuity payments made under an annuity purchased to meet an award made by the Criminal Injuries Compensation Board. It is based on section 329AB of ICTA as amended by the Courts Act 2003.

2812. *Subsection (3)* includes in the definition of the "Criminal Injuries Compensation Scheme" the scheme established for Northern Ireland under the Criminal Injuries (Northern Ireland) Order 2002 SI 2002/796 (NI 1). See *Change 19* in Annex 1.

Section 733: Persons entitled to exemptions for personal injury payments etc.

2813. This section and the next one explain who is entitled to the exemption. It is based on sections 329AA and 329AB of ICTA as amended by the Courts Act 2003.

Section 734: Payments from trusts for injured persons

2814. This section extends the exemption to persons receiving payments from trustees on behalf of an individual entitled to the payments (for example, a child's parents). It is based in section 329AA(4) of ICTA. See *Change 122* in Annex 1.

2815. For the provisions which exempt interest on damages from income tax see section 751.

Section 735: Health and employment insurance payments

2816. This section provides an exemption from income tax for annual payments made under an insurance policy where certain requirements are met. It is based on section 580A of ICTA.

Section 736: Health and employment risks and benefits

2817. This section explains what constitutes a health or employment risk for the purposes of section 735. It is based on section 580A of ICTA.

2818. *Subsections (1)* and *(2)* define "health risk" and "employment risk" respectively. Subsection (2) treats a policy that insures against loss of office as an employment risk while section 580A(3)(b) of ICTA, on which it is based, does not. See *Change 123* in Annex 1.

2819. *Subsection (3)* expands on what is meant by "insurance against a risk". Benefits under this type of insurance are often not restricted to providing an indemnity against a particular liability. This subsection makes it clear that the exemption is also intended to cover benefits other than indemnities.

Section 737: Period for which payments may be made

2820. This section contains the first of the four conditions referred to in section 735(1)(c) and restricts the period for which benefits may be paid if the exemption is to apply. It must be satisfied by all health or employment insurance policies. The section is based on section 580A of ICTA.

2821. Under s*ubsections (1)* and *(2)* the policy may only provide for payments to be made during periods of ill-health or unemployment or while the insured's income is lower than it would otherwise have been. Periods which end in the insured's death and which immediately follow one of these periods are also included. Subsection (2)(b) treats a period throughout which the insured does not hold office as a period in respect of which payments may be made. Section 580A(4)(b) of ICTA, on which it is based, does not. See *Change 123* in Annex 1.

Section 738: Risk of significant loss

2822. This section contains the second of the four conditions referred to in section 735(1)(c) and this condition must be satisfied by all health or employment insurance policies. It is based on section 580A of ICTA.

2823. *Subsections (1)* and *(2)* require that the policy, taking into account investment returns on premiums, should involve the insurer in genuine commercial risk.

Section 739: Conditions to be met by policies also providing other benefits

2824. This section contains the third of the four conditions referred to in section 735(1)(c). It is aimed at preventing abuse of the exemption where an insurance policy covers other risks in addition to ill-health or loss of employment. This section is based on sections 580A and 580B of ICTA.

2825. *Subsections (2)* and *(3)* ensure that where other risks are ensured on the same policy the qualifying risks are not significantly different from what they would be if those other risks were not insured by that policy. Section 580B(2)(c) of ICTA refers to "benefits receivable by or in respect of any person" which reduce other benefits "payable to or in respect of that person". There does not appear to be any significance in the change from "benefits receivable" to "benefits payable" and this subsection refers to benefits "payable" throughout.

Section 740: Conditions to be met where policies are linked

2826. This section contains the last of the four conditions referred to in section 735(1)(c). It is aimed at preventing abuse of the exemption where a person is insured under more than one policy. The section is based on sections 580A and 580B of ICTA.

2827. *Subsections (2)* and *(3)* ensure that any difference in benefits payable for ill-health or loss of employment which arises simply because benefits under another policy are taken into account may be ignored. The source legislation, in section 580B(3)(d) of ICTA, refers to benefits "receivable by or in respect of any person" which reduce other benefits "payable to or in respect of that person". There does not appear to be any significance in the change from benefits "receivable" to benefits "payable". Subsection (3) refers to benefits "payable" throughout.

2828. Section 580B(4) of ICTA is not rewritten as it seems unnecessary to state that the terms of a policy include terms fixing the premium or otherwise in respect of insurance against risk.

Section 741: Aggregation of policies where employment ends for health reasons

2829. This section ensures that, where a person leaves employment but continues to receive benefits under a new separate policy derived from a policy entered into for the benefit of one or more employees, the exemption given by this Chapter continues to apply to payments under the new policy. The section is based on section 580A of ICTA.

Section 742: Meaning of "the insured"

2830. This section gives the meaning of "the insured" for this Chapter. It is based on section 580A of ICTA.

2831. Sections 580A and 580B of ICTA refer throughout to "the insured". During the Standing Committee debate on the Finance Bill which introduced these provisions, it was considered whether the exemption extended to cover insurance policies taken out by parents on behalf of their children. The written answer given by the Financial Secretary to the Treasury was that in such a case the child would be "the insured" to enable the exemption to apply. In practice the exemption has been treated as applying to payments under such policies. In the light of this, sub-paragraph (b) has been added to put the matter beyond doubt. See *Change 124* in Annex 1.

Section 743: Policies for the benefit of others who contribute to premiums

2832. This section provides that where one person takes out a health or employment insurance policy for the benefit of another, that other person may, in certain circumstances, be treated as the insured. It is based on section 580A of ICTA.

2833. Section 580A(7) of ICTA is drafted in terms of the benefits under the policy being apportioned. This section is drafted instead in terms of annual payments in order to be consistent with the other sections dealing with this exemption. This does not alter the effect of the provision.

Section 744: Payments to adopters: England and Wales

2834. This section and the following two sections ensure that certain financial support received by families who adopt are exempt from income tax. The sections are based on section 327A of ICTA which has been split between the different jurisdictions.

2835. Section 744 deals with payments made to adopters (and persons seeking to adopt) in England and Wales. *Paragraph (c)* exempts payments of allowances paid under regulations made under the Adoption Act 1976. The regulations cited in section 327A(1)(c) of ICTA, that is, the Adoption Allowance Regulations 1991, are not rewritten because if the regulations changed before this Act received Royal Assent the citation would be wrong.

Section 745: Payments to adopters: Scotland

2836. This section deals with payments made to adopters (and persons seeking to adopt) in Scotland.

Section 746: Payments to adopters: Northern Ireland

2837. This section deals with payments made to adopters (and persons seeking to adopt) in Northern Ireland.

2838. *Paragraph (c)* exempts payment of allowances under regulations under the Adoption (Northern Ireland) Order 1987. Again, the regulations cited in section 327A(1)(j) of

ICTA, that is, the Adoption Allowance Regulations (Northern Ireland) 1996, are not rewritten.

Section 747: Power to amend sections 744 to 746

2839. This section gives the Treasury the power to amend sections 744 to 746 to take account of future changes in the description of financial support payments.

Section 748: Payments by persons liable to pool betting duty

2840. This section is based on section 126(3) of FA 1990 and section 121 of FA 1991. It gives an exemption from income tax for annual payments made by persons liable to pool betting duty provided the conditions mentioned in *subsection (1)* are satisfied (see the commentary on section 162 for the background to this relief).

2841. The exemption applies to payments made in consequence of a reduction in pool betting duty, whenever that reduction is made (see s*ubsection (2)*). Subsection (2) combines the conditions in FA 1990 and FA 1991. Although the source legislation is restricted to the 1990 and 1991 reductions in pool betting duty, the subsection applies to payments made "in consequence of" any reduction in the duty. See *Change 47* in Annex 1.

2842. *Subsections (3)* and *(4)* set out two further conditions either of which needs to be satisfied. The subsections do not specify that payments in consequence of the 1990 reduction in pool betting duty must be paid for football safety and comfort (see section 126(3) of FA 1990) or that payments in consequence of the 1991 reduction must be paid to the Foundation for Sport and the Arts (see section 121(3) of FA 1991). Instead each subsection applies to a payment in consequence of any reduction in pool betting duty. See *Change 46* in Annex 1.

Chapter 9: Other income

Overview

2843. This Chapter provides for exemption from income tax in respect of miscellaneous income. The income exempted under this Chapter is categorised as follows:

- interest only income;
- interest and royalty payments;
- income from occupation of commercial woodlands;
- housing grants;
- approved share incentive plan distributions;
- foreign income of consular officers and employees;
- income of non-UK residents of certain securities; and
- other income.

Section 749: Interest paid under repayment supplements

2844. This section provides an exemption from income tax for repayment supplement paid by the Inland Revenue. It is based on section 824(8) of ICTA.

Section 750: Interest from tax reserve certificates

2845. This section provides an exemption from income tax for interest from Tax Reserve Certificates ("TRCs") issued by the Treasury. It is based on section 46(2) of ICTA. (The remainder of section 46 concerns unrelated income from savings certificates, which is dealt with in Chapter 2 of Part 6 of this Act.)

2846. TRCs were introduced in 1941 as a mechanism for making payments of tax on account. Interest on TRCs is paid when the certificates are used to settle a tax liability. TRCs have not been issued since the mid-1970s, when they were replaced by Certificates of Tax Deposit. However, TRCs are still used from time to time to settle tax liabilities. In the light of this, it is not possible to regard section 46(2) of ICTA as obsolete for income tax purposes.

Section 751: Interest on damages for personal injury

2847. This section provides an exemption from income tax for interest on damages for personal injury or death. It is based on section 329 of ICTA.

2848. The source legislation deals with interest on damages awarded by reference to various enactments. *Subsection (1)* omits those statutory references. It was never intended to limit the scope of the exemption to particular enactments: the policy was to include any Act under which interest on damages for personal injury could be awarded. See *Change 121* in Annex 1.

2849. Section 329(1)(a) and (b) of ICTA limit the exemption to the interest included in a sum for which judgement is given. *Subsection (1)(a)* refers simply to “a sum awarded by a court”. *Subsection (1)(b)* makes it clear that interest which may arise from the date of the award is not included in the exemption.

2850. *Subsection (1)(c)* gives statutory effect to ESC A30 (interest on damages for personal injuries (foreign court awards)). See *Change 125* in Annex 1.

2851. *Subsection (2)* is based on section 329(3) of ICTA and extends the exemption to interest in respect of payments in satisfaction of a cause of action.

Section 752: Interest under employees’ share schemes

2852. This section contains an exemption from income tax in respect of interest relating to trustees of certain employees’ share schemes. It is based on section 688 of ICTA.

2853. *Subsection (1)* applies the section where the trustees receive interest from a participant in the employees’ share scheme and the scheme is set up to comply with certain statutory provisions. Section 688 of ICTA refers to the trustees receiving interest from “employees and directors” of the company. This reflects the wording of section 54(1) of the Companies Act 1948 (the relevant company law enactment when what became section 688 first came into force). However, the relevant company law enactment is now section 153(4)(b) of the Companies Act 1985. That provision refers to “the provision by a company, in good faith in the interests of the company, of financial assistance for the purposes of an employees’ share scheme.”

2854. Subsection (1) of the section brings the wording of this exemption into line with the corresponding company law enactment. See *Change 126* in Annex 1.

2855. *Subsection (2)* provides that the trustees will be exempt from tax charged under Chapter 2 of Part 4 of this Act on the interest they receive if the scheme requires the trustees to pay to the company an equivalent amount as interest. Section 688 of ICTA refers to an exemption from tax “under Case III of Schedule D”. But the reference in the section to Chapter 2 of Part 4 of this Act will include foreign source interest. It would be possible for UK resident trustees to receive interest from non-UK resident employees etc. In such circumstances, it would be illogical to treat the foreign source interest as outside the scope of the exemption. See *Change 127* in Annex 1.

Section 753: Interest on repayment of student loan

2856. This section provides an exemption from tax for interest paid to borrowers of student loans in respect of refunds of over-repayments of such loans. It is based on section 331A of FA 1999.

Section 754: Redemption of funding bonds

2857. This section provides that, where the issue of funding bonds results in a charge to tax as interest under section 380 of this Act, any interest paid on the subsequent redemption of the funding bonds is exempt from tax. The exemption also applies where the deemed interest on the funding bond was charged to corporation tax but on redemption the bond was held by an income tax payer. The section is based on section 582 of ICTA.

Section 755: Interest on foreign currency securities etc. owned by non-UK residents

2858. This section is based on section 581 of ICTA. It provides an exemption from income tax for interest on certain foreign currency securities, or loans, beneficially owned by people who are not resident in the United Kingdom. The exemption is available only if the Treasury make an appropriate direction.

2859. Section 581(1)(a) of ICTA provides that, if a Treasury direction is made, interest on this type of security or loan is not subject to deduction of tax at source. This provision is not rewritten in this Chapter. It is rewritten as a new section 581A of ICTA (see paragraph 242 of Schedule 1 to this Act).

2860. The meaning of "foreign currency" in this section is dealt with separately in section 756.

2861. *Subsection (1)* sets out the interest within the scope of the exemption for the purposes of this section. Section 581 of ICTA originally applied only to securities issued by local authorities. It was later extended to cover securities issued by, or loans made to, statutory corporations by adding section 581(4) of ICTA.

2862. *Subsection (2)* sets out the conditions to be met if the exemption is to apply. The reference to "eventual repayment" in subsection (2)(b) of the section (and based on section 581(4) of ICTA) is relevant only for a loan with no immediate entitlement to repayment.

2863. *Subsection (3)* of the section is an anti-avoidance provision. Section 581(3) of ICTA is very widely drafted: "where any income of any person is by virtue of any provision of the Income Tax Acts to be deemed to be income of any other person, that income shall not be exempt ...". In fact, there are only two sets of provisions under which this type of income could be deemed to be income of another person. The relevant provisions are listed in subsection (3) of the section.

2864. *Subsection (4)* reflects the effect of the devolution settlements. See *Change* 19 in Annex 1.

Section 756: Which securities and loans are foreign currency ones for section 755

2865. This section defines "foreign currency securities" for the purposes of section 755. It is based on section 581 of ICTA. Although the basic proposition in *subsection (1)* is quite straightforward, there are four qualifications to this proposition, set out in *subsections (3)* to *(6)*.

2866. The source legislation, introduced during the exchange control era, refers to securities and loans "expressed in a currency other than sterling". However, there could be more than one interpretation of the word "expressed". In this context, the logical interpretation is that "expressed" means "repayable". This is in line with the exchange control definition of a foreign currency security, and with the reference to securities "expressed" in a particular currency in other contexts in the Tax Acts. This section is therefore drafted in terms of the currency used for repayment.

Section 757: Interest and royalty payments: introduction

2867. This section acts as a general introduction to sections 758 to 767. It is based on section 97 of FA 2004.

2868. Sections 757 to 767 rewrite most of Chapter 6 of Part 3 of FA 2004 which implements the European Union Interest and Royalties Directive (Council Directive 2003/49/EC of 3 June 2003).This directive provides for the elimination of source state taxation on interest and royalty payments between associated companies in different member States of the European Union.

2869. These sections therefore exempt from income tax certain interest and royalty payments made between associated companies where the beneficial owner is a company of another member State or a permanent establishment of such a company in a member State other than the United Kingdom. Although the person beneficially entitled to the income will be a company, the exemption is from income tax. This is because non-UK resident companies are only within the charge to corporation tax on such payments if they trade in the United Kingdom through a permanent establishment here and the interest or royalties are attributable to the permanent establishment.

2870. Income tax on interest and royalty payments would, apart from this exemption, be collected by deduction under section 349 of ICTA. Section 105(5) of FA 2004 introduced a new subsection (7) in section 349 of ICTA which provides that the latter section is subject to the exemption rewritten in these sections. The general disregard section in Chapter 10 of Part 6 of this Act ensures that, without a specific provision to the contrary, an amount that is exempt under Part 6 is disregarded for all other income tax purposes and this will include section 349 of ICTA. Section 349(7) of ICTA is not therefore amended to refer to the interest exemption but it continues to refer to section 101 of FA 2004 (dealing with the deduction of tax from royalty payments under section 349 of ICTA) which is not rewritten (see commentary on section 762).

Section 758: Exemption for certain interest and royalty payments

2871. This section gives the exemption and conditions for that exemption. Three conditions must be satisfied for the royalties exemption to apply and four for the interest exemption. The section is based on section 98 of FA 2004.

2872. *Subsection (1)* gives the exemption. Section 105(4) of FA 2004 inserts into section 18 of ICTA a subsection which makes the charge under that section subject to the exemption rewritten here. This is not rewritten as it is not considered necessary given the wording of subsection (1) of this section.

Section 759: The person making the payment

2873. The first condition in section 758 is that the payer of the interest or royalties is in the United Kingdom, whether as a UK permanent establishment of a company resident in another member State or a company resident in the United Kingdom (other than its permanent establishment outside the United Kingdom). The purpose of this section is to identify the payer (and thus ensure that the payer is in the United Kingdom) where the paying company has a permanent establishment in another territory. The criterion is where the payments are deductible against tax. If they are deductible against the profits of the permanent establishment in the territory where it is situated it is the permanent establishment that is treated as the payer. The section is based on section 99 of FA 2004.

Section 760: The person beneficially entitled to the payment

2874. The second condition in section 758 is that the person beneficially entitled to the income in respect of the payment is a European Union company other than such a company's permanent establishment in the United Kingdom or in a non-member State. The purpose of this section is to identify the beneficial owner where a European Union company has a permanent establishment in the United Kingdom or a non-member State and to ensure that the condition is satisfied. The section is based on section 99 of FA 2004.

Section 761: Meaning of “25% associates”

2875. The third condition in section 758 is that the payer and beneficial owner should be 25% associates. This section explains what is meant by a 25%. It is based on section 99 of FA 2004.

Section 762: Interest payments: exemption notices

2876. This section enables regulations about exemption notices to be made. These notices are required by the fourth and final condition in section 758 for the interest exemption. The section is based on section 100 of FA 2004.

2877. No exemption notice is required for royalty payments. Section 101 of FA 2004 is not rewritten in this Act as it relates to the deduction of tax. Section 102 of FA 2004 provides for claims for the repayment of tax deducted from interest or royalties paid. This section has not been rewritten.

Section 763: Special relationships

2878. This section provides that the exemption will not apply where the interest or royalties have not been paid between independent parties acting at arm’s length. This is achieved by reference to a “special relationship” (a term used in double taxation treaties) between the payer and the beneficial owner of the income such that the payments will not be at arm’s length. The section is based on section 103 of FA 2004.

2879. *Subsection (3)* provides that where a claim to relief under a double taxation treaty would provide greater relief from tax than is available under this exemption the company may chose to claim relief under the treaty.

Section 764: Application of ICTA provisions about special relationships

2880. This section ensures that the special relationships rule in section 763 is construed in the same way as similar rules in double taxation treaties. (Sections 808A and 808B of ICTA deal with the construction of the term “special relationship” in such treaties.) The section is based on section 103(2) to (4) of FA 2004.

Section 765: Anti-avoidance

2881. This section prevents exemption from tax being given if the purpose or one of the main purposes of the payments is to avoid tax. The wording is based on similar provisions in double taxation treaties. The section is based on section 104 of FA 2004.

2882. *Subsection (1)* applies to interest payments. Because it looks at the purposes of the person concerned with the creation or assignment of the debt, the section may apply where the interest payments are paid indirectly to a person not entitled to the exemption, for example where a payment is dog-legged through a European Union company to a non-European Union company.

Section 766: Interest and royalty payments: interpretation

2883. This section explains various terms used in the sections for this exemption. It is based on section 97 of FA 2004.

Section 767: Power to amend references to the Directive by Order

2884. This section allows the Treasury to amend the provisions for this exemption where that is appropriate for implementing any amendment to, or replacement of, the Directive adopted after 8 April 2004, the date when the clauses for Finance Bill 2004 were finalised. The section is based on section 97 of FA 2004.

2885. *Subsection (2)* enables references in section 101 of the FA 2004 to be amended where necessary as a result of amendments to the Directive. This is necessary as section 101 of that Act has not been rewritten (see commentary on section 762).

2886. Section 97(4) of FA 2004, which allows a first Treasury order to take effect before the making of the order, has not been rewritten as it would apply only if the Directive had been amended before Royal Assent to Finance Bill 2004 in a way that affected Chapter 6 of Part 3 of that Act.

Section 768: Commercial occupation of woodlands

2887. This section exempts income arising from the occupation of commercial woodlands from any charge as miscellaneous income. It is based on paragraph 3(2) of Schedule 6 to FA 1988.

2888. A consequence of this exemption is that no loss relief is available under section 392 of ICTA (losses from miscellaneous transactions). A requirement of that section is that any profit on the transaction would be liable to income tax.

2889. This section is complemented by sections 11 and 267 of this Act. The combined effect of these three sections is that income from the occupation of commercial woodlands is ignored for income tax purposes.

2890. The definition of “commercial woodlands” in *subsection (2)* is supplemented by the definition of “woodlands” in section 876 of this Act.

Section 769: Housing grants

2891. This section exempts from income tax grants paid under legislation intended to assist in providing, maintaining or improving housing. It is based on section 578 of ICTA.

2892. *Subsection (1)* reflects the effect of the devolution settlements. See *Change* 19 in Annex 1.

2893. *Subsection (2)* makes it clear that the expenditure need not be incurred by any particular person and that it may be current or future expenditure.

Section 770: Amounts applied by SIP trustees acquiring dividend shares or retained for reinvestment

2894. The commentary on the SIPs legislation in Chapter 3 of Part 4 of this Act explains the background to approved share incentive plans. This section is based on sections 493(1) and 496(1) of ITEPA. Without these exemptions a tax liability would arise under Chapter 3 of Part 4 of this Act (in respect of cash dividends paid by UK resident companies) or under Chapter 4 of Part 4 of this Act (in respect of cash dividends paid by non-UK resident companies). As the tax liability arises under this Act, the exemptions are rewritten in Part 6 of this Act rather than retained in ITEPA. Signposting provisions to this exemption are in sections 493 and 496 of ITEPA.

2895. The references to tax credits in subsection (2) of sections 493 and 496 of ITEPA are not rewritten in this section. The rewrite of section 231 of ICTA in this Act (see section 397) makes it unnecessary.

Section 771: Relevant foreign income of consular officers and employees

2896. This section exempts from income tax the relevant foreign income of consular officers and employees who satisfy particular conditions where an Order in Council has directed that the section should apply to give effect to a bilateral international convention with a foreign state. The provision is applicable only to a dozen or so conventions and it is unlikely that further Orders in Council will be made. The Consular Relations Act 1968 has made the use of such bilateral conventions unnecessary. "Relevant foreign income" is defined in section 830 of this Act. The section is based on section 322 of ICTA.

2897. *Subsection (1)* provides that the relevant foreign income of a consular officer or employee of a foreign state in the United Kingdom is exempt from tax if an Order in Council directs that the section applies to that state to give effect to a reciprocal arrangement and the individual concerned meets certain conditions. "Reciprocal arrangement" is the term used by section 302 of ITEPA which rewrites the employment income aspects of section 322 of ICTA. "Reciprocal arrangement" is defined in *subsection (5)*.

2898. *Subsection (2)(b)* refers to "a British overseas territories citizen". This rewrites section 322(1)(a) of ICTA "a British Dependent Territories citizen". Section 2(3) of the British Overseas Territories Act 2002 requires any reference to a British Dependent Territories citizen be read as a reference to a British overseas territories citizen. The change of name has been incorporated into this section.

Section 772: Further provisions about Orders under section 771

2899. This section makes further provisions for Orders in Council under section 771. It is based on section 322 of ICTA.

Section 773: Income from Inter-American Development Bank securities

2900. This section provides an exemption from income tax, in certain circumstances, relating to income from a security issued by the Inter-American Development Bank. It is based on section 583 of ICTA.

2901. *Subsections (2)* to *(4)* set out the circumstances which must all apply if the income is to be exempt. The exemption applies in respect of any income from a security issued by the Bank (including dividends or interest).

Section 774: Income from securities issued by designated international organisations

2902. This section provides an exemption from income tax, in certain circumstances, relating to income from a security issued by designated international organisations. It is based on section 324 of ICTA.

2903. *Subsections (2)* to *(4)* set out the circumstances which must all apply if the income is to be exempt. The exemption applies in respect of any income from a security issued by the relevant designated organisation (including dividends or interest).

Section 775: Income towards reducing the national debt

2904. This section provides an exemption from income tax, in certain circumstances, in respect of income arising from property held in trust where the trust funds are to be used for the reduction of the national debt. It is based on section 514 of ICTA.

Section 776: Scholarship income

2905. This section is based on section 331 of ICTA.

2906. *Subsection (1)* sets out the exemption and *subsection (2)* points the way to section 215 of ITEPA. Section 215 of ITEPA provides that if the scholarship income is employment-related, the scholarship exemption applies only to the holder of the scholarship. But such income is also exempt from tax if the conditions set out in section 213 of ITEPA (scholarships provided by trust funds etc) are fulfilled.

Section 777: VAT repayment supplements

2907. This section exempts VAT repayment supplement from tax. It is based on section 827(2) of ICTA. The supplement does not have the character of interest. So the exemption is in this Chapter rather than with the exemptions for interest.

Section 778: Incentives to use electronic communications

2908. This section exempts from tax incentives provided under regulations to make use of electronic communications. It is based in section 143 of FA 2000.

Section 779: Gains on commodity and financial futures

2909. This section is based on section 128 of ICTA. That section was introduced as section 72 of FA 1985. It was part of changes which removed gains on commodity and financial futures from the scope of income tax or corporation tax under Schedule D (unless chargeable as trade profits) and charged them instead as capital gains under section 143 of TCGA. This is an unusual instance of an item which is naturally income being charged instead as a capital profit (most “deeming” legislation is designed to tax capital profits as income).

2910. Section 80 of FA 1997 reversed the FA 1985 change to the extent of gains charged to tax thereafter under Schedule 5AA to ICTA (guaranteed returns on transactions in futures and options, rewritten in Chapter 12 of Part 4 of this Act).

2911. The only Cases of Schedule D which could apply to the gains covered by section 128 of ICTA, where the gain is income on first principles (and disregarding the exemption the section provides), are Schedule D Cases V and VI. As the relevant charging function of those Cases is rewritten in Chapter 8 of Part 5 of this Act, the section is expressed as an exemption from the charge under that Chapter.

2912. Together with the “priority sections” (sections 575 and 576), which award priority to a charge under Part 2 or under Chapter 12 of Part 4 of this Act, expressing the exemption in that way ensures that any gains not falling within that Part or Chapter are not charged to income tax. That leaves the way clear for gains covered by this exemption to be taxed under section 143 of TCGA.

2913. The section imports the definitions provided by section 143 of TCGA.

Section 780: Disabled person’s vehicle maintenance grant

2914. This section is based on section 327 of ICTA and exempts from income tax grants made in respect of a disabled person’s vehicle.

Section 781: Payments under New Deal 50plus

2915. This section is based on section 84 of FA 2000 and exempts from income tax certain payments made to a person participating in the New Deal 50plus scheme.

Section 782: Payments under employment zone programme

2916. This section is based on section 85 of FA 2000 and exempts from income tax payments made to a person participating in an employment zone programme.

Chapter 10: General

Section 783: General disregard of exempt income for income tax purposes

2917. This section confirms that income covered by exemptions in this Part, unless specific rules are provided, is exempt for all purposes of the Income Tax Acts (including information returns and the operation of sections 348 and 349 of ICTA).

2918. The source legislation employs a variety of expressions concerning exemptions which may suggest that particular exemptions might be more narrowly expressed than others. But even where apparently more narrow wording is employed the implications of such wording are mitigated by regulations or practice.

2919. *Subsection (2)* is based on section 325. It provides that the full amount of NSB interest (exempt and non-exempt interest) is to be included in information returns.

2920. *Subsection (3)* provides that specific provisions override this section: an example is the provision of information under the SIP code in paragraph 93 of Schedule 2 to ITEPA.

Part 7: Income charged under this Act: rent-a-room and foster-care relief

Chapter 1: Rent-a-room relief

Overview

2921. The sections in this Part are based on section 59 of and Schedule 10 to F(No 2)A 1992. These provisions are entitled "Furnished Accommodation" in the source legislation but are commonly known as "rent-a-room", the name adopted in this Act.

2922. "Rent-a-room" gives relief in one of two forms for householders who provide furnished accommodation in their homes for lodgers. One form is complete tax exemption for the rent, provided it does not exceed a certain level - the "full relief" form. If the rent does exceed that level the rent-a-room profit is taxable. But taxpayers can choose to have the profit calculated by deducting a fixed amount as expenses, rather than their actual expenses, if that is advantageous - the "alternative method of calculation" form of the relief.

2923. References to "profits or gains" in the source legislation which relate only to income are rewritten in this Chapter omitting the reference to "gains". This continues the tidying up of such references started in section 46(3) of and Schedule 7 to FA 1998.

Section 784: Overview of Chapter 1

2924. This section introduces the relief. It is new.

2925. *Subsection (2)* introduces the key factor in determining the form of relief available: the level of gross receipts.

2926. *Subsection (3)* introduces the full form of the relief where gross receipts are modest.

2927. *Subsection (4)* introduces the alternative method of calculation form of the relief where gross receipts are larger.

Section 785: Person who qualifies for relief

2928. This section states the basic conditions that an individual must satisfy to obtain the relief. It is based on paragraph 2 of Schedule 10 to F(No 2)A 1992.

2929. *Subsection (1)(a)* is a general condition that is satisfied only if the taxpayer claiming rent-a-room relief satisfies the more detailed conditions in respect of the letting.

2930. *Subsection (1)(b)* helps in restricting the relief to the simpler cases for which it is intended. In referring to the income types to which rent-a-room relief is relevant it avoids reference to a "source" – the term used in paragraph 2(3) of Schedule 10 to F(No 2)A 1992 – because what is meant by a "source" in this context may not always be clear. So in rewriting references to a "source", subsection (1)(b) refers to trades, lettings or agreements.

2931. Paragraph 2(3) of Schedule 10 to F(No 2)A 1992 disqualifies an individual from relief if the income from any source from which his or her rent-a-room income is derived also includes income that is not rent-a-room income. "Source" is not defined.

2932. The source of the income arising from a trade is the trade itself.

2933. When Schedule 10 to F(No 2)A 1992 was enacted, relief was available on income from furnished lettings if the income fell within Schedule D Case VI (rather than Schedule A). The source of such income was considered to be the letting in question. FA 1995 brought income from furnished lettings in the United Kingdom within Schedule A and consequentially amended Schedule 10 to F(No 2)A 1992 to make relief available on such income. The amendment was not intended to be read as changing the source of the income for the purposes of that Schedule. For a Schedule A business to be a "source" for this purpose could have capricious results: running a separate business of letting commercial property would disqualify an individual from rent-a-room relief on Schedule A income for letting a room in his or her house (but rent-a-room relief could still be available to a person who ran both a bed-and-breakfast business at home and a separate commercial trade).

2934. As regards amounts incidental to the letting, and within Schedule D Case VI, on which rent-a-room relief might be available (for example, receipts for goods or services such as meals or laundry) the source of the income is the agreement to provide the goods or services in question.

2935. So subsection (1)(b) refers to whatever is the appropriate source for each kind of income for which rent-a-room relief is available.

2936. Section 785, unlike the provision in paragraph 2(1) of Schedule 10 to F(No 2)A 1992, does not impose the condition that to be within rent-a-room, *all* the letting income (or income related to a letting) must be trade or UK property business income. Specifically, it allows rent-a-room relief to apply where certain income related to a letting is received that would, in the source legislation, be within Schedule D Case VI. The existence of any such amounts would, under the source legislation, disqualify the taxpayer from rent-a-room relief in respect of all his or her income. See *Change 128* in Annex 1.

2937. The approach in subsection (1)(b) also removes a potential disqualification from rent-a-room relief in particular circumstances. See *Change 129* in Annex 1.

Section 786: Meaning of "rent-a-room receipts"

2938. This section defines "rent-a-room receipts". It is based on paragraphs 2, 4 and 8 of Schedule 10 to F(No 2)A 1992.

2939. *Subsection (1)(a)* makes explicit what is merely implicit in the source legislation: that the let accommodation must be in the United Kingdom to be within rent-a-room. This approach also removes a disqualification from rent-a-room relief that can arise in respect of a let United Kingdom residence when exceptionally the individual also lets an overseas residence at the same time. See *Change 129* in Annex 1.

2940. *Subsection (1)(b)* refers to an "income period". The period for which receipts must satisfy certain conditions is identified in the source legislation as the "basis period". "Basis period" was appropriate to Schedule D Case I income but less so when applied to Schedule A income where it was potentially confusing. The use of "income period" in the rewritten section makes it possible to avoid using "basis period" for property income and income charged under Chapter 8 of Part 5 of this Act: the conditions have to be satisfied by reference to the events of an "income period". That is, for trade profits, the basis period (see *subsection (3)*). But for property income and income charged under Chapter 8 of Part 5 of this Act it is the tax year or, if letting begins or ends during the tax year, the date of, respectively, the beginning and the end of the letting (see*subsection (4)*).

2941. One incidental consequence of this approach is the way in which it works in conjunction with the requirement in *subsection (1)(c)*. It makes explicit the period during which the "only or main residence" requirement must be met in the years when a letting begins or ends and the income is taxable as property income (in the source legislation it was not clear what was meant by "basis period" in these cases). Now it is explicit that the period is concurrent with the period of the letting and does not extend to the whole of the tax year.

2942. *Subsection (1)(d)* ensures that when the relief is in respect of income chargeable under the trading or property income Parts of this Act, it continues to apply only to amounts to which it applies under the source legislation, that is, to rent-a-room lettings which give rise to trade or property business profits. This provision is necessary because the charges under the trading income and property income Parts of this Act go wider than purely trade and property business profits and include (for example) post-cessation receipts.

2943. Subsection (1)(d) also extends rent-a-room relief to income from the provision of the incidental services mentioned in subsection (1)(a) that would, in the source legislation, be charged under Schedule D Case VI and excluded from rent-a-room. See *Change 128* in Annex 1.

Section 787: Meaning of "residence"

2944. This section is based on paragraph 7 of Schedule 10 to F(No 2)A 1992.

2945. *Subsection (1)(b)* refers to a "caravan or houseboat". There is an Act-wide definition of "caravan": see the commentary on section 875 of this Act and *Change* 148 in Annex 1.

2946. There is also an Act-wide definition of "houseboat": see the commentary on section 878(1) of this Act and *Change* 150 in Annex 1.

Section 788: Meaning of "total rent-a-room amount"

2947. This section introduces and defines a key rent-a-room term: "total rent-a-room amount". It is based on paragraphs 9 and 11 of Schedule 10 to F(No 2)A 1992.

2948. The term "total rent-a-room amount" is new. It sets out how the amount of income to be compared with the limit is calculated. The level of an individual's "total rent-a-room amount" determines which form of rent-a-room relief the individual is entitled to: the full relief or the alternative method of calculation.

2949. *Subsection (1)(b)* includes any relevant balancing charges in the "total rent-a-room amount" to remove an anomaly in the source legislation. See *Change 130* in Annex 1.

Section 789: The individual's limit

2950. This section determines the individual's rent-a-room limit for the tax year. The "limit" is the maximum amount of rent-a-room income that is exempt from tax. It is based on paragraphs 5 and 6 of Schedule 10 to F(No 2)A 1992.

2951. *Subsection (1)* signposts to the section which sets out the full conditions that must be met to qualify for the full "basic amount".

Section 790: Exclusive receipts condition

2952. This section states the detail of the conditions that must be met to qualify for the full "basic amount". It is based on paragraph 5 of Schedule 10 to F(No 2)A 1992.

2953. *Subsection (1)(a)* makes it clear that a third party letting of *any* kind in the same residence triggers the halving rule. That in turn reflects the policy in the source legislation that only the "simplest" cases should get the full value of the relief.

2954. The source legislation refers to a "basis period". The approach of section 786 (described in the commentary on that section) is reflected in section 790 where reference to basis periods is avoided.

Section 791: Full rent-a-room relief: introduction

2955. This section introduces the sections that provide for full relief. It is based on paragraph 9 of Schedule 10 to F(No 2)A 1992.

Section 792: Full rent-a-room relief: trading income

2956. This section provides for full relief when the rent-a-room income is trading income. It is based on paragraph 9 of Schedule 10 to F(No 2)A 1992.

2957. This section is simpler than the two sections that immediately follow it. That is because for both of the latter the rent-a-room income element may have to be separately identified from non rent-a-room income taxable under the same Part of this Act. That is not the case for rent-a-room income that is trading income. If receipts of a single trade include both rent-a-room and non rent-a-room income none of that income is eligible for relief (paragraph 2(3) of Schedule 10 to F(No 2)A 1992 rewritten as section 785(1)). So a trade qualifies for rent-a-room relief only if its income consists wholly of rent-a-room income.

2958. A person carrying on a trade is normally eligible for capital allowances or liable to balancing charges under CAA. The effect of *subsection (2)* is that neither are taken into account when full relief is due under section 792. Saying that the profits and losses are nil achieves that because capital allowances and balancing charges are taken into account in calculating those profits and losses.

Section 793: Full rent-a-room relief: property income

2959. This section provides for full relief when the rent-a-room income is property income. It is based on paragraph 9 of Schedule 10 to F(No 2)A 1992.

2960. *Subsection (3)* states explicitly what is merely implicit in the source legislation. That is, in calculating the profits of a property business, no capital allowances or balancing charges are to be made in respect of rent-a-room related assets.

2961. This form of the rule is needed because the rent-a-room letting may be part of a property business comprising other lettings. Tax under Part 3 of this Act is charged on the profits of a UK property business, which may include activities other than rent-a-room lettings. Section 793 cannot treat the profits of the whole UK property business as nil, but instead expressly excludes all amounts relating to rent-a-room activities from the calculation of the profits of the UK property business. Those amounts include capital allowances and balancing charges which relate to rent-a-room lettings and, accordingly, section 793(3) excludes them.

Section 794: Full rent-a-room relief: income chargeable under Chapter 8 of Part 5

2962. This section provides for full relief when the rent-a-room income includes income charged under Chapter 8 of Part 5 of this Act. It is new.

2963. *Subsection (1)* reflects the change referred to in the last paragraph of the commentary on section 786. The extension of rent-a-room relief to certain income charged under Schedule D Case VI in the source legislation requires the rule in this section to relieve such income when the relevant conditions are met. See *Change 128* in Annex 1.

2964. There is no equivalent in this section of section 793(3). Such a provision is not needed for rent-a-room income charged under Chapter 8 of Part 5 of this Act because there is no statutory provision for capital allowances for that type of income.

Section 795: Alternative calculation of profits: introduction

2965. This section introduces the sections that provide for the second form of the relief – the alternative method of calculating profits. It is based on paragraph 11 of Schedule 10 to F(No 2)A 1992.

2966. *Paragraphs (a)* to *(c)* state the three conditions that must be met. See *Change 130* in Annex 1.

Section 796: Alternative calculation of profits: trading income

2967. This section sets out the basis of calculation when the rent-a-room income is wholly or partly trading income and it exceeds the rent-a-room limit. It is based on paragraph 11 of Schedule 10 to F(No 2)A 1992.

2968. *Subsection (2)(a)* makes explicit what is merely implicit in the source legislation: the retention of any balancing charge where the alternative method of calculation applies. As in exemption cases, there is no entitlement to capital allowances if the taxpayer elects for the alternative method of calculation (paragraph 11(6) of Schedule 10 to F(No 2)A 1992). But - and this differs from exemption cases - any balancing charge remains. In the source legislation the retention of the balancing charge is merely implicit in paragraph 11(6) of Schedule 10 to F(No 2)A 1992: it is simply not mentioned as part of the disapplication of the allowance under section 55 of CAA.

2969. *Subsection (3)(b)* gives a formula for calculating the correct deduction when the rent-a-room income consists of trading income and another type of income. In these circumstances the total rent-a-room deduction is apportioned between the rent-a-room income types.

Section 797: Alternative calculation of profits: property income

2970. This section sets out the basis of calculation when the rent-a-room income is wholly or partly property income and it exceeds the rent-a-room limit. It is based on paragraph 11 of Schedule 10 to F(No 2)A 1992.

2971. S*ubsection (3)(b)* makes explicit what is merely implicit in the source legislation: the capital allowances adjustments that are required. Like section 796(2)(a), subsection (3)(b) refers explicitly to the retention of any balancing charge where the alternative method of calculation applies. But subsection (3)(b) also refers to an allowance. That is required because this section deals with profits that may represent only part of the overall profits of a property business. So to give proper effect to the rent-a-room adjustment it needs to state explicitly what is to be included in, and excluded from, the overall calculation of the profits of that business.

Section 798: Alternative calculation of profits: income chargeable under Chapter 8 of Part 5

2972. This section sets out the basis of calculation when the rent-a-room income is income that is taxed under Chapter 8 of Part 5 of this Act and it exceeds the rent-a-room limit. It is new.

2973. *Subsection (1)* reflects the extension of rent-a-room relief to certain income that is, in the source legislation, charged under Schedule D Case VI. See *Change 128* in Annex 1. It gives a deduction rule for income charged under Chapter 8 of Part 5 of this Act that reflects similar rules for trading and property income in, respectively, section 796 and section 797.

2974. *Subsection (3)* provides for an apportionment of the available rent-a-room deduction between income charged under Chapter 8 of Part 5 of this Act and other income. It does not address the case where an individual's rent-a-room income consists wholly of income charged under Chapter 8 of Part 5 of this Act. That is because such income can, in the rent-a-room context, exist only in company with other (normally property business) rent-a-room letting income.

2975. There is no reference to any capital allowances adjustments because there is no statutory provision for capital allowances for income within Chapter 8 of Part 5 of this Act.

Section 799: Election not to apply full relief

2976. This section allows a taxpayer to opt out of full relief (it may not always be beneficial, for example, if he or she has losses to use). It is based on paragraph 10 of Schedule 10 to F(No 2)A 1992.

2977. It follows the approach of the source legislation in making the exemption automatic unless the taxpayer opts out. That is because, in the type of small case to which the exemption will most frequently apply, the likelihood is that it will be beneficial.

2978. *Subsection (3)* converts references, in the source legislation, to the Board of Inland Revenue and to an officer of the Board of Inland Revenue into references to the Inland Revenue. See *Change* 149 in Annex 1.

2979. Subsection (3) expresses the time limit by reference to the normal Self Assessment rules.

Section 800: Election for alternative method of calculating profits

2980. This section provides a rule that allows a taxpayer to choose the alternative method of calculation if he or she qualifies. It is based on paragraph 12 of Schedule 10 to F(No 2)A 1992.

2981. This section follows the approach of the source legislation in making an election necessary in order to benefit from the alternative method of calculation. That is because this form of the relief is likely to apply to larger, more complex cases. Whether or not the relief is beneficial in these cases will depend on the particular circumstances.

2982. *Subsection (5)* converts references, in the source legislation, to the Board of Inland Revenue and to an officer of the Board of Inland Revenue into references to the Inland Revenue. See *Change* 149 in Annex 1.

2983. Subsection (5)(a) expresses the time limit by reference to the normal Self Assessment rules.

Section 801: Time limit on adjustment of assessment

2984. This section allows adjustments to be made to assessments within a certain time to give effect to rent-a-room elections or withdrawals of elections. It is based on paragraphs 10 and 12 of Schedule 10 to F(No 2)A 1992.

2985. *Subsection (2)* expresses the time limit by reference to the normal Self Assessment rules.

Section 802: Minor definitions

2986. This section provides interpretation for terms not defined elsewhere. It is based on paragraphs 9 and 11 of Schedule 10 to F(No 2)A 1992 and paragraph 86 of Schedule 2 to CAA.

Chapter 2: Foster-care relief

Overview

2987. The sections in this Chapter are based on section 176 of and Schedule 36 to FA 2003. These provisions are entitled "Foster carers" in the source legislation.

2988. They give relief in one of two forms for individuals who provide foster care. One form is complete tax exemption for their foster-care income provided their gross receipts do not exceed a certain level - the “full” form of relief. If gross receipts do exceed that level the income is taxable. But taxpayers can choose to have it calculated by deducting a fixed amount as expenses, rather than their actual expenses, if that is advantageous - the “alternative method of calculation” form of the relief.

2989. Foster-care relief shares certain features with rent-a-room relief (see Chapter 1 of this Part) on which the source legislation was modelled.

Section 803: Overview of Chapter 2

2990. This section introduces the relief. It is based on paragraph 1 of Schedule 36 to FA 2003.

2991. *Subsection (2)* introduces the key factor in determining the form of relief available: the level of gross foster-care receipts, that is receipts before any deductions for expenses.

2992. *Subsection (3)* introduces the full form of the relief where gross receipts are modest: they are simply not charged to tax.

2993. *Subsection (4)* introduces the alternative method of calculation form of the relief where gross receipts are larger.

2994. Not all taxpayers prepare accounts to 5 April. *Subsection (5)* alerts the reader to the fact that special rules apply in that case.

2995. The nature of the activity requires a rather different approach to capital allowances than that in rent-a-room. *Subsection (5)(b)* introduces the special provisions.

Section 804: Person who qualifies for relief

2996. This section states the basic condition that an individual must satisfy to obtain the relief. It is based on paragraph 2 of Schedule 36 to FA 2003.

2997. *Subsection (1)* is a general condition that is satisfied only if the taxpayer claiming foster-care relief satisfies the more detailed conditions in the sections that follow.

2998. *Subsection (1)(b)* refers to an “arrangement” as well as a trade. This covers cases where the foster care does not amount to a trade and where any profits from it would be taxed, in the source legislation, under Schedule D Case VI as profits from the contractual provision of services.

2999. Subsection (1)(b) prevents relief in cases where the foster care that would otherwise qualify for relief is combined with activities that would not. In so doing it limits the relief to the simpler cases.

Section 805: Meaning of “foster-care receipts”

3000. This section defines “foster-care receipts”. It is based on paragraph 3 of Schedule 36 to FA 2003.

Section 806: Meaning of providing foster care

3001. This section explains what is meant by references in this Chapter to the provision of foster care. It is based on paragraph 4 of Schedule 36 to FA 2003.

3002. Foster care is regulated by a number of non-tax laws. These are cited in the source legislation as a part of the qualifying conditions to benefit from the relief: an individual will qualify only if he or she is a foster carer by virtue of those non-tax laws.

3003. *Subsections (3)* and *(4)* list the relevant non-tax tax laws. They do not reproduce the references in paragraph 4(3)(a) and (b)(i) of Schedule 36 to FA 2003 to the particular provision of the regulations at 9 April 2003. Those references are of no substantive effect and if the regulations are altered the references will not be helpful.

Section 807: Calculation of "total foster-care receipts"

3004. This section clarifies the meaning of a key term, "total foster-care receipts". It is based on paragraph 5 of Schedule 36 to FA 2003.

3005. "Total foster-care receipts" is a key term because the level of an individual's "total foster-care receipts" determines which form of relief the individual is entitled to: full relief or the alternative method of calculation.

Section 808: The individual's limit

3006. This section defines the individual's "limit" for the tax year. It is based on paragraphs 7 and 9 of Schedule 36 to FA 2003.

3007. This section is the first of a group of four sections which explain how to work out an individual's limit for a tax year. The "limit" is the maximum amount of foster-care income that is not charged to tax. It is the amount with which the taxpayer's "total foster-care receipts" are compared to determine which type of relief is due.

3008. *Subsection (1)* introduces the two elements that make up the limit. One is a fixed amount (apportioned between foster carers in a single residence) and the other varies according to the number and ages of the children fostered.

Section 809: Share of fixed amount: residence used by more than one foster carer

3009. This section reduces the fixed amount when a residence is used by more than one foster carer. It is based on paragraph 7 of Schedule 36 to FA 2003.

3010. *Subsection (2)* apportions the fixed amount equally between each foster carer in the same residence.

3011. *Subsections (3)* and *(4)* define "residence". The definition refers to a "caravan or houseboat". There is an Act-wide definition of "caravan": see the commentary on section 875 of this Act and *Change 148* in Annex 1.

3012. There is also an Act-wide definition of "houseboat": see the commentary on section 878(1) of this Act and *Change 150* in Annex 1.

Section 810: Share of fixed amount: income period not a year

3013. This section reduces the fixed amount when the foster-care period is for less than a year. It is based on paragraph 7 of Schedule 36 to FA 2003.

3014. *Subsection (2)* makes it clear that the reduction applies to an individual's *share* of the fixed amount if section 809 applies because there is more than one foster carer in the same residence.

Section 811: The amount per child

3015. This section determines the variable component in calculating the individual's "limit" for the tax year: "the amount per child". It is based on paragraphs 8 and 9 of Schedule 36 to FA 2003.

3016. The amount per child for a tax year depends on the duration of the foster care and the age of the child fostered.

3017. The duration of the foster care is measured in weeks. *Subsections (4)* to *(6)* give rules that identify relevant weeks.

Section 812: Full foster-care relief: introduction

3018. This section provides for the full form of the relief when the individual's foster-care receipts do not exceed his or her limit. It is based on paragraph 10 of Schedule 36 to FA 2003.

3019. The reference to the limit is in terms that make it clear that foster-care receipts that equal the individual's limit are within the full relief.

3020. The majority of foster carers who are trading prepare accounts to 5 April. There are special rules for those who do not, which are located later in the Chapter. *Paragraph (c)xcludes such cases from the main full relief provisions and signposts the reader to the other relevant provisions.*

Section 813: Full foster-care relief: trading income

3021. This section authorises the full form of the relief when the foster-care income is trading income. It is based on paragraph 10 of Schedule 36 to FA 2003.

Section 814: Full foster-care relief: income chargeable under Chapter 8 of Part 5.

3022. This section authorises the full form of the relief when the income derives from foster care that does not amount to a trade. It is based on paragraph 10 of Schedule 36 to FA 2003.

3023. *Subsection (2)* limits the effect of the relief to the foster-care income and associated expenses.

Section 815: Alternative calculation of profits: introduction

3024. This section is the first of five sections that provide for the alternative form of the relief. It is based on paragraph 11 of Schedule 36 to FA 2003.

3025. The alternative calculation form of the relief applies when the individual's foster-care receipts exceed his or her limit.

3026. Unlike the full form of the relief the alternative calculation form applies only if the individual elects for it.

3027. As in the case of the full form of the relief (see the commentary on section 812) there are special rules for those who do not prepare trading accounts to 5 April. These are located later in the Chapter.

Section 816: Alternative calculation of profits: trading income

3028. This section sets out the basis of calculation when the foster-care income is trading income and it exceeds the individual's limit. It is based on paragraph 12 of Schedule 36 to FA 2003.

Section 817: Alternative calculation of profits: income chargeable under Chapter 8 of Part 5

3029. This section sets out the basis of calculation when the income is from foster care that does not amount to trading and it exceeds the individual's limit. It is based on paragraph 13 of Schedule 36 to FA 2003.

Section 818: Election for alternative method of calculating profits

3030. This section provides for a foster carer to elect for the alternative form of the relief. It is based on paragraph 14 of Schedule 36 to FA 2003.

3031. This section also provides explicitly for a procedure to withdraw an election within the stated time limit. The absence of such a procedure in the source legislation for foster-care relief is in contrast to the source legislation for rent-a-room on which the former is otherwise closely modelled. It was not considered necessary in the source foster-care relief legislation because, unlike the rent-a-room relief election, a foster-care relief election is made only for one year. It was implicit in the year by year approach that the foster-care election could be withdrawn within the Self Assessment time limits by, for example, an amendment to a return. This Part puts these similar reliefs side by side and a contrast in approach might wrongly suggest a different intended legal effect. To make the position clear this section provides explicitly for the withdrawal of an election.

3032. *Subsection (2)* makes it clear that the election applies only to the year for which it is made.

3033. *Subsection (3)* converts references, in the source legislation, to the Board of Inland Revenue into references to the Inland Revenue. See *Change* 149 in Annex 1.

Section 819: Adjustment of assessment

3034. This section provides for an election for the alternative form of relief to be made following an adjustment to an individual's return of foster-care profit. It is based on paragraph 14 of Schedule 36 to FA 2003.

3035. Without this section an individual might be prevented from electing for the alternative form of relief if his or her return of foster-care profits were adjusted after the normal election time limit in section 818.

3036. *Subsection (3)* makes it clear that the election applies only to the year for which it is made.

3037. *Subsections (3)* and *(4)* follow the approach described in the commentary on section 818 in providing for the withdrawal of an election under this section.

Section 820: Periods of account not ending on 5th April

3038. This section is the first of four sections that deal with cases where the foster-care activities amount to a trade and accounts are prepared to a date other than 5 April. It is based on paragraph 15 of Schedule 36 to FA 2003.

3039. The rules that apply to this sort of case have been extracted from the main body of the rules and grouped together in a place of less prominence as they are believed to apply only to a minority of foster carers.

Section 821: Meaning of "relevant limit"

3040. This section introduces and defines the term "relevant limit". It is based on paragraph 15 of Schedule 36 to FA 2003.

3041. For cases where the foster-care activities amount to a trade and accounts are prepared to a date other than 5 April, the amount with which the individual's total foster-care receipts are compared to determine what form of relief is available is the individual's "relevant limit" (and not, as normally, "the limit"). The calculation of the relevant limit reflects the fact that the basis period of the trade will not coincide with the periods (tax years) for which the "fixed amount" and the "amount per child" are determined. This section give rules to link the "fixed amount" and the "amount per child" for tax years to basis periods.

Section 822: Full relief

3042. This section provides for full relief in "accounting date other than 5 April" cases. It is based on paragraph 15 of Schedule 36 to FA 2003.

3043. It achieves the same effect for these cases as section 812 and section 813 together achieve for other cases.

Section 823: Alternative method of calculating profits

3044. This section provides for the alternative form of relief in "accounting date other than 5 April" cases. It is based on paragraphs 14 and 15 of Schedule 36 to FA 2003.

3045. It achieves the same effect for these cases as section 815 and section 816 together achieve for other cases.

3046. *Subsection (3)* applies the election and adjustment of assessment provisions in section 818 and section 819. In so doing it imports (through section 818(3) and section 819(4)) the conversion of references, in the source legislation, to the Board of Inland Revenue into a reference to the Inland Revenue. See *Change 149* in Annex 1. It expresses the time limits by reference to the Self Assessment rules.

Section 824: Capital allowances: introduction

3047. This section is the first of four sections that deal with the capital allowances aspects of foster-care relief. It is based on paragraphs 16 and 20 of Schedule 36 to FA 2003.

3048. The section introduces key terms and links the language of this Chapter with that of CAA: the language and concepts have to link directly with those of CAA. The "chargeable period" mentioned in *subsection (2)(a)* is an example. In CAA "chargeable period" does not necessarily mean, for individuals, "tax year". It can mean (for trades) "period of account" (section 6(1) of CAA). *Subsection (3)* provides the link so that the provisions work properly.

3049. The overall effect of the four capital allowances sections is that, in tax years when either form of foster-care relief applies, capital allowances and balancing charges are not relevant.

3050. Unlike paragraph 16 of Schedule 36 to FA 2003, the capital allowances sections in this Chapter make no reference to the rules that apply when the foster care does not amount to a trade and the foster-care receipts are chargeable under Schedule D Case VI. That is because an arrangement to provide foster care is not a qualifying activity within section 15(1) of CAA and therefore the question of capital allowances and balancing charges cannot arise.

3051. Dropping these references will have no practical effect because entitlement to an allowance or liability to a balancing charge does not arise from Schedule 36 to FA 2003 but from CAA. The references in Schedule 36 to FA 2003 are, however, potentially confusing and removing them makes the rewritten legislation clearer.

Section 825: Carried forward unrelieved qualifying expenditure

3052. This section provides for the temporary suspension of allowances and charges in respect of pool expenditure during tax years when foster-care relief applies. It is based on paragraph 17 of Schedule 36 to FA 2003.

3053. *Subsection (3)* deals with the transition from a year when foster-care relief does not apply to a year when it does.

3054. *Subsection (4)* deals with the transition from a year when foster-care relief does apply to a year when it does not.

Section 826: Excluded capital expenditure

3055. This section prevents an allowance for capital expenditure incurred at a time when foster-care relief applies. It is based on paragraph 18 of Schedule 36 to FA 2003.

Section 827: Excluded capital expenditure: subsequent treatment of asset

3056. This section provides for an allowance, when foster-care relief ceases to apply, in respect of capital expenditure incurred at a time when foster-care relief did apply (and for which therefore no allowance was due in accordance with section 826). It is based on paragraph 19 of Schedule 36 to FA 2003.

Section 828: Overlap profit

3057. This section preserves entitlement to overlap relief when the foster-care activities are a trade. It is based on paragraphs 10 and 15 of Schedule 36 to FA 2003.

3058. *Subsection (2)(a)* allows relief for overlap profit against foster-care profits calculated under the rules in this Part. That may include relief for overlap profit that was created before the introduction of foster-care relief. If foster-care profits are treated as nil (because full foster-care relief under section 813 or section 822 applies) the overlap relief can create a loss.

3059. *Subsection (2)(b)* allows the creation of overlap profit when the foster-care alternative basis of calculation applies (no overlap profit can be created when full foster-care relief applies). The overlap profit is calculated by reference to the profit after the foster-care rules have applied.

Part 8: Foreign income: special rules

Overview

3060. This Part contains rules that may affect the calculation of income charged under this Act or under Parts 9 or 10 of ITEPA.

3061. In the source legislation for this Act, income arising outside the United Kingdom is charged to income tax mainly under Schedule D Cases IV and V (section 18 of ICTA sets out the Cases of Schedule D). But some foreign income may be taxed under Schedule D Case VI or under a non-schedular charge if the provision covers both U K and non-UK income. And profits made by the foreign branch of a UK trade, profession or vocation are charged under Schedule D Cases I and II, and are not foreign income (see sections 6(1) (trade profits: territorial scope of charge to tax) and 7(5) (trade profits: income charged)).

3062. The term “foreign income” has not been used in the Tax Acts (other than as part of the obsolescent term “foreign income dividends”), and it does not have any clear or defined meaning. Chapter 1 of this Part of this Act introduces the label “relevant foreign income” to describe the income and other amounts charged to income tax in this Act that are charged under Schedule D Cases IV or V in the source legislation. That income is charged in this Act alongside the equivalent UK income (with the exception of dividends from non-UK resident companies (Chapter 4 of Part 4 of this Act)).

3063. A number of special rules apply to relevant foreign income. Rather than repeat the rules in every place where they apply, the rules are rewritten in this Part. The “income charged” sections for any charge that includes relevant foreign income incorporates the rules by making the main calculation rule in that section subject to this Part. For example, see section 7(4) (trade profits: income charged).

3064. Chapter 4 of this Part of this Act has a potentially wider application than Chapters 2 or 3 of this Part, as it can apply to all income arising outside the United Kingdom rather than just relevant foreign income.

3065. There are a number of charges under Parts 9 (pension income) and 10 (social security income) of ITEPA that, before being rewritten in ITEPA, were charges under Schedule D Case V. See sections 573, 609 to 611, 629, 633 and 678 of ITEPA. The amount of income charged under those provisions is calculated by reference to certain rules in ICTA, some of which are rewritten in this Part. Schedule 1 to this Act amends the ITEPA provisions for calculating income under those charges to provide an "income charged" rule and to deem the income in question to be relevant foreign income for the application of rules in this Part of this Act (see paragraphs 606 to 609 and 613 of that Schedule).

3066. Unless the remittance basis applies (see Chapter 2 of this Part of this Act), or the income arises from a trade, profession or vocation (see section 7 (trade profits: income charged)), the amount of relevant foreign income charged for a tax year is the income arising in the year. This rule is based on section 65(1) of ICTA and forms part of the basis of each "income charged" provision in this Act for relevant foreign income. See, for example, section 403 (dividends from non-UK resident companies). Where a charge includes both relevant foreign income and equivalent UK income the same rule serves for both. See, for example, section 370 (interest: income charged).

3067. The "income charged" provisions do not rewrite the words "whether the income has been or will be received in the United Kingdom" from section 65(1) of ICTA.

3068. Before FA 1914, the remittance basis was the only basis of assessment for income within Schedule D Cases IV and V. It applied to all UK residents and not just to those persons who were non-UK domiciled, or were both not ordinarily resident in the United Kingdom and were either Commonwealth or Irish citizens (as necessary for a claim under section 65(4) of ICTA). FA 1914 took certain Schedule D Cases IV and V income out of the remittance basis and that income was taxed thereafter on the arising basis.

3069. The words "whether the income has been or will be received in the United Kingdom" were included in the 1914 legislation to emphasise that income within Schedule D Cases IV and V was now chargeable to tax, whether or not the income had been remitted to the United Kingdom. That emphasis is no longer needed.

3070. In the source legislation the basis for charging income arising in the Republic of Ireland is provided as follows:

- income from trades, professions or vocations: section 68(3) and (4) of ICTA;
- income from property: section 65A of ICTA;
- other Schedule D Case IV or V income: section 68(1) of ICTA; and
- pension income: Part 9 of ITEPA, but the rules in section 68 of ICTA apply.

3071. Parts 2 and 3 of this Act integrate the rules in sections 68(3) and (4) and 65A of ICTA in respect of trade profits and property business income arising in the Republic of Ireland with the rules for other such income.

3072. The wording of section 68(1) of ICTA is identical in all material respects to section 65(1) of ICTA. The "income charged" provisions for relevant foreign income charged on the arising basis, in Parts 4 and 5 of this Act, are based on both sections 65(1) and 68(1) of ICTA. Likewise, the deductions provided by Chapter 3 of this Part are based on both sections 65 and 68 of ICTA.

3073. See also Chapter 2 of Part 10 of this Act for further rules that may affect the calculation of income arising outside the United Kingdom charged on the arising basis.

Chapter 1: Introduction

Overview

3074. This Chapter sets out the content of Part 8 and provides a definition of "relevant foreign income" for this Act.

Section 829: Overview of Part 8

3075. This section is new.

Section 830: Meaning of "relevant foreign income"

3076. This section is based on section 18 of ICTA. The main provisions in this Act which apply to relevant foreign income (apart from numerous charges to tax and "income charged" sections) are:

- section 771: exemption for relevant foreign income of consular officials and employees;
- Chapter 2 of this Part: relevant foreign income charged on remittance basis; and
- Chapter 3 of this Part: relevant foreign income charged on arising basis: deductions and reliefs.

3077. To be "relevant foreign income", income must arise from a source outside the United Kingdom, and be chargeable under one of the provisions listed in *subsection (2)*. (See also the definition of "income" in section 878(1), by virtue of which "income" includes amounts treated as income. A number of the provisions listed in subsection (2) include such income; for example, see Chapter 8 of Part 4 of this Act.)

3078. The definition is based on words in section 18(3) of ICTA:

- "tax in respect of income arising from securities out of the United Kingdom" (Schedule D Case IV); and
- "tax in respect of income arising from possessions out of the United Kingdom" (Schedule D Case V).

3079. Section 18(1) and (3) of ICTA require that, for an amount to fall within the charge under those Cases, as opposed to another charging provision, it has to be (a) income, (b) which arises from, (c) securities or possessions, (d) out of the United Kingdom and (e) is not charged in priority under another Schedule of ICTA or under ITEPA.

3080. Case law establishes that "securities" are a sub-set of "possessions". The definition of "relevant foreign income" does not maintain any distinction between income which, in the source legislation, is within Schedule D Case IV and income which is within Schedule D Case V.

3081. The definition uses "source" rather than "possessions" (the expression in Schedule D Case V). "Possessions", in the context of Schedule D Cases IV and V, appeared in the first income tax Act of 1799 when the word carried associations with, in particular, colonial property that it no longer has. The definition employs the more widely used term "source".

3082. The meaning of "possessions" in Schedule D Case V has been interpreted by case law. It covers any and every source of income arising outside the United Kingdom. Income charged to tax under Schedule D Cases IV and V by virtue only of section 18(3) of ICTA (that is, excluding amounts treated as income by another provision in the source legislation and charged under Schedule D Case IV or V) has an identifiable source.

3083. In Colquhoun v Brooks (1889), 2 TC 490 HL (where the subject was how to tax a partner's share of a foreign trade), Lord Macnaghten dealt with the meaning of "possessions" in terms of a source of income (page 508):

"Turning now to the "fifth case," I ask why are not the Respondent's profits and gains from his Melbourne business within the "fifth case"? What is the meaning of the term "possessions" in that case? The word "possessions" is not a technical word. It seems to me that it is the widest and most comprehensive word that could be used. Why, for instance, should not possessions in Ireland mean everything, every source of income that the person chargeable has in Ireland, whatever it may be? Why should not "profits from possessions out of Great Britain," which is to be found in Schedule G., No. XI., and recalls the expression "income out of Great Britain" in the Act of 1799, mean profits from every source of income abroad? I use the expression "source of income" because it is as a source of income that the Act contemplates and deals with property and everything else that a person chargeable under the Act may have, and the Act itself, in section 52, uses the expressions "sources chargeable under the Act" and "all the sources contained in the said several schedules" as describing everything in respect of which the tax is imposed.

3084. There were at that time no income tax charges on amounts treated as income. But the scope of Schedule D Cases IV and V has since been extended by provisions which charge to income tax, within one or other of the Cases, a profit or gain which would not otherwise be income arising from a security or from possessions within section 18(3) of ICTA. That is, on first principles it would be a capital profit or receipt. Such chargeable amounts could not therefore be said to derive from a "source" in the traditional sense. In Walker v Centaur Clothes Group Ltd (2000), 72 TC 379 HL[17], Lord Hoffmann commented (page 416):

"Income tax is traditionally a source-based annual tax, liability depending upon the existence of a source of income falling under one of the Schedules during the year of assessment (see *Brown* (*Surveyor of Taxes*) *v National Provident Institution* [1921] 2 AC 222, 8 TC 57).

If the income tax had retained that ancient simplicity, it would be true to say that income could not be within the charge to tax unless there was a source within the charge and a person could not be within the charge unless he had a source of income within the charge. But that would be because of the nature of the income tax and not anything in the language of the definition.

It is, however, no longer true to say that liability to income tax depends upon the existence during the year of assessment of a source within the charge. There are cases (such as post-cessation receipts) when liability depends upon the existence of income defined by reference to a source which does not exist within the year of assessment. Or liability may depend upon an event, such as a balancing charge on the sale of an asset which has attracted a capital allowance, or the receipt of a capital sum from a particular kind of transaction, which is deemed to be taxable income received in that year of assessment or sometimes spread over several years of assessment.

3085. Although the definition uses "income which arises from a source" in respect of all income within the definition, specific rules have been added, in view of Lord Hoffmann's remarks, in sections 428(3) (deeply discounted securities) and 658(2) (beneficiaries' income from estates in administration), to attribute a foreign source to the income in question to ensure that there is no doubt that the definition applies to these provisions.

3086. Subsection (2) lists by Chapter or section the provisions in this Act that charge income and other amounts which the source legislation charges under Schedule D Cases IV or V. Where a Chapter contains more than one charge and only one of those charges applies to relevant foreign income, the section applying that charge has been specified – for example, see section 579 (charge to tax on royalties and other income from intellectual property). Chapter 2 of Part 4 of this Act has been included in full because, if any interest from a registered industrial and provident society is foreign interest, although it is not charged under Cases IV and V in the source legislation, it is treated by the Act as relevant foreign income. See *Change 131* in Annex 1.

3087. *Subsection (3)* eliminates income that would otherwise be within the definition of "relevant foreign income" because it is charged under one or other of the provisions

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listed in subsection (2) in accordance with section 844. In the source legislation, such income is charged under Schedule D Case VI. This subsection is based on section 584(4) of ICTA.

Chapter 2: Relevant foreign income charged on remittance basis

Overview

3088. This Chapter provides an alternative to the arising basis for calculating the charge on relevant foreign income where a claim is made by an eligible claimant. It is based on section 65 of ICTA. The well-known term "remittance basis" is used in the Chapter heading and section headings but not in the sections themselves.

3089. The term is also used in section 878(2) (other definitions). The definition in that section applies for the purpose of the expression "a person to whom the remittance basis applies" (see, for example, sections 357 (charge to tax on overseas property income) and 857 (partners to whom the remittance basis may apply)).

3090. The Chapter includes a relief for "delayed remittances", based on section 585 of ICTA.

Section 831: Claims for relevant foreign income to be charged on the remittance basis

3091. This section is based on sections 65 and 68 of ICTA. If a claim is made under this section neither Chapter 3 nor Chapter 4 of this Part applies to the claimant's income for that year. (Those Chapters deal respectively with relevant foreign income charged on the arising basis (deductions and reliefs) and with unremittable income.)

3092. A claim under this section is for the remittance basis to be applied for a tax year rather than (as in the source legislation) a claim for a purely personal status from which the remittance basis flows for that year.

3093. A claim is made for a particular tax year. The claim is an annual claim. In the source legislation, a claim has to be made to the Board of Inland Revenue. In practice, it is usually made by applying the remittance basis in making the claimant's self assessment. The section reflects this practice and does not require the claim to be made either to the Board or to the Inland Revenue. (Those terms are defined in section 878(1).) See *Change 149* in Annex 1.

3094. *Subsections (2)* to *(4)* set out the conditions for a valid claim. In the source legislation condition B has a further requirement, that the claimant is a Commonwealth citizen or a citizen of the Republic of Ireland. That requirement is not rewritten. See *Change 132* in Annex 1.

3095. Income arising in the Republic of Ireland is never charged on the remittance basis, so such income is excluded from a claim under this section.

Section 832: Relevant foreign income charged on the remittance basis

3096. This section is based on section 65 of ICTA.

3097. The source legislation has separate rules for calculating the amount of income charged on the remittance basis under Schedule D Case IV and under Case V. As there is no significant difference in these bases in practice no such distinction is made in this section. See *Change 133* in Annex 1.

3098. The words "in respect of relevant foreign income" have been included, indicating that the sums received should either comprise the relevant foreign income in question, or represent that income. Lord Radcliffe said in Thomson v Moyse (1960), 39 TC 291 HL (page 335):

"No doubt proper construction of those words [sums received] require that the sums computable must be "of" the income, by which I would understand "sums of money derived from the application of the income to achieving the necessary transfer".

3099. Generally, relevant foreign income charged on the remittance basis is charged on the full amount of sums received in the United Kingdom without any deductions. However, the source legislation (tail words of section 65(5)(b) of ICTA) permits such deductions as are allowed under the Income Tax Acts in respect of profits chargeable under Schedule D Case I, that is, income from a trade but not from a profession or vocation.

3100. *Subsections (3)* and *(4)* also apply the deductions to income from a profession or vocation carried on wholly abroad. This recognises that, in the context of income arising in the United Kingdom, the calculation of income from professions and vocations uses the trading income calculation rules. See *Change 134* in Annex 1.

3101. Paragraph 150 of Schedule 2 to this Act ensures that the remittances taxed by virtue of this section may include income which arose before the tax year 2005-06.

Section 833: Income treated as remitted: repayment of UK-linked debts

3102. This section contains anti-avoidance measures to defeat the practice of taking out loans in the United Kingdom and subsequently arranging for the debt to be transferred abroad and repaid out of unremitted relevant foreign income. It is based on section 65(6) to (9) of ICTA.

3103. The source legislation has already been rewritten for the purposes of employment income. See section 33 of ITEPA.

Section 834: Arrangements treated as repayment of UK-linked debts

3104. This section supplements section 833 and deals with indirect methods of repaying UK-linked debts using relevant foreign income. It is based on section 65(8) and (9) of ICTA.

3105. *Subsection (4)* extends the usual meaning of lender to include any person for the time being entitled to repayment (i.e. not necessarily the person who lent the money).

Section 835: Relief for delayed remittances

3106. This section allows income chargeable to tax for a tax year on the remittance basis to be reduced by sums which, for reasons outside the taxpayer's control, could not be remitted in an earlier tax year ("delayed income"). Those sums are then treated as remitted in the year in which they arose and taxed for that year. The section is based on section 585 of ICTA.

3107. Paragraph 151(1) of Schedule 2 to this Act ensures that a claim under this section covers income which arose in a tax year before 2005-06.

3108. A claim may be made in respect of some or all of the delayed remittances. See *Change 136* in Annex 1.

3109. Condition B, for income being delayed income, refers to the impossibility of obtaining currency in the territory in question and makes explicit that this means currency that can be transferred to the United Kingdom (whether the currency of that or another territory). See *Change 135* in Annex 1.

3110. The source legislation refers to "foreign currency". This means a currency other than the currency of the territory in question. Since the *local* currency must be obtainable, it is superfluous to add that currency not obtainable is 'foreign'.

3111. The requirement in the source legislation, that the inability to transfer the income to the United Kingdom was not due to any want of reasonable endeavours on the part of the claimant, is omitted. See *Change 135* in Annex 1.

3112. For periods preceding Self Assessment the basis year may be different from the tax year. Section 585(3) to (5) of ICTA contains rules which cater for that possibility. By 2005-06 no claim will be possible for a period preceding Self Assessment. For periods of Self Assessment the basis period is always the tax year, whether the amount chargeable is calculated by reference to the income arising or remitted. The rules in section 585(3) to (5) of ICTA have therefore not been rewritten in this Chapter. (But see paragraph 151 of Schedule 2 to this Act, which applies the rules where a claim is made under this Chapter and the tax year in which the income arose was 1996-97 or earlier.)

Section 836: Relief for delayed remittances: backdated pensions

3113. This section is based on section 585(2) of ICTA. It provides relief under section 835 for pension arrears charged under Part 9 of ITEPA. Paragraphs 606, 607 and 609 of Schedule 1 to this Act amend the relevant provisions of ITEPA to treat the income as relevant foreign income, so that the provisions of this Part may apply to such income.

3114. Arrears of pension income do not *arise* before the pension etc is granted, even if the grant is retrospective. So, but for this section, arrears of pension income would not meet condition A for delayed income in section 835 for all years before the year for which relief is claimed.

3115. *Subsection (3)* disapplies condition B for income being delayed income in section 835 for any period before the arrears become payable.

Section 837: Claims for relief on delayed remittances

3116. This section provides administrative rules for claims for relief under section 835. It is based on section 585 of ICTA.

Chapter 3: Relevant foreign income charged on arising basis: deductions and reliefs

Overview

3117. This Chapter provides certain deductions and a relief that may affect the calculation of the amount of relevant foreign income charged on the arising basis. "Relevant foreign income" is defined for these purposes in section 830.

3118. The deductions are of limited scope. They were introduced in FA 1914, when the remittance basis was withdrawn from most types of Schedule D Cases IV and V income for persons domiciled and ordinarily resident in the United Kingdom.

Section 838: Expenses attributable to collection or payment of relevant foreign income

3119. This section is based on section 65(1) of ICTA. The source legislation makes deductions available only to income not received in the United Kingdom. But in practice the deductions are given whether or not the income in question has been received in the United Kingdom. This section reflects practice, so the words "subject in the case of income not received in the United Kingdom" are not rewritten. See *Change 137* in Annex 1.

3120. The source legislation does not identify exactly what deductions are envisaged. The words used "the same deductions and allowances as if [the income] had been received [in the United Kingdom]" date from FA 1914 when taxpayers found their income taxed on the arising rather than the remittance basis. But it is an unhelpful analogy because the remittance basis does not allow any deductions (except in the case of trading income

– see section 65(3) of ICTA). Rather than relying on an analogy, the section therefore specifies the deductions intended. This includes, for example, banking costs involved in the collection and forwarding of dividends. See *Change 138* in Annex 1.

3121. The section applies to all relevant foreign income, including trading profits within the definition of that term. It does not rewrite the restriction in section 65(3) of ICTA denying these deductions to such trading profits. See *Change 138* in Annex 1.

3122. See also Chapter 2 of Part 10 of this Act for further rules that may qualify the deductions available under this section.

Section 839: Annual payments payable out of relevant foreign income

3123. This section is based on section 65(1) of ICTA.

3124. By virtue of *subsection (3)*, which refers to a payment that "would have been chargeable" to tax under certain provisions, the range of annual payments falling within condition B is in fact reduced by any that are within the exemption provided by section 727 (certain annual payments by individuals).

3125. *Subsection (6)* reflects differences in the source legislation between the rules for calculating income arising in the Republic of Ireland and those for calculating other relevant foreign income.

Section 840: Relief for backdated pensions charged on the arising basis

3126. This section is new. It enacts ESC A55, but adopts the method used in section 836 (and the administrative rules in section 837) as a model for providing relief. That is, the income is treated as arising in an earlier year than the year in which it in fact arose, rather than a tax adjustment being made in the later year. See *Change 139* in Annex 1.

3127. Paragraph 152 of Schedule 2 to the Act ensures that an earlier tax year to which income is attributed because of a claim under this section covers a tax year before 2005-06.

Chapter 4: Unremittable income

Overview

3128. This Chapter provides relief from income tax if income arising in a territory outside the United Kingdom cannot be remitted to the United Kingdom. The Chapter also invokes the relevant charges outside Part 8 of this Act to withdraw relief if such income ceases to be unremittable. And it explains how unremittable income is to be valued where no claim is made for the relief. The relief applies only to income charged on the arising basis so does not apply to income charged on the remittance basis (Chapter 2 of this Part). The Chapter is based on section 584 of ICTA.

3129. The Chapter applies to "income arising in a territory outside the United Kingdom". This is a wider term than relevant foreign income. So the relief may apply, for example, to some of the income charged in the source legislation under a non-schedular charge or under Schedule D Case VI. (Chapter 13 of Part 2 of this Act provides an equivalent relief in respect of unremittable receipts of a trade, profession or vocation. And section 272 (profits of a property business: application of trading income rules) applies that Chapter for the purposes of Part 3 of this Act.)

3130. The Chapter does not rewrite the appeal jurisdiction rules in section 584(9) of ICTA. An appeal on the application of the section may therefore be heard by General Commissioners (and the taxpayer retains the right to elect for a hearing by the Special Commissioners). See *Change 142* in Annex 1. (But paragraph 153(3) and (4) of Schedule 2 to this Act preserve the rules in section 584(9) of ICTA if the appeal involves income that arose in a tax year before 2005-06.)

3131. Paragraph 153(1) and (2) of Schedule 2 to this Act ensure that the Chapter applies for 2005-06 and later tax years even though the income in question arose in an earlier tax year.

Section 841: Unremittable income: introduction

3132. This section is based on section 584 of ICTA.

3133. The source legislation refers to "foreign currency". This means a currency other than the currency of the territory in question. Since the *local* currency must be obtainable, it is superfluous to add that currency not obtainable is 'foreign'.

3134. Condition A for unremittable income refers to the impossibility of obtaining currency in the territory in question and makes explicit that this means currency that can be transferred to the United Kingdom (whether the currency of that or another territory). See *Change 135* in Annex 1.

3135. The requirement in the source legislation, that the inability to transfer the income to the United Kingdom was not due to any want of reasonable endeavours on the part of the claimant, is omitted. See *Change 135* in Annex 1.

Section 842: Claim for relief for unremittable income

3136. This section is based on section 584 of ICTA.

3137. *Subsection (1)* provides that unremittable income is not taken into account for income tax purposes. This means primarily that it is omitted from taxable income in the year in which it arises.

3138. *Subsection (4)* defines an Export Credit Guarantee Department payment ("ECGD payment"). The statutory references in the source legislation have been updated. As section 13(1) of the Export and Investment Guarantees Act 1991 delegates the functions of the Secretary of State under section 2 of the 1991 Act to the Export Credits Guarantee Department, the role of that Department (rather than the Secretary of State) in administering this scheme is recognised.

3139. *Subsection (5)* sets out the time limit for making a claim under this section. The time limit is tied to the tax year for which the income would otherwise be chargeable, rather than to the tax year in which the income arises (as in the source legislation). This brings the time limit into line with the normal time limit for claims. See *Change 140* in Annex 1.

Section 843: Withdrawal of relief

3140. This section brings together the consequences both of unremittable income becoming remittable and of a payment being made by the Export Credits Guarantee Department. It is based on section 584 of ICTA.

3141. *Subsections (3)* to *(5)* set out when, and at what value, income ceasing to be unremittable is treated as arising. Income so treated as arising is charged under the provision appropriate to the income type (or types) that would otherwise have applied to the income when it arose. (Section 844 provides rules for charging income if the source of the income has ceased before the tax year in which it is treated under this section as arising.)

3142. Subsection (4) provides that, when an ECGD payment is made, income is treated as arising at that time, to the extent of the payment. This reflects the intention of the legislation as originally drafted. Amendments made by FA 1996 obscured the point. See *Change 141* in Annex 1.

3143. *Subsection (6)* indicates that subsections (3) to (5) do not apply if the income has otherwise been treated as arising as a result of this section. For example, if relief has been withdrawn because an ECGD payment is received, there is no further charge under this section – to the extent of that payment – if the income itself subsequently becomes remittable.

Section 844: Income charged on withdrawal of relief after source ceases

3144. The section is based on section 584 of ICTA.

3145. It provides that, where relief given under this Chapter cannot be withdrawn in accordance with section 843, because the trade, profession, vocation or property business in question has permanently ceased, the amount in respect of which relief is withdrawn is dealt with as a post-cessation receipt under the relevant Chapter of Part 2 or Part 3 of this Act. For other unremittable income becoming remittable, the section provides that the income should be taxed as if the source had not ceased.

3146. See *Change 22* in Annex 1.

3147. Income charged by virtue of this section is not "relevant foreign income", as defined in section 830 (see subsection (3) of that section). In the source legislation, the charge is under Schedule D Case VI (rather than Schedule D Cases IV or V). The potential relevance of such income to relief under section 392 of ICTA (Case VI losses) has been preserved by the appropriate entry in section 836B of ICTA (introduced by paragraph 340 of Schedule 1 to this Act).

Section 845: Valuing unremittable income

3148. This section is based on section 584 of ICTA.

Part 9: Partnerships

Overview

3149. This Part of the Act contains the rules that apply to partnerships.

3150. Section 1 of the Partnership Act 1890 defines partnership as "the relation which subsists between persons carrying on a business in common with a view of profit". Section 4 of the Partnership Act 1890 explains that "firm" is the term used for the purposes of that Act for persons in partnership.

3151. The sections in this Act follow the Partnership Act 1890 and refer to the partners collectively as a "firm". But the word "partnership" is commonly used as a synonym for "firm". So the title of the Part and some of the titles of the sections use the word "partnerships", again following the lead of the Partnership Act 1890.

3152. The rules in this Part of the Act determine each partner's share of the income of the firm. That income share is then charged under the normal rules for the type of income concerned.

Section 846: Overview of Part 9

3153. This section introduces this Part of the Act. It is new.

Section 847: General provisions

3154. This section introduces the concept of a "firm". It is based on section 111 of ICTA.

3155. *Subsection (2)* adopts the same approach as the trading income Part of this Act. Most of the Chapters in the trading income Part of the Act have a rule that the trading income rules apply to professions and vocations as they apply to trades. The rules themselves refer only to trades. The sections in this Part refer to trades. They apply also to professions (but not to vocations, which cannot be carried on in partnership). Paragraph (a) of the subsection ensures that there is no need to repeat the phrase "trade or profession". If the firm has other income, there are special rules for assessing it. The sections then have to deal with businesses other than trades or professions - paragraph (b) caters for that possibility.

Section 848: Assessment of partnerships

3156. This section makes it clear that, for income tax purposes, a firm is not an entity distinct from the partners in the firm. It is based on section 111(1) of ICTA.

3157. In the case of firms established under English law this provision merely confirms their position under that law. But Scottish firms, for example, are legal entities. This provision ensures that all firms are treated in the same way.

Section 849: Calculation of firm's profits or losses

3158. This section contains the basic rules for calculating the profits of a firm. It is based on section 111 of ICTA.

3159. If some of a firm's partners are resident in the United Kingdom and some are not, the profits of the firm's trade must be calculated on different bases. For the resident partners, the calculation includes profits arising outside the United Kingdom; for the non-resident partners, the calculation is restricted to profits arising in the United Kingdom.

3160. Section 111 of ICTA is not explicit that the profits may have to be calculated on more than one basis. This section brings together the rules for resident and non-resident partners. *Subsection (1)* introduces the idea that more than one calculation may be needed.

3161. The source legislation refers to the computation of the profits from the actual trade "for any period". Profits are calculated for a period of account. So subsections (2) and (3) make it clear that the section applies to a period of account. It is possible for a partner to be both resident (for one tax year) and non-resident (for another) within a single period of account. In such a case, the firm's profit has to be calculated twice to arrive at the partner's share of the profits.

3162. *Subsection (2)* sets out the normal basis for calculating the profits, for an individual resident in the United Kingdom. The profits are calculated as if the firm were an individual resident in the United Kingdom.

3163. *Subsection (3)* sets out an additional basis for calculating the profits. If the partner (who may be a non-resident company liable to income tax) is not resident in the United Kingdom the profits of the firm are calculated as if the firm were an individual not resident in the United Kingdom.

Section 850: Allocation of firm's profits or losses between partners

3164. This section is the link between the firm's profits and the amounts assessable on the partners. It is based on section 111(3) of ICTA.

3165. *Subsections (2)* and *(3)* set out what happens if the calculation of a partner's share of the firm's profits under subsection (1) produces a loss, even though the overall result for the firm is a profit. This is most likely to arise when one or more partners are entitled to a salary or interest on the firm's capital. The "loss" determined under subsection (1) is reallocated to the other partners, to reduce their shares of the profit. See *Change 143* in Annex 1.

3166. It is also possible for the calculation of a partner's share under subsection (1) to produce a profit, even though the overall result for the firm is a loss.

3167. *Subsections (4)* and *(5)* set out what happens in the case of an overall loss. The "profit" determined under subsection (1) is reallocated to the other partners, to reduce their shares of the loss. See *Change 143* in Annex 1.

3168. *Subsection (6)* contains definitions. If at least one of the partners in the firm is liable to corporation tax, the firm's profit (FP) or loss (FL) will include part of the profits or losses allocated to the partner liable to corporation tax, even though that part of the profits is not charged to income tax. So it is necessary, in the reallocation of the profits under subsection (3) or losses under subsection (5), that the total profits (TP) or losses (TL) include those allocated to the partner liable to corporation tax. The definition of "partner" for the purposes of the section makes it clear that partners liable to corporation tax are part of the picture.

Section 851: Calculations etc. where firm has other income or losses

3169. This section sets out the rule for a firm's non-trading income. It is based on section 111(7) of ICTA.

3170. Section 847(2)(a) of this Act applies to this section but section 847(2)(b) does not. So the reference to a "trade" in subsection (1)(a) of this section is to be read as including a profession but not a business.

3171. A trading firm may have income that does not arise from the trade or from a business. Such income is calculated and allocated to the partners in the same way as trading income, in accordance with sections 849 and 850. Each partner's share is assessed using the basis period rules set out in section 854.

Section 852: Carrying on by partner of notional trade

3172. This section gives the rules for determining when a partner's notional trade starts and ceases. It is based on sections 110, 111 and 112 of ICTA.

3173. *Subsection (1)* introduces the "notional trade" carried on by each partner. This phrase is used instead of the "deemed trade or profession" in section 111(4) of ICTA. The basis period rules in Chapter 15 of Part 2 of this Act apply to the notional trade carried on by each partner.

3174. *Subsection (2)* deals with a partner joining the firm. The general rule is that the notional trade starts when the partner joins the firm. The subsection makes it clear that the notional trade may start when the firm starts to trade. This is merely implicit in section 111 of ICTA.

3175. *Subsection (3)* is an exception to the general rule. If a firm is formed by a sole trader taking another person into partnership to carry on the same trade, the original trader is treated as starting to carry on a notional trade at the start of the actual trade. This provides continuity of treatment for the original trader.

3176. *Subsection (4)* deals with a partner leaving the firm. The general rule is that the partner ceases to carry on the notional trade when the partner leaves the firm. The subsection makes it clear that the notional trade may end when the firm ceases to trade. This is merely implicit in section 111 of ICTA.

3177. *Subsection (5)* is an exception to the general rule. If a firm is dissolved and its trade is continued by a sole trader, the continuing partner's notional trade is treated as ceasing only when the actual trade ceases. This provides continuity of treatment for the continuing trader.

3178. *Subsection (6)* is the equivalent for partners of the general rule for individuals in section 17 of this Act.

3179. Section 112(1B) of ICTA operates by treating a partner who changes tax residence as ceasing to be a partner. That triggers a cessation of the deemed trade or profession in accordance with section 111(4)(e) of ICTA. This subsection says directly that a continuing partner who becomes, or ceases to be, resident in the United Kingdom is treated as ceasing to carry on one notional trade and starting another.

3180. *Subsection (7)* preserves the partner's right to carry forward trading losses even if the notional trade is treated as ceasing by subsection (6).

Section 853: Basis periods for partners' notional trades

3181. This section sets out the rules for determining the basis periods for the assessment of each partner's share of the firm's profits or loss. It is based on section 111 of ICTA.

3182. *Subsection (1)* sets out the general rule that the basis periods for the partner's notional trade are determined by reference to the accounting dates of the firm's actual trade. The subsection repeats the assumption in section 111(2) of ICTA that the notional trade is carried on by an individual.

3183. Section 111(4)(c) of ICTA ensures that, in most cases, the basis period for the partner's deemed trade or profession is determined by reference to the same periods of account as are used by the firm. Section 111(4)(d) of ICTA also ensures that, even if the firm has a change of accounting date, the general rule usually still applies.

3184. This result is stated explicitly in subsection (1)(b) of the section.

3185. *Subsection (2)* deals with an exception to the general rule.

3186. Section 111(5) of ICTA applies if the firm has an "ineffective" change of accounting date. In that case, the basis period rules are applied as if the accounts were drawn up to the old accounting date. The description of the change as ineffective does not appear in the source legislation or elsewhere in the text of this Act. But it appears in the heading to section 219 of this Act and is used here in conjunction with a cross-reference to section 216.

3187. *Subsection (3)* sets out how a firm can give the notice required by section 217 of this Act. It goes on to set out how the firm can appeal against a notice by the Inland Revenue under section 218.

3188. *Subsection (4)* is a special rule to deal with the case of enterprise allowance received by an individual partner. It explains how section 207 of this Act operates so that the allowance is taxed only once.

Section 854: Carrying on by partner of notional business

3189. This section gives the rules for determining when a partner starts or ceases to carry on a notional business. It is based on sections 111 and 112 of ICTA.

3190. *Subsection (1)* introduces the "notional business" carried on by each partner in the firm. The notional business consists of the partner's share of the untaxed income of the firm that is not trade profits.

3191. *Subsection (2)* deals with the start of the notional business.

3192. The general rule in section 111(8) of ICTA is that a partner's income from the notional business (in ICTA, "the second deemed trade or profession") is assessed using the same basis periods as those for the notional trade (in ICTA, "the deemed trade or profession") carried on by the partner. But this rule applies only if section 111(2) and (3) of ICTA apply in relation to the profits of an actual trade (see section 111(7) of ICTA). So, if a firm is formed to receive non-trading income, the general rule does not apply and the non-trading income is assessed on the usual tax year basis.

3193. A problem may arise if the members of an existing firm start trading for the first time. A strict interpretation of section 111(8)(b) of ICTA seems to require that the basis periods for each partner's notional business are determined to be the same as those for the notional trade, not only for the year in which trading starts but also for all the years since the firm was formed. Subsection (2)(b) of this section makes it clear that the partner's "notional business" does not start until the firm starts to trade. See *Change 144* in Annex 1.

3194. *Subsection (3)* makes it clear that the notional business continues even though particular sources of untaxed income may start and cease.

3195. The date on which a partner starts to carry on a notional business is determined by the date on which the partner joins a firm, or (if later) the date on which the firm starts the actual trade. It does not matter when the firm starts to receive untaxed income. Nor does it matter whether in a particular year there is income from the notional business. The basis periods for a partner's notional business may be determined before the firm starts to receive untaxed income. And, once the basis periods are established for the partner, they change only if the accounting date of the actual trade changes.

3196. *Subsection (4)* deals with the date on which a partner ceases to carry on a notional business. This happens when the partner leaves the firm or (if earlier) when the firm ceases to carry on the actual trade.

3197. *Subsection (5)* is the equivalent for partners of the general rule for individuals in section 17 of this Act.

3198. Section 112(1B) of ICTA operates by treating a partner who changes tax residence as ceasing to be a partner. That triggers a cessation of the second deemed trade or profession in accordance with section 111(8)(d) of ICTA. This subsection says directly that a continuing partner who becomes, or ceases to be, resident in the United Kingdom is treated as ceasing to carry on one notional business and starting another.

Section 855: Basis periods for partners' notional businesses

3199. This section gives the rules for determining the basis periods for the assessment of a partner's share of the non-trading income of a firm if the firm carries on a trade. It is based on section 111 of ICTA.

3200. There is no special basis of assessment for a partner's share of the taxed income of a firm, or of the untaxed income of a firm that does not carry on a trade. In those cases, the usual tax year basis applies.

3201. *Subsection (1)* gives the general rule that the basis period for the partner's notional business is the same as that for the partner's notional trade.

3202. *Subsections (2)* and *(3)* are similar to section 852(3) and (5), dealing with notional trades.

3203. If a firm is formed by a sole trader taking another person into partnership to carry on the same trade, subsection (2) makes it clear that the original trader's notional business starts with the formation of the firm. Similarly, if a firm is dissolved and a partner carries on the same trade alone, subsection (3) makes it clear that the continuing trader is treated as ceasing to carry on a notional business.

3204. It follows from the rules in sections 854 and 855 that the income from the partner's notional business is assessed in accordance with the commencement and cessation rules in sections 199, 200 and 202 of this Act.

Section 856: Overlap profits from partners' notional businesses

3205. This section sets out a special rule to deal with the possibility that the deduction of overlap profit may produce a loss. It is based on section 111(9) of ICTA.

3206. A consequence of the application of the trading income basis period rules is that there may be overlap profit (see section 204 of this Act) of a partner's notional business.

3207. *Subsection (1)* deals with the case where a deduction is made for overlap profit on a change of accounting date (to a date later in the tax year), in accordance with section 220.

3208. *Subsection (2)* deals with the case where a deduction is made for overlap profit on cessation of the firm's actual trade, in accordance with section 205.

3209. *Subsection (3)* gives relief for any excess of overlap profit over the income otherwise to be assessed for the year of the change of accounting date or cessation. This excess would not usually qualify for relief against total income because it is not a trading loss. But this section ensures that relief is given in that way.

Section 857: Partners to whom the remittance basis may apply

3210. This section gives a special rule for the treatment of the profits of a firm that is managed and controlled outside the United Kingdom. It is based on section 112(1A) of ICTA. The source legislation charges the remittance basis partner's share of the profits of such a firm under Schedule D Case V.

3211. In most cases, the charge under Case V rather than Case I has no practical effect on the partner's income tax liability. But, if the profits of the firm arise from the carrying on of a trade wholly or partly outside the United Kingdom, an individual who is assessed on the basis of the amount of income received in the United Kingdom (the "remittance basis") is charged only to the extent that the overseas profits are received in the United Kingdom.

3212. This result is achieved by two rules in section 112(1A) of ICTA which require:

- computation of the firm's profit as if the trade were carried on by an individual not resident in the United Kingdom; and
- treatment of any profits arising outside the United Kingdom as arising from a "possession out of the United Kingdom".

3213. *Subsection (2)* of the section reproduces the first ICTA rule. The assumption in ICTA that the trade is carried on by a non-resident individual means that the computation of the firm's profits excludes any profits that arise outside the United Kingdom. This section does not require that assumption. Instead, this rule is directed specifically at the profits arising in the United Kingdom to produce the same result. The determination of the firm's profits in accordance with section 849 will involve subsection (2) of that section (because the partner is resident in the United Kingdom – see *subsection (1)(c)* of this section).

3214. *Subsection (3)* of the section reproduces the second ICTA rule. The assumption that the profits arising outside the United Kingdom arise from a "possession out of the United Kingdom" means that the partner's share of those profits may be assessed on the remittance basis. This section treats the profits as "relevant foreign income" for the purposes of this Act. So the remittance basis may apply.

3215. Section 112(1A) of ICTA applies if "any of the partners … satisfies the Board that he is not domiciled in the United Kingdom…". The quoted words (introduced in 1995) are based on section 65(4) of ICTA as it was until 1996.

3216. As part of the introduction of Self Assessment, all such references to the Board being satisfied were intended to be removed – a person self-assessing could not know whether the Board were satisfied. So the words in section 65(4) of ICTA were changed, by section 134 of and Schedule 20 to FA 1996. The words became "any person who makes a claim to the Board stating that that he is not domiciled …".

3217. The corresponding amendment to section 112 of ICTA was not made. It is clear that section 112(1A) of ICTA should apply to exactly the same category of person as section 65(4) of ICTA.

3218. This section applies if a partner is an individual who satisfies the conditions in section 831 of this Act. So the rule for a non-domiciled partner is expressed in the same way as the rule for non-domiciled individuals generally.

Section 858: Resident partners and double taxation agreements

3219. This section ensures that a UK resident partner's share of the income of a foreign firm remains liable to United Kingdom tax even though the income of the firm as a whole is exempt from United Kingdom tax in accordance with a double taxation agreement. It is based on section 112(4) and (5) of ICTA.

3220. The business profits article of the United Kingdom/Jersey double taxation arrangement exempts the profits of a Jersey firm from United Kingdom tax. In the case of Padmore v CIR (1989), 62 TC 352 CA[18], the Court of Appeal decided that the exemption extended to the share of the profits arising to a United Kingdom resident individual. The rules in section 112(4) and (5) of ICTA were enacted in 1987 to remove the exemption.

3221. *Subsection (1)* sets out the type of individual and firm with which the section is concerned. It goes on to identify the sort of exemption from tax that was considered in the Padmore case.

3222. For United Kingdom tax purposes, if it is necessary to consider where a firm is resident, the question is likely to be decided by the place where the firm's business is controlled and managed. But it is possible that, under foreign law, a firm may be considered to be resident elsewhere, for example, by reference to where the firm was established. So the section uses both the "control and management" test and the "resides" test.

3223. *Subsection (2)* makes it clear that the section does no more than remove any exemption under a double taxation arrangement. It does not deny other reliefs, such as tax credit relief. See *Change 145* in Annex 1.

3224. *Subsection (3)* deals with United Kingdom tax credits. A double taxation arrangement may give a non-resident person an entitlement to payment of a tax credit on a distribution by a United Kingdom company. The entitlement is restricted to the share of the distribution that arises to a United Kingdom resident partner.

Section 859: Special provisions about farming and property income

3225. This section clarifies the position of firms that carry on a farming trade or property business. It is based on sections 15 (paragraph 1(3) of Schedule A), 53(2) and 65A(4) of ICTA.

3226. In section 53(2) of ICTA there is a rule that all farming carried on in the United Kingdom by a person is a single trade. The section refers to a "particular person or partnership or body of persons".

3227. In section 15 of ICTA there is a similar rule that all property income activity carried on by a person forms a single property business. Paragraph 1(3) of Schedule A refers to a "particular person or partnership". Section 65A(4) of ICTA, which deals with overseas property businesses, also refers to a "particular person or partnership".

3228. *Subsection (1)* is the rule that all farming carried on by a firm is a single trade. The subsection also makes it clear that the firm's single farming trade is separate from any farming trade carried on personally by a partner in the firm.

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3229. *Subsections (2)* and *(3)* are the corresponding rules for UK property businesses and overseas property businesses.

Section 860: Adjustment income

3230. This section sets out the rules for taxing adjustment income when a trade is carried on in partnership. It is based on paragraph 13 of Schedule 22 to FA 2002.

3231. *Subsection (1)* provides that there can be a change of basis at the same time as a partial change in the membership of the firm.

3232. *Subsection (3)* ensures that the adjustment income rules are applied to the firm, rather than to the individual partners.

3233. *Subsection (7)* ensures that the special rules in this section apply instead of the main partnership rules. In particular, the income is allocated between the partners in accordance with subsection (2) instead of section 850. And the charge is on income treated as arising on the last day of the new period of account in accordance with section 232 of this Act instead of by reference to the basis period rules in sections 852 and 853.

Section 861: Sale of patent rights: effect of partnership changes

3234. This section sets out what happens when there is a sale of patent rights by a trader and there is change in the membership of any firm that carries on the trade. It is based on section 558 of CAA.

3235. The rules for intellectual property are split:

- the rules that give capital allowances are in CAA;
- the rules that charge non-trading profits from the sale of patent rights are in Chapter 2 of Part 5 of this Act; and
- the special rules that apply to firms are set out in this section and section 862.

3236. If a trader receives a sum from the sale of patent rights in the ordinary course of the trade the sum is a trade receipt. In that case, it is not a "capital sum" and section 524(1) of ICTA ensures that the special rules do not apply. In this Act the treatment is the same because section 575(1) ensures that a charge under Part 2 of this Act takes precedence over a charge under Part 5 of this Act (which includes income from intellectual property in Chapter 2 of that Part).

3237. If a trader receives a capital sum from the sale of patent rights, the sum is excluded from the calculation of the trade profits by the general rule that excludes capital receipts. Instead, the sum is separately charged to income tax under section 587 of this Act. The profit on the sale is charged to tax over six years. But the seller may elect to have the sum charged in the year in which the proceeds of sale are received. Or the charge may be spread in accordance with section 591 or 592.

3238. *Subsection (2)* sets out the "tax condition" for the section to apply. The condition is that the charge on the proceeds from the sale of patent rights is spread over several tax years.

3239. *Subsection (3)* sets out the "partnership condition" for the section to apply. The condition is that the trade that gives rise to the sale of patent rights is carried on in partnership, either at the time of the sale or at any time during the tax spreading period. In this case the charge under section 524 of ICTA "falls to be made on two or more persons jointly" (section 525(3) of ICTA).

3240. *Subsection (4)* sets out the "non-cessation condition" for the section to apply. The condition is that the there is not a complete change in the persons carrying on the trade. If there is such a change, section 862 applies instead.

3241. *Subsection (5)* sets out the what happens if all the conditions in the previous three subsections are met: the charge on the proceeds of sale of the patent rights is made on the current partners in the firm. This subsection is based on section 558(3) of CAA.

3242. *Subsection (6)* makes clear the assumptions on which the charge on the current partners is to be calculated. All the current partners step into the shoes of the persons who were partners at the time of the original sale.

Section 862: Sale of patent rights: effect of later cessation of trade

3243. This section sets out what happens when there has been a sale of patent rights to which the previous section applied and there is a complete change in the persons carrying on the trade. It is based on section 525 of ICTA.

3244. *Subsection (1)* sets out the conditions for the section to apply.

3245. *Subsection (1)(b)* is the condition that the current charge on the proceeds from a sale of patent rights is made on a firm. It is possible for an individual to "inherit" such a charge from a firm as a result of section 861. In that case when the individual ceases to carry on the trade the assessment of the remaining instalments of the charge is not disturbed.

3246. *Subsection (1)(d)* is the condition that there is a complete change in the persons carrying on the trade. If there is a partial change, section 861 applies.

3247. *Subsection (2)* is the main rule that when the firm ceases to carry on the trade the remaining tax charges are "rolled up" in the last year of the trade.

3248. *Subsection (3)* sets out how the "rolled-up" charge is split between the current partners on cessation of the trade.

3249. *Subsections (4)* to *(6)* allow an election to have the remaining tax charge spread evenly over the years since the original sale of patent rights.

3250. The time limit for the election is the same as that in section 593 and is brought into line with the time limit for other elections in this Act. See *Change 104* in Annex 1.

3251. This section does not specify that the election is to be made to "the inspector". Section 878(4) of this Act draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to "an officer of the Board".

Section 863: Limited liability partnerships

3252. This section contains the rules that treat limited liability partnerships ("LLPs") in the same way for tax purposes as ordinary partnerships ("firms" in this Act). It is based on section 118ZA of ICTA.

3253. The Limited Partnerships Act 1907 established "limited partnership". It built on the Partnership Act 1890 and established a class of partner whose liability for the debts of the firm did not extend beyond the partner's contribution to the firm. But there had also to be at least one general partner whose liability was not so limited and the firm was not a separate legal person.

3254. The Limited Liability Partnerships Act 2000 created a new form of legal entity, a limited liability partnership. It is a body corporate with legal personality separate from its members. In many ways, LLPs are treated for non-tax purposes in the same way as companies. In particular, there are requirements as to accounts and audit. Members of an LLP may be subject to disqualification in the same way as directors. And various provisions relating to insolvency and winding up apply to LLPs as they do to companies.

3255. A first version of section 118ZA of ICTA was inserted by the Limited Liability Partnerships Act 2000. FA 2001 replaced it with a new section. Those Acts also introduced special rules (which are not in this Act) for:

- losses;
- capital gains;
- relief for interest; and
- some types of investment vehicle.

3256. *Subsection (3)* ensures that the basic rule in subsection (1) continues to apply to an LLP if the LLP would otherwise temporarily fail to qualify for treatment as an ordinary firm on account of the LLP:

- ceasing to carry on a trade with a view to profit; or
- being wound up.

Part 10: General provisions

Chapter 1: Introduction

Section 864: Overview of Part 10

3257. This section introduces Part 10. It is new.

Chapter 2: General calculation rules etc.

Overview

3258. Chapter 2 contains a number of generally applicable rules modelled on similar rules in Parts 2 and 3 of this Act. They apply to income charged to income tax other than income within those Parts.

3259. These rules are included here to save repetition at numerous points in the Act. Some of the rules apply provisions from the Parts 2 and 3 equivalent rules, rather than repeat them here. Section 1 signposts at the beginning of the Act that there are general calculation rules in this Part.

Section 865: Unpaid remuneration: non-trades and non-property businesses

3260. This section is based on section 43 of FA 1989. That section applies where profits or gains are to be "charged under Schedule D for a period of account…". Profits or gains may be calculated for a period of account in respect of a business which is neither a trade, profession or vocation nor a property business (for example, a business whose income is charged under Chapter 3 of Part 5 of this Act (films and sound recordings: non-trade businesses)).

3261. This section uses "profits or other income", as do other sections in this Chapter, rather than "profits or gains", to define the scope of the rule. See the commentary on the omission of "gains" in the overview to Chapter 2 of Part 2 of this Act.

3262. The section alters the claim procedure. See *Change 8* in Annex 1.

3263. See the related commentary on sections 36 and 37 of this Act.

3264. See also paragraph 154 of Schedule 2 to this Act which preserves the commencement rule for the amendment of the source legislation by Schedule 24 to FA 2003.

Section 866: Employee benefit contributions: non-trades and non-property businesses

3265. This section is based on Schedule 24 to FA 2003. The provisions in that Schedule apply where "a calculation is required to be made for tax purposes of a person's profits for any period…". Profits may be calculated for a period in respect of a business which is neither a trade nor a property business.

3266. This section applies sections 39 to 44 in Part 2 of this Act in calculating the profits of a business for the purpose of any income tax charge which is not in Parts 2 or 3 of this Act. For further detail, see the commentary for those sections.

3267. See also paragraph 155 of Schedule 2 to this Act which preserves the commencement rule for the amendment of the source legislation by Schedule 24 to FA 2003. And see paragraph 156 of Schedule 2 to this Act which preserves source legislation as it applies before the FA 2004 rules about pension schemes take effect from 6 April 2006.

Section 867: Business entertainment and gifts: non-trades and non-property businesses

3268. This section is based on section 577 of ICTA. That section denies a deduction for certain expenses "in computing profits chargeable to tax under Schedule D". Profits chargeable to tax under Schedule D include profits of a business which is neither a trade, profession or vocation nor a property business. And section 577(7)(b) of ICTA indicates that references to a trade, for the purposes of the section, include references to a business.

3269. Although in theory the section is applicable to all profits or other income charged to income tax, other than profits charged in Parts 2 and 3 of this Act, some of which are not charged under Schedule D in the source legislation, the application of the section is qualified. *Subsection (1)* restricts its scope to profits or other income "which arise from the carrying on of a business" . In effect, this puts the scope of the rule in line with that of the source legislation.

3270. This section applies the same rules regarding business entertainment and gifts as are in sections 45 to 47 in Part 2 of this Act. For further detail, see the commentary for those sections.

3271. *Subsection (5)* contains a number of exceptions, using sections 46 to 47 for this purpose. Section 47(5) makes an exception for gifts to charities and named bodies. The source legislation, section 577(9) of ICTA, limits this exception to the computation of profits under Schedule D Cases I and II, that is, to income calculated under rules rewritten in Part 2 of this Act. It was not intended that the exception be applied narrowly to the disadvantage of a business other than a trade or property business. This subsection extends the exception to such businesses. See *Change 146* in Annex 1.

Section 868: Social security contributions: non-trades etc.

3272. This section prevents a deduction for most social security contributions in calculating profits or income. It is based on section 617 of ICTA.

3273. The rule is that there can be no deduction for a taxpayer's own social security contributions. The section achieves this by prohibiting a deduction for any contributions and making an exception for contributions that an employer makes for employees.

3274. The rule in section 617 of ICTA applies generally for tax purposes. This Act splits the rule:

- This section sets out the income tax rule for non-trading income charged to tax by this Act (including rents from "concerns" charged to tax by Chapter 8 of Part 3 of the Act);
- Section 53 sets out the income tax trading income rule (applied also to property income by section 272);
- A new section 360A of ITEPA is introduced by this Act (see paragraph 594 of Schedule 1 to this Act) to set out the rule for employment income; and

- Section 617 of ICTA as consequentially amended (see paragraph 262 of Schedule 1 to this Act) continues to apply for corporation tax.

Section 869: Penalties, interest and VAT surcharges: non-trades etc.

3275. This section contains the general rule that tax penalties and interest are not to be deducted for tax purposes. It is based on section 90 of TMA and section 827 of ICTA.

3276. The section brings together all the rules prohibiting a deduction for penalties, interest and surcharges imposed by statute. So it deals with interest on unpaid income tax (imposed by TMA) in the same section as the penalties, interest and surcharges relating to the indirect taxes that are dealt with in section 827 of ICTA.

3277. The table in subsection (4) sets out the specific statutory references because a general description of the penalties etc would not be precise enough. But the second column of the table is a description of the tax to indicate what is involved.

Section 870: Crime-related payments: non-trades and non-property businesses

3278. This section is based on section 577A of ICTA. That section denies a deduction for certain crime-related expenses "in computing profits chargeable to tax under Schedule D…" Profits chargeable to tax under Schedule D include profits of a business which is neither a trade, profession or vocation nor a property business.

3279. The section applies to profits or other income charged to income tax other than in Parts 2 and 3 of this Act. Some of those profits or other income are not charged under Schedule D in the source legislation. But the prohibition of a deduction is not thought to have any practical effect on profits or other income which are not charged under Schedule D in the source legislation. The scope of the prohibition is therefore unchanged.

3280. See the related commentary for section 55 of this Act. See also paragraph 157 of Schedule 2 to this Act which preserves the commencement rule for the amendment of the source legislation by section 68 of FA 2002.

Section 871: Apportionment etc. of miscellaneous profits to tax year

3281. This section is based on section 72 of ICTA. That section applies where it is necessary to apportion profits or losses for a period of account between tax years "in the case of any profits or gains chargeable under Case I, II or VI of Schedule D…" The application of section 72 of ICTA is therefore not limited to profits or losses of a trade, profession or vocation.

3282. The section applies where income is chargeable under a provision to which section 836B of ICTA applies (that section is inserted by paragraph 340 of Schedule 1 to this Act). Although section 836B of ICTA does not apply to relevant foreign income, *subsection (2)* of this section qualifies the reference to that section so that the benefit of the apportionment rules extends to such income (that is, to income charged under Schedule D Case IV or V in the source legislation). See *Change 147* in Annex 1.

3283. The section uses "profits" rather than "profits or gains" to define the scope of the rule. See the commentary on the omission of "gains" in the overview to Chapter 2 of Part 2 of this Act.

3284. *Subsection (5)* reflects the practice of making the apportionment by reference to a factor other than a strict count of days, if it is reasonable to do so and the alternative basis of apportionment is applied consistently. The subsection makes clear that the option to choose an alternative basis of apportionment is exercisable only by the taxpayer (not the Inland Revenue). See *Change 52* in Annex 1.

3285. See the related commentary for section 203 of this Act. See also paragraph 158 of Schedule 2 to the Act which provides for the situation where a period of account straddles end of the tax year 2004-05 and the beginning of 2005-06.

Section 872: Losses calculated on same basis as miscellaneous income

3286. This section is based on numerous provisions, including section 827 of ICTA.

3287. The application of the section is limited to "miscellaneous income", defined in *subsection (3)* by reference to section 836B of ICTA (that section is inserted by paragraph 340 of Schedule 1 to this Act). The source legislation does not generally limit the scope of the rule. For example, section 827(1) of ICTA says "the payment shall not be allowed as a deduction in computing any income, profits or losses for any tax purposes". But in practice these provisions affect only the calculation for income tax purposes of amounts, other than profits within Parts 2 or 3 of this Act, chargeable under a provision listed in the table in section 836B of ICTA.

3288. *Subsection (2)* ensures that this rule does not overturn any rules already provided for the computation of losses. For example, see section 398 of ICTA (which supplements the calculation of losses for the purposes of a claim under section 392 of ICTA).

3289. See the related commentary for section 26 of this Act.

Chapter 3: Supplementary and general provisions

Section 873: Orders and regulations made by Treasury or Board

3290. This section is based on section 828 of ICTA.

Section 874: Activities in UK sector of continental shelf

3291. This section is based on section 830 of ICTA.

Section 875: Meaning of "caravan"

3292. This section is based on sections 15 and 65A of ICTA, section 29 of the Caravan Sites and Control of Development Act 1960, section 13 of the Caravan Sites Act 1968, section 8 of the Mobile Homes Act 1975 and Schedule 9 to the Roads (Scotland) Act 1984.

3293. It effects a change in the law in two ways. First it provides a uniform definition of "caravan" for the whole of the United Kingdom. Second it applies that definition to all occurrences of "caravan" in this Act. See *Change 148* in Annex 1.

Section 876: Meaning of "farming" and related expressions

3294. This section defines "farming" and "market gardening" and clarifies the meaning of "forestry" and "woodlands". It is based on section 832(1) of ICTA and section 154 of FA 1995.

3295. Section 832(1) of ICTA defines "farm land" and "market garden land". It then goes on to say that "farming" and "market gardening" "shall be construed accordingly". The reasons for this approach are largely historic and date from the time when the charge on farming and market gardening was under Schedule B. "Farm land" and "market garden land" are no longer terms used in the rules concerned with farming and market gardening; they remain only in the definition in section 832(1) of ICTA.

3296. The definitions in this section take a different approach. They define "farming" and "market gardening" by reference to the nature of the activity, not the land on which the activity is carried out. Farming excludes market gardening.

3297. Farming is an activity which is given differing taxation treatment depending on whether or not the land is situated in the United Kingdom. Section 832(1) of ICTA provides that the definitions of "farm land" and "market garden land" are confined to land occupied in the United Kingdom.

3298. There is no territorial restriction in the definitions in this Act. Instead the territorial restriction is included in the rewrite of section 53(1) and (2) of ICTA as section 9 of this Act and not in the definitions.

3299. *Subsection (1)* provides the definition of "farming". It requires the land to be occupied wholly or mainly for the purposes of husbandry. This reflects a long-standing distinction in tax law between profits resulting from the taxpayer's occupation of the land and profits from an activity in which occupation of the land is merely incidental.

3300. In the first case the trader exploits or uses the land, for example, by growing crops or grazing animals. In the second case the trader occupies the land only because a physical location, such as a shop or factory, is needed from which to carry on the trade. Factory farming, that is the intensive rearing of fish or livestock, is not farming for income tax purposes. This is because the animals do not live or draw their sustenance from the land.

3301. Husbandry is a fairly old-fashioned term but one that is the subject of a considerable body of case law. The status of any marginal case must be determined in the light of that case law subject to the clarification given in *subsection (2)*.

3302. The definition of "farm land" in section 832 of ICTA excludes "any dwelling or domestic offices". This section does not repeat this exclusion of farmhouses.

3303. As originally enacted, the definition of farm land in section 832(1) of ICTA specifically included the farmhouse and farm buildings as part of the farm land. The House of Lords in IRC v Korner and Others (1969), 45 TC 287 HL, held that the effect of this provision was that a farmhouse was an asset of the trade for which a 100% deduction could be obtained. This applies even if the farmer also uses the farmhouse as a private residence. An amendment was introduced in FA 1969 to reverse the effect of that decision. This is why the definition of "farm land" in section 832(1) of ICTA excludes "any dwelling or domestic offices".

3304. In practice a farmer is allowed to make deductions in respect of expenditure of a revenue nature on office buildings used purely for business purposes. Such expenditure has always been treated as being incurred wholly and exclusively for the purposes of the trade and not prohibited from being deducted under section 74(1)(a) of ICTA.

3305. Section 74(1)(c) of ICTA deals with the deduction of rent where only part of a dwelling house or domestic offices are used for trade purposes. Again, in practice, a taxpayer whose trade is farming is permitted to make deductions in respect of such houses and offices.

3306. In the case of any other expenses of a residential property which is subject to dual private and business use a trader is permitted to apportion these and the proportion attributable to trade use is allowed as a deduction. Again this treatment applies to farmers. See section 34 of this Act (expenses not wholly and exclusively for trade and unconnected losses).

3307. A farmer who wishes to claim a deduction for the proportion of expenses of his or her farmhouse attributable to trade rather than private purposes can do so through section 34. Omitting the exclusion of farmhouses and domestic offices from the definition of farming gives statutory effect to what occurs in practice.

3308. *Subsection (2)* identifies two specific types of activity as "husbandry" and therefore farming.

3309. *Paragraph (a)* is based on the definition of market garden land in section 832(1) of ICTA. Hop growing is generally recognised to be farming but is often spoken of as taking place in a garden. This could bring it within the definition of “market garden land” in section 832(1) of ICTA but for the fact that hop growing is excluded from that definition. Subsection (2)(a) makes clear that hop growing is farming.

3310. *Paragraph (b)* is based on the ordinary meaning of the word farming. Stud farming has generally been assumed to be farming for income tax purposes. The reference to “the breeding and rearing of horses and the grazing of horses in connection with those activities” makes clear what that activity encompasses for the purposes of this Act.

3311. *Subsection (5)* defines “market gardening”. It makes it clear that the produce sold must have been grown on the relevant land rather than being bought in for resale.

Section 877: Meaning of grossing up

3312. This section explains what is meant by “grossing up” for the purposes of this Act and provides a formula for calculating the gross amount to be taxed. It is new.

Section 878: Other definitions

3313. *Subsection (1)* defines various terms.

3314. The definition of “houseboat” is based on section 15(1) of ICTA. It effects a change in the law because it applies a single definition of “houseboat” for the whole Act. See *Change 150* in Annex 1.

3315. The definition of “Inland Revenue” is new. See *Change 149* in Annex 1.

3316. The definition of “personal representatives” is new. See *Change 151* in Annex 1.

3317. *Subsection (3)* provides a general rule concerning the making of claims and elections. It is based on section 42(11) of TMA and paragraph 2 of Schedule 1A to TMA.

3318. In the source legislation some provisions specify that a claim or election has to be in writing while others are silent. But the effect of paragraph 2(3) to (5) of Schedule 1A to TMA is that claims and elections have to be in writing (unless a specific provision says otherwise).

3319. *Subsection (5)* defines whether persons are connected by reference to section 839 of ICTA. Section 839 of ICTA applies the following tests in determining whether persons are “connected”:

“(1) For the purposes of, and subject to, the provisions of the Tax Acts which apply this section, any question whether a person is connected with another shall be determined in accordance with the following provisions of this section (any provision that one person is connected with another being taken to mean that they are connected with one another).

(2) A person is connected with an individual if that person is the individual’s wife or husband, or is a relative, or the wife or husband of a relative, of the individual or of the individual’s wife or husband.

(3) A person, in his capacity as trustee of a settlement, is connected with—

(a) any individual who in relation to the settlement is a settlor,

(b) any person who is connected with such an individual, and

(c) any body corporate which is connected with that settlement.

In this subsection “settlement” and “settlor” have the same meaning as in Chapter IA of Part XV (see section 660G(1) and (2)).

(3A) For the purpose of subsection (3) above a body corporate is connected with a settlement if—

(a) it is a close company (or only not a close company because it is not resident in the United Kingdom) and the participators include the trustees of the settlement; or

(b) it is controlled (within the meaning of section 840) by a company falling within paragraph (a) above.

(4) Except in relation to acquisitions or disposals of partnership assets pursuant to bona fide commercial arrangements, a person is connected with any person with whom he is in partnership, and with the wife or husband or relative of any individual with whom he is in partnership.

(5) A company is connected with another company—

(a) if the same person has control of both, or a person has control of one and persons connected with him, or he and persons connected with him, have control of the other; or

(b) if a group of two or more persons has control of each company, and the groups either consist of the same persons or could be regarded as consisting of the same persons by treating (in one or more cases) a member of either group as replaced by a person with whom he is connected.

(6) A company is connected with another person if that person has control of it or if that person and persons connected with him together have control of it.

(7) Any two or more persons acting together to secure or exercise control of a company shall be treated in relation to that company as connected with one another and with any person acting on the directions of any of them to secure or exercise control of the company.

(8) In this section—

"company" includes any body corporate or unincorporated association, but does not include a partnership, and this section shall apply in relation to any unit trust scheme as if the scheme were a company and as if the rights of the unit holders were shares in the company;

"control" shall be construed in accordance with section 416; and

"relative" means brother, sister, ancestor or lineal descendant.

3320. *Subsection (6)* applies the definition of "control" in section 840 of ICTA. Section 840 of ICTA defines "control" in relation to a body corporate as follows:

"For the purposes of, and subject to, the provisions of the Tax Acts which apply this section, "control", in relation to a body corporate, means the power of a person to secure—

(a) by means of the holding of shares or the possession of voting power in or in relation to that or any other body corporate; or

(b) by virtue of any powers conferred by the articles of association or other document regulating that or any other body corporate,

that the affairs of the first-mentioned body corporate are conducted in accordance with the wishes of that person, and, in relation to a partnership, means the right to a share of more than one-half of the assets, or of more than one-half of the income, of the partnership.

Section 879: Interpretation: Scotland

3321. This section incorporates the effect of the devolution settlement and deals with the application of certain terms used in the Act to Scotland.

3322. *Subsection (1)* is based on sections 24(5) and 539(2) of ICTA which provide that in applying the provisions of Schedule A and of Chapter 2 of Part 13 of ICTA to Scotland, "assignment" means "assignation".

3323. *Subsection (2)* is based on *Change 19* in Annex 1 and gives certainty to the meaning of "Act".

3324. *Subsection (3)* is based on *Change 19* in Annex 1 and gives certainty to the meaning of "enactment".

Section 880: Interpretation: Northern Ireland

3325. This section incorporates the effect of the devolution settlement and deals with the application of certain terms used in the Act to Northern Ireland. It is new.

3326. *Subsection (1)* is based on *Change 19* in Annex 1 and gives certainty to the meaning of "Act".

3327. *Subsection (2)* is based on *Change 19* in Annex 1 and gives certainty to the meaning of "enactment".

3328. *Subsection (3)* provides that section 631 of this Act does not extend to Northern Ireland legislation. It is improbable that "enactment" in section 660B(2) of ICTA, on which section 631 is based, includes Northern Ireland legislation and to include section 631 within *Change 19* as regards to Northern Ireland would be taxpayer adverse.

Section 881: Disapplication of corporation tax: section 9 of ICTA

3329. This section ensures that the provisions of this Act which apply for income tax purposes only are not applied by section 9 of ICTA for corporation tax purposes. It is new.

Section 882: Consequential amendments

3330. This section is new. It contains a subsection introducing Schedule 1 and a power to allow the Treasury to make by order consequential amendments.

3331. The power will not be invoked without the agreement of the Tax Law Rewrite Project's Consultative and Steering Committees to the proposed modifications.

3332. *Subsection (1)* gives effect to Schedule 1.

3333. *Subsections (2)* to *(5)* contain the power. It is to be exercised by Treasury order and will where appropriate allow both amendments and repeals in consequence of this Act only. But those amendments and repeals are limited in effect by subsections (4)(a) and (5). Subsection (4)(b) allows appropriate transitional or savings provisions to be made in respect of any of those amendments or repeals.

Section 883: Commencement and transitional provisions etc.

3334. This section is new. It provides for the commencement of the Act and also provides for certain orders to take effect on passing of the Act. It also contains a power to make by order any further transitional provision or saving which might not have been dealt with in the Act.

3335. The power will not be invoked without the agreement of the Tax Law Rewrite Project's Consultative and Steering Committees to the proposed transitional provision or saving.

3336. *Subsection (1)*, which sets out when the Act comes into force and has effect, deals with the position for both income tax and corporation tax. The Act is in substance an income tax only Act. But it makes numerous consequential amendments to the corporation tax code. Those consequential amendments do not change the law but do require a commencement provision.

3337. *Subsection (3)* provides that the certain provisions will come into force on the passing of the Act.

3338. *Subsection (5)* contains the power. It is to be exercised by Treasury order.

Section 884: Repeals and revocations

3339. This provision gives effect to Schedule 3.

Section 885: Abbreviations and general index in Schedule 4

3340. This provision gives effect to Schedule 4.

Schedule 1: Consequential Amendments

Part 1: Income and Corporation Taxes Act 1988

Paragraph 3: section 1A of ICTA

3341. Section 1A of ICTA is an income tax only provision. As this section is primarily concerned with rates of tax it is not rewritten.

3342. The repeal of Schedule F and Schedule D Cases III, IV, V and VI (for income tax purposes) means that it is now possible to restructure section 1A of ICTA to identify more clearly the types of income within the scope of the section. So, for example, instead of bringing in *all* income chargeable under Schedule D Case III, and then excluding certain items, it is now possible to focus directly on the income within section 1A of ICTA.

3343. As a result of the revised approach, section 1A(4)(b) of ICTA – dealing with estate income chargeable under section 695(4)(b) or 696(6) of ICTA – can be repealed. Similarly, it is not necessary to retain section 1A(7) of ICTA which effectively brings purchased life annuities within the scope of section 1A of ICTA – such purchased life annuities are now brought in by the consequential amendment to section 1A(2)(a) of ICTA.

Paragraph 7: section 9 of ICTA

3344. This Act deals in substance with income tax only. As a result the income tax and corporation tax codes will be separated to a much greater extent than in the source legislation.

3345. Corporation tax law, in statute, is made up of a combination of express corporation tax provisions and applied income tax principles, law and practice.

3346. The income tax principles, law and practice are applied by section 9 of ICTA .

3347. Section 9 of ICTA, so far as it operates on statutory provisions, operates in the source legislation on both income tax provisions that are rewritten in this Act and income tax provisions that are not rewritten in this Act (for example, parts of ITEPA). It also extends to case law and practice.

3348. The amendments to section 9 of ICTA maintain this approach in the context of the greater separation of the two codes. But section 9 of ICTA does not operate on the provisions in this Act to convert them into provisions of the Corporation Tax Acts, see section 881.

Paragraph 9: section 18 of ICTA

3349. Paragraph 9 amends section 18 of ICTA so that subsections (1) to (4) apply only for corporation tax purposes. The income tax aspects of this provision are rewritten as follows:

Cases I and II

The income charged under Schedule D Case I or II in the source legislation is rewritten for income tax purposes in Chapter 2 of Part 2 of this Act.

Case III

3350. The income charged under Schedule D Case III in the source legislation is rewritten for income tax purposes in the following places in this Act:

- Part 4 - Chapter 2 (interest), Chapter 7 (purchased life annuity payments), Chapter 8 (deeply discounted securities), Chapter 10 (distributions from unauthorised unit trusts); and
- Part 5 - Chapter 2 (receipts from intellectual property) - but royalties only, Chapter 4 (certain telecommunication rights: non-trading income) and Chapter 7 (annual payments not otherwise charged).

3351. The corporation tax version of Schedule D Case III in section 18(3A) of ICTA will continue to work for corporation tax.

Cases IV and V

3352. Except in respect of foreign dividends, the charge on foreign income under these Cases in the source legislation has been integrated with the charge on equivalent types of UK income in this Act for income tax purposes. The charge under Case V in the source legislation on foreign dividends is rewritten for income tax purposes in Chapter 4 of Part 4 of this Act. The Cases continue to operate as amended by section 18(3A) to (3E) of ICTA for corporation tax purposes.

Case VI

3353. The provisions which are rewritten in this Act for income tax purposes, and which charge income to income tax under Schedule D Case VI in the source legislation, have been replaced by charges on each type of income. See the following Parts of this Act:

- Part 2 – Chapter 2 (income taxed as trade profits, including wayleaves), Chapter 17 (adjustment income: trades, professions and vocations) and Chapter 18 (post-cessation receipts: trades, professions and vocations);
- Part 3 – Chapter 7 (adjustment income: UK property businesses), Chapter 8 (rent receivable in connection with a UK section 12 concern), Chapter 9 (rent receivable for UK electric-line wayleaves) and Chapter 10 (post-cessation receipts);
- Part 4 – Chapter 2 (interest, including funding bond interest), Chapter 9 (gains from contracts for life insurance etc.), Chapter 11 (transactions in deposits) and Chapter 12 (disposals of futures and options involving guaranteed returns); and
- Part 5 – section 579 (royalties and other income from intellectual property), section 583 (income from disposals of know-how), section 587 (income from sales of patent rights), Chapter 3 (films and sound recordings: non-trade businesses), Chapter 4 (certain telecommunication rights: non-trading income), Chapter 5 (settlements: amounts treated as income of settlor), section 682(3) (estates in administration: assessments, adjustments and claims after the administration period) and Chapter 8 (income not otherwise charged).

3354. Additionally, amendments have been made to all of the Schedule D Case VI provisions in ICTA and other enactments which are not being rewritten in this Act but which apply for income tax purposes (see the table in Part 1 of section 836B of ICTA, inserted by paragraph 339 of this Schedule, referred to in the amendment in paragraph 167 of this Schedule for section 392 of ICTA). The amendments remove references to income tax being charged under Schedule D Case VI and create free standing income tax charges.

The Schedule D Case VI references have been retained where needed for corporation tax purposes.

3355. Some of the Schedule D Case VI provisions which are not rewritten in this Act are of an administrative nature. These provisions typically withdraw reliefs and operate under the source legislation by way of an assessment under Schedule D Case VI (see particularly section 30(4) of TMA, sections 307(1), 384(8), 384A(6) and 703(3) of and paragraph 4(2) of Schedule 15B to ICTA and paragraph 27(2) of Schedule 16 to FA 2002). These provisions are rewritten as simple assessments (in the case of section 30(4) of TMA, by the omission of subsection (4)). This is because the provisions that apply generally to income and amounts treated as income charged to income tax under Schedule D Case VI (sections 18, 59, 69 and 392 of ICTA) have no application to these provisions.

Paragraph 10: section 20 of ICTA

3356. Section 20 of ICTA, Schedule F, is rewritten in Chapter 3 of Part 4 of this Act (dividends etc. from UK resident companies etc.). It is repealed for all tax purposes.

Section 20(1) paragraph 1 of ICTA – the Schedule F charging provision

3357. Section 20(1) paragraph 1 of ICTA is an income tax only provision. It therefore applies *directly* to persons subject to income tax (unless they are dealers or certain individual members of Lloyd’s in which case they are taxed under Schedule D Case I or II).

3358. As an income tax only provision, section 20(1) paragraph 1 of ICTA does not directly apply to persons subject to corporation tax. This is clear from the wording of section 20(1) paragraph 1 of ICTA itself but confirmation of this is also given by section 6 of ICTA.

3359. Therefore, section 20(1) paragraph 1 of ICTA could only apply to corporation tax *indirectly*, that is, via section 9 of ICTA.

3360. However, section 9 of ICTA is subject to exceptions. On one interpretation of the legislation section 208 of ICTA is one such exception.

3361. Applying this interpretation, where section 208 of ICTA applies section 9 of ICTA does not and so section 20(1) paragraph 1 of ICTA cannot apply.

3362. An alternative interpretation is that section 208 of ICTA is not an exception to section 9 of ICTA but an exemption from corporation tax on dividends and other distributions charged under Schedule F.

3363. Applying this interpretation, section 9 of ICTA applies and so section 20(1) paragraph 1 of ICTA applies, but section 208 of ICTA prevents the dividend or other distribution from being chargeable to corporation tax.

3364. On either interpretation, if section 208 of ICTA applies there is no liability under section 20(1) paragraph 1 of ICTA. Conversely, if section 208 of ICTA does not apply, there is.

3365. There are three exceptions to section 208 of ICTA. These are:

- section 95(1A)(c) of ICTA (dealers);
- section 219(4A) of FA 1994 (Lloyd’s underwriters); and
- section 434(1) of ICTA (franked investment income and life assurance profits).

3366. However, in each case Schedule F does not apply. Instead, dividends and other distributions are taxed under Schedule D Case I or Schedule D Case VI.

3367. There are therefore no instances where a body corporate acting in a beneficial capacity is chargeable to corporation tax under section 20(1) paragraph 1 of ICTA.

Section 20(1) paragraph 2 of ICTA – the income chargeable

3368. Section 20(1) paragraph 2 of ICTA determines the income chargeable and is expressed to apply for "all purposes of the Tax Acts". It therefore applies directly to a company subject to corporation tax unless there is an express provision to the contrary.

3369. Section 20(1) paragraph 2 of ICTA is expressly disapplied in the case of:

- dealers;
- Lloyd's underwriters; and
- certain life assurance companies.

3370. Where section 20(1) paragraph 2 of ICTA might otherwise be relevant, that is, in order to establish that income is the aggregate of the dividend etc and the tax credit (for example, under section 13 of ICTA (small companies' relief), in connection with the surplus ACT rules etc), the relevant legislation uses the term "franked investment income". Franked investment income is defined in almost identical terms as section 20(1) paragraph 2 of ICTA.

3371. Section 20(1) paragraph 2 of ICTA therefore serves no practical purpose in a corporation tax context.

Section 20(2) of ICTA –priority provision

3372. Section 20(2) of ICTA applies to a distribution "which is chargeable under Schedule F". It does not therefore apply in a corporation tax context because section 20(1) paragraph 1 of ICTA does not apply.

Section 20(3) of ICTA - signpost

3373. In a corporation tax context, section 20(3) of ICTA introduces Part 6 of ICTA but this introduction is no longer required.

Replacement expressions for special tax rates

3374. The following replacement terms are used:

- Schedule F ordinary rate becomes "dividend ordinary rate";
- Schedule F upper rate becomes "dividend upper rate"; and
- Schedule F trust rate becomes "dividend trust rate".

Paragraph 36: section 60 of ICTA

3375. This paragraph omits section 60 of ICTA and the section is repealed by Schedule 3 to this Act.

3376. Section 60(4) of ICTA deals with the death of a taxpayer. It ensures that on the death of a person carrying on a trade the necessary cessation adjustments can be made, and the tax collected from the personal representatives.

3377. The rule in section 60(4) of ICTA dates from the time when adjustments on cessation could involve not only an adjustment for the year of death (the assessment for which might already have been made on a previous year basis) but also adjustments to the two previous years to increase the amount of the assessments to the profits of those years on a current year basis.

3378. Under Self Assessment any return of income for the year of death will naturally take account of the death. And there is no question of adjusting assessments for previous years on account of the death.

3379. The general rule in section 74 of TMA (that the personal representatives inherit the tax liabilities of the deceased) is enough. There is no need for the special rule in section 60(4) of ICTA for trade profits.

3380. See also the commentary on the repeal of section 113(6) of ICTA.

Paragraph 43: section 71 of ICTA

3381. This paragraph omits section 71 of ICTA and that section is repealed in Schedule 3 to this Act.

3382. Section 71 of ICTA applies to all the Cases of Schedule D when a preceding year basis of assessment applies. It provides that a person will remain chargeable in a year when no income from the relevant source arises. It is based on section 22 of FA 1928 which was enacted in response to the House of Lords decision in Whelan v Henning (1926), 10 TC 263 to the effect of "no income in year of assessment, no liability to tax".

3383. There is no longer a preceding year basis of assessment for any Schedule D Case. So the provision is redundant.

Paragraph 45: section 74 of ICTA

3384. Section 74(1) of ICTA lists various items in respect of which no deduction is allowed in computing profits to be charged under Schedule D Case I or II.

3385. Section 74(1)(b) of ICTA prohibits deductions in respect of expenditure on "maintenance of the parties, their families or establishments, or any sums expended for any other domestic or private purposes distinct from the purposes of the trade, profession or vocation".

3386. Section 74(1)(b) of ICTA is not rewritten for income tax purposes because the deductions which it prohibits are covered by section 34 which rewrites the general prohibition on deductions not "wholly and exclusively laid out for the purposes of the trade, profession or vocation" in section 74(1)(a) of ICTA. And because it applies only to individuals, there is no need to preserve section 74(1)(b) of ICTA. It is therefore omitted.

3387. Section 74(1)(h) of ICTA prohibits deductions for interest forgone on capital used in the trade or in improving the trade premises. It is unlikely that any accounts drawn up in accordance with generally accepted accounting practice would include a deduction for notional interest. Section 74(1)(h) of ICTA is not rewritten for income tax purposes as it is considered to be redundant.

3388. Section 74(1)(k) of ICTA prohibits deductions for "any average loss beyond the actual amount of loss after adjustment". This rule applies to the practice in shipping and aviation trades of sharing between all parties with a financial interest in a vessel and its cargo the financial loss incurred where *part* of a vessel or its cargo is lost or damaged in an attempt to save the vessel, the crew and passengers or the rest of the cargo. The term "average loss" is applied to the share of the loss allocated to each party. The amount of the average loss "after adjustment" may not be known for some years after the actual loss has occurred.

3389. Section 74(1)(k) of ICTA is not rewritten for income tax purposes. This allows the tax treatment of the average loss to follow the generally accepted accountancy practice in such cases. This is to make a provision in the year of loss and to review that provision in subsequent years.

3390. Section 74(1)(m) of ICTA prevents a deduction for any annuity and other annual payment "payable out of the profits". Because the rule applies only to amounts payable "out of the profits", it has no application to the calculation of those profits. The rule is not rewritten for income tax purposes.

3391. Section 74(1)(o) of ICTA prevents a deduction in calculating trade profits for any interest that has qualified for Mortgage Interest Relief At Source. When MIRAS was available for mortgage interest generally this rule against double deductions served an important function. Since 1999 MIRAS has been available only on loans to buy a life annuity and secured on the private residence of a person aged 65 years or over. The relief is given only to loans in existence on 9 March 1999 or replacement loans.

3392. It is very unlikely that any interest would satisfy the conditions to qualify both for MIRAS and as a deduction in calculating trade profits. For this reason this Act does not rewrite section 74(1)(o) of ICTA.

Paragraph 53: section 82 of ICTA

3393. This paragraph omits section 82 of ICTA and the section is repealed in Schedule 3 to this Act.

3394. There are two reasons for repealing this section:

- the section no longer achieves its original purpose; and
- the section is, in part, out of step with modern tax principles.

3395. Section 82 of ICTA is a complex provision which prevents a deduction in computing trade profits for payments of annual interest to a non UK resident except in two circumstances.

3396. The first is when the payer has made the payment as required by section 349(2) of ICTA under deduction of tax and has accounted to the Inland Revenue for the tax: section 82(1)(a) of ICTA. (This is interpreted to include payments within section 349(2) of ICTA made gross solely because of a double taxation agreement.)

3397. The second is when the interest is not within section 349(2) of ICTA but is paid by a UK resident trader under a liability incurred exclusively for the purposes of the trade. The interest has to be payable and paid outside the United Kingdom and either incurred for the purposes of activities outside the United Kingdom or paid in foreign currency: section 82(1)(b) of ICTA.

3398. Section 82 of ICTA originates from FA 1949. At the time it was introduced annual interest was not a permitted trading deduction: relief was obtained by the payer deducting income tax before paying the interest. But in certain circumstances, notably where the source of the interest was outside the United Kingdom, the payer could not legally deduct tax and could therefore get no effective relief for the interest. So what is now section 82(1)(b) of ICTA was introduced to give relief by allowing the gross payment as a Schedule D Case I or II deduction.

3399. FA 1969 ended deduction of tax at source from most interest paid and with it the general relief for interest paid that the deduction at source system gave. New rules were introduced which gave relief for interest only on loans for particular purposes, mainly the purchase or improvement of land. Where, however, the interest was for a trading purpose it could be deducted in computing trading profits.

3400. The FA 1969 reforms preserved deduction of tax at source for payments of annual interest only in a limited number of circumstances and the tax deducted had to be paid over to the Inland Revenue (rather than be retained by the payer). One such circumstance was when it was paid to a person whose usual place of abode was outside the United Kingdom. It was recognised that what is now section 82(1)(b) of ICTA could no longer operate as an exception to the former general rule against allowing interest as a deduction in computing trading profits: that rule had gone. But it was preserved in a form which allowed a deduction only when its original conditions were satisfied. In addition, what is now section 82(1)(a) of ICTA was grafted onto it as new legislation to take account of the new deduction at source rule.

3401. The current position is that what started life as a permissive provision, allowing relief as a trading deduction in circumstances where none would otherwise have been available, has become a restrictive one. It restricts relief where, on general principles, it would otherwise be due: interest paid gross would normally have to satisfy only the "wholly and exclusively" test in section 74(1)(a) of ICTA to be deductible. The linking of a right to deduction as a trading expense with the obligation to deduct tax on payment does not reflect modern principles of determining deductibility of trade expenses.

3402. The section no longer fulfils any practical purpose and is therefore redundant.

Paragraph 60: section 86 of ICTA

3403. This section allows a person carrying on a trade to deduct the cost of an employee who is seconded to a charity or educational establishment in calculating the profits of the trade.

3404. Section 86(5) of ICTA lists educational establishments in Scotland for the purposes of relief under section 86 of ICTA. Section 86(5)(d) of ICTA refers to "a self-governing school within the meaning of the Self-Governing Schools etc (Scotland) Act 1989".

3405. Section 86(5)(d) of ICTA is not rewritten for income tax purposes because such schools were abolished on 1 April 2003. But there is a transitional rule in paragraph 21 of Schedule 2 to this Act to deal with the case of a secondment being relevant to a period of account ending on or after 6 April 2005.

Paragraph 65: section 89 of ICTA

3406. Section 89 of ICTA is not rewritten for income tax purposes. See the commentary on section 35 and *Change 7* in Annex 1.

Section 92 of ICTA (no paragraph in Schedule 1)

3407. Section 92 of ICTA applies to regional development grants under Part 2 of the Industrial Development Act 1982. The Industrial Development Act 1982 was repealed by the Statute Law (Repeals) Act 2004 with effect from 22 July 2004. No applications under Part 2 of the 1982 Act could be made after 31 March 1988 and there are no payments outstanding in respect of grants made before that date. So section 92 of ICTA is not rewritten for income tax purposes.

Paragraph 94: section 113 of ICTA

3408. This paragraph omits section 113 of ICTA and the section is repealed in Schedule 3 to this Act.

3409. Section 113(1) of ICTA applies to trade profits. But it is extended to property businesses by section 21B of ICTA. It ensures that a trade is treated as ceasing when there is a change in the persons carrying it on. The need for the rule arises from the fact that some rules in ICTA are expressed in terms of the commencement and cessation of a trade, rather than the position of the person carrying it on.

3410. The rewritten basis period rules in Chapter 15 of Part 2 of this Act are expressed in terms of the person carrying on the trade. Other rules that depend on the commencement or cessation of a trade are also rewritten in terms of the person carrying on the trade.

3411. So there is no need for a special rule deeming there to be a cessation where the trade is carried on by a successor.

3412. In many cases, a rule in ICTA is explicit that a change in the persons carrying on a trade to which section 113(1) of ICTA applies is to be treated as a cessation for the purposes of the rule: for instance, the post-cessation receipts rules in sections 103 to 109A of ICTA (see section 110(2)(a) of ICTA).

3413. In other cases there is no explicit indication that section 113(1) of ICTA applies to treat the trade as ceasing. In each of the following sections the rewritten rule makes it clear that the trade is not treated as ceasing unless there is a complete change in the persons carrying it on. This retains the effect of section 113(1) of ICTA as limited by section 113(2):

- Section 77: Payments in respect of employment wholly in employer's trade;
- Section 79: Additional payments;
- Section 173: Valuation of trading stock on cessation; and
- Section 182: Valuation of work in progress on cessation.

3414. Section 113(6) of ICTA deals with the death of a taxpayer. It ensures that on the death of a person carrying on a trade the necessary cessation adjustments can be made and the tax collected from the personal representatives.

3415. The rule in the subsection dates from the time when adjustments on cessation could involve not only an adjustment for the year of death (the assessment for which might already have been made on a previous year basis) but also adjustments to the two previous years to increase the amount of the assessments to the profits of those years on a current year basis.

3416. Under Self Assessment any return of income for the year of death will naturally take account of the death. And there is no question of adjusting assessments for previous years on account of the death.

3417. The general rule in section 74 of TMA (that the personal representatives inherit the tax liabilities of the deceased) is enough. There is no need for the special rule in section 113(6) of ICTA for trade profits (or property income, to which it is applied by section 21B of ICTA).

3418. See also the commentary on the repeal of section 60(4) of ICTA.

Paragraph 106: section 122 of ICTA

3419. In section 122(2) of ICTA the reference to section 121(2) of ICTA has been amended to "section 121(3)". This corrects a minor error in ICTA.

3420. Section 122(4) of ICTA has been omitted. It became redundant when FA 1995 removed the requirement to deduct income tax from the payment of rent within section 119 of ICTA.

Paragraph 141: section 333 of ICTA

3421. Section 333 of ICTA is rewritten in Chapter 3 of Part 6 of this Act but section 333(4)(e) of ICTA allows the regulations to include provisions generally for the administration of corporation tax. Since this cannot be rewritten in this Act and a repeal of all of section 333 of ICTA but for that small part would be ungainly this new section has been substituted.

Paragraph 146: section 347A of ICTA

3422. In the source legislation, section 347A(1) of ICTA makes provision about the tax treatment of certain annual payments both from the perspective of the payer and the recipient. Section 347A(1) of ICTA provides that a payment to which the section applies is not a charge on income for the person paying it. Section 347A(1)(a) of ICTA then denies the payer a deduction from his income in respect of the payment and section 347A(1)(b) of ICTA deals with the recipient and gives the recipient an exemption from income tax or corporation tax (as the case may be).

3423. Section 347A(2) of ICTA describes the payments to which section 347A(1) of ICTA applies for both these purposes.

3424. The income tax exemption is rewritten in Chapter 8 of Part 6 of this Act. So section 347A(1)(b) of ICTA has been amended by this Schedule (see paragraph 146(2)) so that section 347A(1)(b) of ICTA is an exemption from corporation tax only.

3425. Further, the Schedular/Case system of classification of income has been abolished for income tax purposes. So section 347A(2) of ICTA now applies to annual payments which, but for the exemption, would be within the charge to corporation tax under Schedule D Case III of Schedule D (except to the extent those payments are excluded by subparagraphs (a) to (d)). And a new subsection "(2A)" has been inserted by this Schedule (see paragraph 146(3)) to deal with the income tax equivalent of section 347A(2) of ICTA (as amended). Because the conditions in section 347A(2) of ICTA are rewritten in sections 727 to 729 of this Act, new subsection (2A) refers to the payments which are exempt from income tax as a result of section 727 of this Act.

3426. This Schedule also omits section 347A(5) of ICTA (see paragraph 146(4)) and the subsection is repealed by Schedule 3 to this Act.

3427. Section 347A(5) of ICTA is rewritten so far as deductions under sections 65(1)(b) and 68(1)(b) of ICTA are concerned. The reference to section 355 of ITEPA in section 347A(5) of ICTA is not rewritten. Section 347A(5) of ICTA denies a deduction for an annual payment paid out of certain foreign income if that annual payment would not have been within the charge to tax if the payment had arisen in the United Kingdom.

3428. Section 355 of ITEPA allows an employee to claim a deduction against foreign earnings for certain payments made abroad which if the payments had been made in the United Kingdom would have given rise to tax relief. If there is no such tax relief in the United Kingdom, section 355 of ITEPA effectively denies a deduction. So in the context of section 347A(5) of ICTA the reference to section 355 of ITEPA is superfluous.

Paragraph 147: section 348 of ICTA

3429. Paragraph 147(3) of this Schedule inserts a new subsection into section 348 of ICTA. It is based on sections 233(1)(c), 249(4)(c), 249(6)(c), 421(1)(c), 547(5)(c) and 699A(6) of ICTA. The new subsection applies for the purposes of section 348 and 349 of ICTA. The new subsection gathers together the provisions which would otherwise be "stranded" in the source legislation about amounts not being brought into charge to tax for the purposes of sections 348 and 349.

Paragraph 148: section 349 of ICTA

3430. The new section 349ZA(3) of ICTA defines "the net amount of the proceeds or instalment" for the purposes of the application of section 349 of ICTA in the context of section 524 of ICTA (taxation of receipts from sale of patent rightrs). Any incidental expenses of the sale which are deducted before payment are taken into account for this purpose. The source legislation does not explicitly mention incidental expenses of sale, although the words "net proceeds of sale" in section 524(1) of ICTA imply that some deduction is available.

3431. The reference in section 524(3) of ICTA to the net proceeds of sale had significance for the purposes of the rule that the payer must deduct income tax from the capital sum comprised in the net proceeds of sale. In deducting tax, the payer is required to leave out of account certain matters that affect the seller's ultimate liability to tax. Although the seller's liability may be reduced if he bought the rights for a capital sum, such a reduction does not affect the amount of tax that is to be deducted by the payer (see section 524(7) to (9) of ICTA). And if the seller makes an election to spread his tax liability over six years, that election does not affect the amount of tax that is to be deducted by the payer (see section 524(4)(a) of ICTA).

3432. These rules ensure that the payer is not required, in deducting tax, to take account of matters that may be outside his knowledge. Against this background, it makes sense for the rule requiring the deduction of income tax at source to require the payer to take into account only those incidental expenses that are deducted before payment of the sale proceeds. The payer would otherwise be required to take into account matters that he could not readily ascertain. The rule requiring the payer only to take account of those incidental expenses that are deducted before payment does not affect the seller's ultimate liability to tax.

Paragraph 167: section 391 of ICTA

3433. Section 391 of ICTA provides relief for the losses of a trade, profession or vocation taxed under Schedule D Case V. Such losses can be used only against the losses of another Case V trade, profession or vocation (or certain income within ITEPA).

Paragraph 168: section 392 of ICTA

3434. The amendment of section 392 of ICTA by paragraph 168 of this Schedule preserves the loss regime that applies to income that is, in the source legislation, income within Schedule D Case VI.

3435. Section 392 of ICTA is an income tax only provision that provides relief for losses in income types that, in the source legislation, are charged to tax under Schedule D Case VI. It provides the only avenue of relief available in respect of such losses.

3436. In the source legislation the charge under Schedule D Case VI comprises three elements:

- a cornerstone, "sweeping-up" charge that catches any income not caught by the other Schedules and Cases;
- a range of specific charges on miscellaneous transactions and receipts; and
- a range of specific charges of an administrative nature to recover excess relief or undercharges of tax.

3437. On account of its breadth and diversity, Schedule D Case VI is often referred to as a "sweep-up" charge. Subject to some important qualifications mentioned below, the purpose of section 392 of ICTA is to allow set-off of losses arising from these different types of swept-up income against swept-up profits. Losses are allowed, and profits relieved, on an undifferentiated basis. That is, once within section 392 of ICTA, a loss can be set off against a profit of any sort (provided it is a Schedule D Case VI profit or, in addition, since ITEPA, certain pension profit) and is not limited to set off only against profit of the same type.

3438. But not all of the items within the Schedule D Case VI charge fall automatically within the section 392 of ICTA loss regime because not all are inherently capable of producing a loss. And section 392 of ICTA requires the presence of a "transaction" from which the loss or profit must arise.

3439. If there *is* a transaction, section 392 of ICTA provides:

- (where a loss can arise) for the loss to be allowable provided that, had the transaction from which it arises been profitable, that profit would have been chargeable under Schedule D Case VI; and
- for the set-off of such a loss against the profits of any other transactions chargeable under Schedule D Case VI (or against certain pension income chargeable under ITEPA) for the current year and carry-forward of any surplus against similar profits of later years.

3440. This Act makes wide-ranging changes in the way Schedule D Case VI income is charged. Specifically:

- the labels “Schedule D” and “Case VI” disappear;
- certain income charged under Schedule D Case VI is transferred to other heads of charge such as trading income or property income;
- other income is charged under various bespoke sections in Parts 4 and 5; and
- there is a pure “sweep-up” section in Part 5 (section 687).

3441. The amendment of section 392 of ICTA will ensure that, notwithstanding these recategorisations, the scheme of loss relief provided by the source legislation will continue unchanged. The table in the new section 836B of ICTA lists the provisions that, as they apply before the commencement of this Act, contain a Schedule D Case VI charge and to which section 392 of ICTA is, therefore, potentially relevant. Provisions of an administrative nature to recover excess relief and undercharges of tax are excluded: see the commentary on the amendment in Schedule 1 to this Act of section 18, Schedule D Case VI, of ICTA . These are:

FA 1950

- section 40(3) (recovery of relief);

TMA

- section 30(4) (recovery of over-repayment of tax; repealed, see paragraph 15 of this volume of Explanatory Notes and Schedule 3);

ICTA

- section 118ZH(3) (recovery of relief);
- section 307(1) (withdrawal of relief not due);
- section 384(8) (withdrawal of certain loss relief);
- section 384A(6) (withdrawal of certain loss relief);
- section 399(3) (withdrawal of certain loss relief);
- section 703(3) (recovery of inappropriate tax repayment);
- section 788(7) (double taxation relief adjustment);
- section 790(11) (double taxation relief adjustment);
- paragraph 4 of Schedule 15B (recovery of venture capital trust relief); and

FA 2002

- paragraph 27(2) of Schedule 16 (withdrawal of community investment tax relief).

3442. There is one Schedule D Case VI provision in the source legislation where the position in the source legislation has not been preserved. That is section 127 of ICTA (enterprise allowance) which is rewritten as section 207 in Chapter 15 of Part 2 of this Act. The amount charged under Schedule D Case VI in the source legislation is dealt with in this Act as part of the calculation of trade profits: see *Change 53* in Annex 1. So it does not need to be included in the amendment of section 392 of ICTA.

Section 443 of ICTA (no paragraph in Schedule 1)

3443. Section 443 of ICTA is repealed for income tax purposes. This is achieved by retaining the text of this provision, as Schedule D Cases I and VI will apply solely for corporation tax purposes after this Act.

3444. Section 443 of ICTA deals with the case in which the proceeds of a life assurance policy are paid out in the form of assets and not in cash. When section 443 of ICTA was introduced as section 35 of FA 1967 the section governed the treatment of the assets for the purposes of both capital gains and short term gains (Schedule D Case VII).

3445. At that time the disposal by the insurance company would usually be taxed as a capital gain. The main purpose of the 1967 legislation was to make clear that the disposal was at market value. It seems the reference to Schedule D Cases I, VI and VII was to deal with the less common case in which the corporation tax charge on the company on disposal was taxed under these Cases.

3446. The section also put it beyond doubt that the base cost of the asset to the policy holder was market value either for capital gains or short term gains purposes.

3447. The reference to short term gains was repealed in 1971. And with the consolidation of the capital gains tax code, the capital gains tax rule can now be found in section 204(3) of TCGA. These changes to the section mean that, in the income tax context, section 443 of ICTA now deals only with the policy holder's acquisition of the assets for the purposes of Schedule D Cases I and VI. But of course the mere acquisition of the assets cannot give rise to any liability under Schedule D Cases I or VI.

3448. The value of the assets acquired would be reflected in a Schedule D Case I computation only if the policy itself were held as trading stock. In that unlikely event the Inland Revenue is content to follow generally accepted accounting practice in calculating the profits of the trade.

3449. It is very difficult to envisage any circumstances in which the disposal of assets acquired on the maturity of an insurance policy would give rise to a Schedule D Case VI liability. But in that most unlikely event the application of the decision in Curtis Brown Ltd v Jarvis (1929), 14 TC 744 HC would suggest a similar result as for Schedule D Case I.

Paragraphs 209 to 228: sections 539 to 554 of ICTA

3450. The amendments for these sections do three things. First, they ensure that any liability arising under Chapter 2 of Part 13 of ICTA is chargeable to corporation tax only (see, in particular, the amendments of sections 539 and 547 of ICTA). Second, sections 552 to 552B of ICTA (information: duty of insurers) are amended to reflect the fact that the same event will be a chargeable event under both Chapter 2 of Part 13 of ICTA and Chapter 9 of Part 4 of this Act, and the gain produced by the event is treated as arising under both Chapters. (But the gain, or a part of the gain, is only charged on any taxpayer under or by virtue of one of those Chapters according to that taxpayer's liability for tax.) Third, the redundant section 554 of ICTA is repealed.

3451. The amendment of the definition of a life annuity in section 539 of ICTA recognises that the determination of what is, or is not, a purchased life annuity depends on whether the annuitant is within the corporation tax or income tax charge. The annuitant may be subject to one tax charge and the person who is liable for a gain arising on a chargeable event in respect of the annuity contract may be subject to the other. Both provisions for determining an annuity have to be mentioned here to avoid restricting the scope of the charge under section 547(1)(b) of ICTA. The amendment of section 543 of ICTA is made for the same reasons as regards the calculation of the gain.

3452. A new section, section 539ZA (policies and contracts in which persons other than companies are interested), is inserted in ICTA. This section deals with the circumstance where the application of Chapter 2 of Part 13 of ICTA (and related provisions) – that is, whether there is a chargeable event and what the amount of the gain is – has to take into account anything that occurred (or may yet occur) in respect of the policy or contract at a time when any liability may, wholly or in part, arise or have arisen under Chapter 9 of Part 4 of this Act. It mirrors section 544 of this Act.

3453. The section makes clear that Chapter 2 of Part 13 of ICTA and related provisions, "the corporation tax provisions", apply in respect of any other circumstance regardless of any application of Chapter 9 of Part 4 of this Act at that time. For example, if there has been a chargeable event under section 540(1)(a)(v) of ICTA (so that there was also a chargeable event under section 509) at a time when liability on the gain arose wholly or in part under Chapter 9 of Part 4 of this Act, that event is still to be taken into account in the later application of the corporation tax provisions to that policy or contract.

3454. This new section therefore recognises that both the corporation tax provisions and the provisions in Chapter 9 of Part 4 of this Act apply to a policy or contract. There is a chargeable event under each, but the two sets of provisions apply separately as regards liability. (There are a number of reliefs and other rules that affect income tax liability only.)

3455. As a consequence of the repeal of section 547(1)(a) of ICTA (rewritten in section 465) and section 547(1)(e) of ICTA (rewritten in section 468), the subsections in section 547 of ICTA interpreting the meaning of trusts created by an individual and providing the definition of a "foreign institution" have been relocated to section 547A of ICTA.

3456. The amendments of sections 552 to 552B of ICTA provide for a single certificate to be given to each relevant policy holder (and, where required, to the Inland Revenue) in respect of an event and the gain which it produces, notwithstanding that the event is a chargeable event under both Chapter 2 of Part 13 of ICTA and Chapter 9 of Part 4 of this Act, and the gain is treated as arising under both Chapters. The amendments also reflect the different language in the two Chapters and the fact that certain provisions of Chapter 9 of Part 4 of this Act have no equivalent in the amended Chapter 2 of Part 13 of ICTA.

3457. Section 553C of ICTA is amended so that it is a corporation tax provision, as the income tax application of the section and the related parts of the Personal Portfolio Bonds (Tax) Regulations 1999 (SI 1999/1029, as amended by SI 2001/2724 and SI 2002/455) are rewritten in Chapter 9 of Part 4 of this Act.

3458. Section 553C(9A) to (9E) of ICTA enables regulations under that section to provide for a chargeable event gain to arise in relation to a policy or contract which is a personal portfolio bond despite the fact that, at the time, rights in the policy or contract are so held that liability on a gain would be charged under, or by virtue of, Chapter 9 of Part 4 of this Act. The power is limited so that the regulations may make provisions only for the purposes of enabling the gain to be taken into account on the later application of Chapter 2 of Part 13 of ICTA to the policy or contract.

3459. Section 554 of ICTA is omitted. It is spent.

Paragraph 247 and 248: sections 586 and 587 of ICTA

3460. These amendments repeal sections 586 and 587 of ICTA for income tax purposes. Both sections apply only when the United Kingdom is in a declared state of war. They disallow payments made in connection with war damage indemnity schemes and in respect of war injuries to employees. The sections were enacted to deal with the particular circumstances of the second world war when high rates of taxation meant that payments could be made almost entirely at the Exchequer's expense. They are now obsolete.

Paragraphs 284 and 285: sections 695 and 696 of ICTA

3461. This concerns the amendment of sections 695(4)(b) and 696(6) of ICTA so that they will apply for corporation tax purposes without references to the charge to income tax under Schedule D Case IV.

3462. Part 16 of ICTA deems certain payments made to beneficiaries from estates in administration to be income. Although Part 16 of ICTA principally applies to beneficiaries within the charge to income tax, it is also capable of applying to beneficiaries within the charge to corporation tax. Chapter 6 of Part 5 of this Act rewrites the provisions which apply for income tax purposes, and Schedule 1 amends Part 16 of ICTA so that it will only apply for corporation tax purposes.

3463. Section 695 (limited interests in residue) and section 696 (absolute interests in residue) of ICTA apply respectively to persons who have a limited interest in the residue of an estate at any time during the administration period or an absolute interest in the residue.

3464. Under sections 695(2) and 696(3) of ICTA payments made in respect of those interests are deemed to be paid to the persons with the interests as income for the tax year in question. Section 695(4) of ICTA makes different provision about the amount of the income deemed to have been paid and the way it is treated for tax purposes according to whether the estate is a United Kingdom estate or a foreign estate in the tax year in which the amount is deemed to have been paid. Similar provision is made by section 696(4) and (6) of ICTA for persons with absolute interests in estates. (The relevant parts of these sections are rewritten for income tax purposes in sections 649(1), 656 and 657.)

3465. In the case of UK estates, a free-standing non-Schedular charge is imposed because the provisions merely say that the amount is income, but do not specify a charging Schedule. In the case of foreign estates, sections 695(4)(b) and 696(6) of ICTA provide that the amount deemed to have been paid as income is to be "chargeable to income tax under Schedule D Case IV as if it were income arising from securities in a place out of the United Kingdom". This operates successfully for persons liable to income tax. But there is no longer any charge under Schedule D Case IV for corporation tax purposes. Paragraph 5 of Schedule 14 to FA 1996 introduced a new Schedule D Case III for corporation tax purposes to replace the previous Cases III and IV (see section 18(3A) of ICTA). This income does not fall within the ambit of the new Schedule D Case III.

3466. So, since there are no Schedular charges imposed on this income from foreign estates for corporation tax purposes, the amendments of sections 695(4)(b) and 696(6) of ICTA in Schedule 1 omit the words referring to the charge under Schedule D Case IV. This leaves the income subject to non-Schedular charges in the same way as the income from United Kingdom estates.

Paragraph 327: section 817 of ICTA

3467. This amendment repeals section 817 of ICTA for income tax purposes. The section is an income calculation rule because it applies "in arriving at the amount of profits or gains for tax purposes". It can trace its origins back almost unchanged to the 1803 Act.

3468. The primary purpose of the section is set out in subsection (1)(a). This provides no deduction is allowed in calculating the profits unless it (the deduction) is "expressly enumerated in the Tax Acts". This clarification may have served some purpose in the early years of income tax. But as both ITEPA and this Act set out what deductions are to be allowed there is no need for a general rule that says no other deductions are to be allowed.

Paragraph 333: section 827A of ICTA

3469. This new section replaces the territorial provisions in section 18(1)(a) of ICTA, which will be repealed for income tax purposes, as they affect those charges under Schedule D Case VI which are not rewritten in this Act.

3470. Such charges would otherwise lose the benefit of the territoriality rules in section 18(1)(a) of ICTA. This new section aims to replace those rules. It is modelled on the territorial scope sections in Chapter 1 of Parts 4 and 5 of this Act.

3471. See the commentary on section 368 of this Act as to how section 18(1)(a) of ICTA and the rules on territorial scope apply to charges under Schedule D Case VI.

3472. Some provisions in Tables 1 and 3 of new section 836B of ICTA have their own territoriality rules or the provisions may otherwise make clear how income from a source outside the United Kingdom is to be taxed. For this reason the territoriality rules are to apply, subject to any express or implied provision to the contrary (*subsection (5)*).

Paragraph 338: section 833 of ICTA

3473. Section 531(6) of ICTA provides that income from the disposal of know-how is to be earned income in certain cases. However, the concept of earned income is not rewritten in this Act. This paragraph rewrites section 531(6) of ICTA as subsection (5A) of section 833 of ICTA.

3474. Section 529 of ICTA provides that "income from patent rights" is to be earned income in certain cases. However, the concept of earned income is not rewritten in this Act. This paragraph rewrites section 529 of ICTA as subsections (5B) to (5E) of section 833 of ICTA.

3475. There is no definition of "income from patent rights" in Chapter 1 of Part 13 of ICTA. Section 833(5B) of ICTA provides for "patent income" to be earned income in certain circumstances, mirroring the circumstances specified in section 529(1) of ICTA. The definition of "patent income" in new section 833(5D) of ICTA follows the definition of "income from patents" in section 533(1) of ICTA (except that it is drafted by reference to the intellectual property provisions in this Act rather than in ICTA). See *Change 152* in Annex 1.

Paragraph 348(3): paragraph 7A of Schedule 22 to ICTA

3476. This new paragraph rewrites paragraph 7(1), (3) and (4) of Schedule 13 to FA 1996. These sub-paragraphs deal with how relief is to be given for losses on deeply discounted securities incurred by pension trustees where the securities have been held since 26 March 2003 and are listed on a recognised stock exchange. Because this provision is likely to be of extremely limited application and will disappear with the repeal of Schedule 22 to ICTA with effect from 6 April 2006 it has been relegated from Chapter 8 of Part 4 of this Act to this Schedule.

Paragraph 352(2): paragraph 5 of Schedule 30 to ICTA

3477. This amendment repeals paragraph 5 of Schedule 30 to ICTA for income tax purposes.

3478. Paragraph 5 of Schedule 30 to ICTA is a transitional measure that relates to the pre-1963 version of Schedule A. Under that version of Schedule A a trader who owned the property from which he or she carried on a trade was allowed a Schedule D Case I deduction equal to the amount of the Schedule A charge on the property. The right to the deduction was removed when Schedule A moved from a charge on the annual value of the property to a charge on the rent received.

3479. Timing differences between Schedule D Case I and Schedule A could result in a loss of relief if the taxpayer ceased to occupy the property for the purposes of the trade in a period in which he or she did not also cease to carry on the trade. FA 1963 introduced a relief to compensate for this loss of relief. It is based on the relief that would have been given for the tax years 1963-64 and 1964-65 and is allowed as a deduction in calculating the trade profits for the tax year in which they cease to carry on the trade.

3480. While in theory it is still possible to claim the relief, given the passage of over 40 years and the effects of inflation it is almost certain no new claims will be made in or after the tax year 2005-06.

Paragraph 352(3): paragraph 18 of Schedule 30 to ICTA

3481. This amendment repeals paragraph 18 of Schedule 30 to ICTA.

3482. Paragraph 18 of Schedule 30 to ICTA is a transitional measure that applies to stock relief. Stock relief was available under different schemes from 1976 to 1984. It was given as a deduction in computing trade profits. Although FA 1984 abolished stock relief with effect from 12 March 1984 it allowed any unused relief to be carried forward and deducted in later years. The relief brought forward has to be used in the first tax year that has the capacity to absorb it. Paragraph 10 of Schedule 9 to FA 1981 provided that any unused relief brought forward which is not used in six years would be lost.

3483. It was necessary to preserve the transitional right to deducted unused relief brought forward when ICTA consolidated the earlier legislation in 1988. But this transitional measure is no longer required.

Part 2: Other Enactments

Taxes Management Act 1970

Paragraphs 362, 365 and 371: sections 9D, 12AE(2) and 31(3) of TMA

3484. These amendments repeal the sections of TMA that give effect to the “Crown Option”. Under the “Crown Option” the Inland Revenue has the right to determine under what Case of Schedule D to charge income that falls both within Cases I or II and Cases III, IV or V. In practice this option is always exercised to tax the income under Schedule D Cases I or II.

3485. This Act includes sections that enact the Crown Option by giving priority to the trading income Part if income that is taxed under Schedule D in the source legislation falls within more than one Part. See *Change 66* in Annex 1. These priority sections mean that the determination powers in TMA are not required.

Taxation of Chargeable Gains Act 1992

3486. The following three sections rewrite paragraph 1 and paragraphs 4A(5) to (9) of Schedule 5AA to ICTA. They provide rules for computing a capital gain or loss where a chargeable profit or an allowable loss has arisen under Chapter 12 of Part 4 of this Act which deals with futures and options involving guaranteed returns. The rules are considered more appropriate to TCGA than to this Act.

Paragraph 435: sections 148A, 148B and 148C of TCGA

Section 148A Futures and options involving guaranteed returns

3487. This new section of TCGA prevents a profit or gain chargeable under Chapter 12 of Part 4 of this Act from being taxed again under TCGA or losses under that Chapter from being relieved other than under the provisions of new section 836B of ICTA (what is now Schedule D Case VI losses). It is based on paragraph 1 of Schedule 5AA to ICTA.

Section 148B Deemed disposals at a gain under section 564(4) of ITTOIA 2005

3488. Section 564 (deemed disposal where futures run to delivery or options are exercised) deems a disposal to take place immediately before a future runs to delivery or an option is exercised. Eventually the asset acquired under that future or option may itself be sold for a capital gain. Any gain on that disposal will, under the TCGA rules, include that part of the gain that has already been taxed under Chapter 12 of Part 4 of this Act as a result of the deemed disposal. This new section of TCGA provides rules to prevent that double taxation by excluding that element of the gain from the chargeable gain. It is based on paragraph 4A of Schedule 5AA to ICTA.

3489. *Subsection (2)* provides for the rules in sections 37 and 39 of TCGA to be disregarded. These sections prevent an amount taxed as income from being included in the disposal proceeds of an asset or sums deductible in an income tax computation from being deductible against the capital gains computation.

3490. *Subsection (4)* prevents indexation allowance being added to the increase in the acquisition cost made under subsection (3). This is because that adjustment is a notional adjustment only and not actual expenditure.

3491. *Subsection (6)* provides for the grant of an option and its deemed disposal to be treated as a single acquisition for the purposes of adjusting the capital gains computation under subsections (3) to (5). Treatment as a single acquisition allows the premium received by the grantor of the option to be taken into account in calculating the consideration for acquisition of the asset. Section 144 of TCGA, which applies by virtue of section 562 (when disposals of futures or options occur: general), performs the same service for disposals under Chapter 12 of Part 4 of this Act other than deemed disposals (see commentary on section 563 (timing of certain grants of options where related disposals occur later)). This subsection is needed because deemed disposals under section 564 (deemed disposals where futures run to delivery or options are exercised) are not disposals for the purposes of section 144 of TCGA.

Section 148C Deemed disposals at a loss under section 564(4) of ITTOIA 2005

3492. Section 564 (deemed disposal where futures run to delivery or options are exercised) deems a disposal to take place immediately before a future runs to delivery or an option is exercised. Eventually the asset acquired under that future or option may itself be sold for a capital loss. Any loss on that eventual disposal will, under the TCGA rules, include that part of the loss that may be relieved under Chapter 12 of Part 4 of this Act as a result of the deemed disposal. This new section of TCGA provides rules to prevent a double allowance of that loss by excluding the loss allowable under Chapter 12 of Part 4 of this Act from the capital loss. The section is based on paragraph 4A of Schedule 5AA to ICTA.

3493. *Subsection (2)* provides for the rules in sections 37 and 39 of TCGA to be disregarded. These sections prevent an amount taxed as income from being included in disposal proceeds of an asset or sums deductible in an income tax computation from being deductible against the capital gains computation.

3494. *Subsection (3)* provides for the grant of an option and its deemed disposal to be treated as a single acquisition for the purposes of adjusting the capital gains computation under subsections (4) and (5). This allows the premium received by the grantor of the option to be taken into account in calculating the consideration for acquisition of the asset. Section 144 of TCGA which applies by virtue of section 562 (when disposals of futures or options occur: general) performs the same service for disposals under Chapter 12 of Part 4 of this Act other than deemed disposals (see commentary on section 563 (timing of certain grants of options where related disposals occur later)). But deemed disposals under section 564 (deemed disposals where futures run to delivery or options are exercised) are not disposals for the purposes of section 144 of TCGA.

3495. *Subsections (4)* and *(5)* apply where an asset has been disposed of at a loss by means of a future running to delivery or an option being exercised. The consideration for that asset for the purposes of the capital gains computation is decreased by the amount of the loss arising under Chapter 12 of Part 4 of this Act, thus effectively preventing a double allowance of the loss that arises on the deemed disposal under that Chapter. Under subsection (4) two distinct situations are foreseen, first where the person sustaining a loss on the deemed disposal acquires an asset as a result of a future running to delivery or the exercise of an option and, second, where the person sustaining a loss on the deemed disposal disposes of an asset as a result of a future running to delivery or the exercise of an option.

3496. *Subsection (5)* ensures that the consideration cannot be reduced below zero. Where the loss under Chapter 12 of Part 4 of this Act exceeds the consideration, the consideration is reduced to nil and the excess is treated as a chargeable gain.

3497. *Subsections (6)* and *(7)* deal with occasions where the loss under Chapter 12 of Part 4 of this Act on the deemed disposal exceeds the consideration for the asset and is treated as a capital gain under subsection (5). The capital gain arises either when an asset acquired under the future or option is eventually disposed of, or, if the asset is already held but disposed of under the future or option, on that disposal.

3498. *Subsections (8)* and *(9)* supplement the rule in subsections (6) and (7). They establish when a chargeable gain under subsection (5)(b) is treated as arising in circumstances which involve special capital gains tax provisions.

Paragraph 438: section 151C of TCGA

3499. This new section of TCGA provides that where a capital loss accrues as part of any scheme or arrangement which has an unallowable purpose that loss is disregarded. Schedule 13 to FA 1996, relevant discounted securities, is rewritten in Chapter 8 of Part 4 of this Act. Because this paragraph of the Schedule deals with capital losses on such securities it is more appropriate to TCGA. The section is based on paragraph 14C of Schedule 13 to FA 1996.

3500. *Subsection (1)(b)* requires payment to be made other than for the acquisition or disposal of a strip – these payments will typically be payments under option agreements. An allowable loss may accrue on a payment while a comparable gain on a strip escapes tax under section 115 of TCGA. “Disposal” in this subsection takes the meaning in Chapter 8 of Part 4 of this Act (*subsection (4)*).

Paragraph 443: section 254(1)(c) of TCGA

3501. Section 254(1)(c) of TCGA has been repealed in relation to loans made after 16 March 1998. The amendment for deeply discounted securities is required because it still has life for loans made before that date.

Finance Act 1993

Paragraph 464: section 171(2) of FA 1993

3502. Section 171(2) of FA 1993 provides that the aggregate profits of an individual underwriter at Lloyd's are taxed under Schedule D Case I and under no other Case or Schedule. The integrated approach to foreign trade profits means that the trading income Part does not distinguish between income that is taxed under Schedule D Cases I and V in the source legislation. Where it is necessary to make this distinction this Act does so through the definition of “relevant foreign income” in section 830.

3503. This amendment also uses the concept of “relevant foreign income” to reproduce the reference to Schedule D Case I in section 171(2)(a) of FA 1993.

Income Tax (Earnings and Pensions) Act 2003

Paragraph 592: section 325A of ITEPA

3504. This new section of ITEPA gives a person receiving payments under an insurance policy which insures against a health and employment risk exemption from taxation on those payments as employment income.

3505. This rewrites section 580A(7) of ICTA to the extent that it relates to employment income.

3506. The payment must first have the capacity for exemption under section 735 (health and employment insurance payments) on the assumption that it is an annual payment (and thus exempt under that section). But it must also meet two further conditions.

3507. First the payments must be to an employee (or to his or her spouse) who contributed under a policy that another person took out for his or her benefit and secondly the payments must represent the contributions the employee has made.

Paragraph 594: section 360A of ITEPA

3508. This new section of ITEPA rewrites part of the rule in section 617(3) and (4) of ICTA, which prohibits the deduction of most social security contributions in calculating income for tax purposes. The remainder of the rule is rewritten, for income tax, in section 868 (social security contributions) of this Act.

3509. In some circumstances an employee may be allowed a deduction for wages paid. In that case, the associated employer's national insurance contributions may also be allowed. The deduction is allowed if it would meet the tests in section 336 of ITEPA (see section 617(4)(d) of ICTA). But it should also be allowed if it meets the tests in any of sections 337 to 342 of ITEPA. See *Change 153* in Annex 1.

Paragraph 606: section 575 of ITEPA

3510. Section 575 of ITEPA is amended because the ICTA references on which it depends are rewritten and repealed for income tax purposes. This paragraph is based on sections 65, 68, 584 and 585 of ICTA.

3511. The paragraph provides rules for calculating the income charged by virtue of Chapter 4 of Part 9 of ITEPA. The income is treated as relevant foreign income for the purposes of Chapters 2 and 3 of Part 8 of this Act. See section 830(4) of this Act (meaning of "relevant foreign income") and the commentary on Part 8 of this Act (overview and Chapter 1 of that Part) for further detail.

3512. *Sub-paragraph (3)* rewrites the 10% deduction given from pension income in the source legislation by sections 65(2) and 68(5) of ICTA. It does not rewrite one of the conditions for that deduction imposed by section 68(5) of ICTA for pension income arising in the Republic of Ireland. See *Change 154* in Annex 1.

3513. Section 575(4) of ITEPA, which is inserted by sub-paragraph (3), reflects small differences in the source legislation between the conditions attached to the deduction for annual payments in section 68(3) of ICTA (income from the Republic of Ireland) and section 65(1) of ICTA (other foreign income).

Paragraph 607: section 613 of ITEPA

3514. Section 613 of ITEPA is amended because the ICTA references on which it depends are rewritten and repealed for income tax purposes. This paragraph is based on sections 65, 68, 584 and 585 of ICTA.

3515. The commentary on paragraph 606, amending section 575 of ITEPA, applies equally here, with the necessary modifications for the fact that this section deals with annuities rather than a pension. See *Change 154* in Annex 1.

3516. The 10% deduction given in the source legislation by sections 65(2) and 68(5) of ICTA does not extend to annuities from the Republic of Ireland. This paragraph extends the deduction to such annuities. See *Change 155* in Annex 1.

Paragraph 608: section 631 of ITEPA

3517. Section 631 of ITEPA is amended because the ICTA references on which it depends are rewritten and repealed for income tax purposes. This paragraph is based on sections 65 and 68 of ICTA.

3518. Some of the commentary on paragraph 606, amending section 575 of ITEPA, applies equally here. See *Change 154* in Annex 1.

3519. The main difference between that section and this is that, although the income to which this section applies is treated as relevant foreign income, it is income paid in the United Kingdom. Chapters 2 and 4 of Part 8 of this Act (which rewrite sections 584 and 585 of ICTA) cannot apply. And the only provision in Chapter 3 of that Part which can apply is section 838 as the other provisions in that Chapter do not apply to income paid in the United Kingdom.

Paragraph 609: section 635 of ITEPA

3520. Section 635 of ITEPA is amended because the ICTA references on which it depends are rewritten and repealed for income tax purposes. This paragraph is based on sections 65, 68, 584 and 585 of ICTA.

3521. The commentary on the paragraph 606, amending section 575 of ITEPA, applies equally here. See *Change 154* in Annex 1.

Paragraph 610: section 644A of ITEPA

3522. This new section of ITEPA gives a person receiving payments under an insurance policy which ensures against a health and employment risk exemption from taxation on those payments as pension or annuity income.

3523. This rewrites section 580A(7) of ICTA to the extent that it relates to pension income.

3524. The commentary on new section 325A of ITEPA applies equally to this section except that the insurance payments must be to the pensioner rather than the employee.

Paragraph 611: section 646A of ITEPA

3525. This new section of ITEPA provides a similar exemption for consular employees' foreign pension income to that in section 771 of this Act.

3526. The section is based on section 322 of ICTA and brings into ITEPA the exemption for income within subsection (1A)(b) and (c) of that section. This is income that was previously charged under Schedule D Case V. This section now brings the exemption for foreign pension income into ITEPA under which the income would be charged if it were not exempt.

3527. The commentary on section 771 (relevant foreign income of consular officers and employees) applies also to this paragraph when read as for pension income.

Paragraph 613: section 679 of ITEPA

3528. Section 679 of ITEPA is amended because the ICTA references on which it depended are rewritten and repealed for income tax purposes. This paragraph is based on sections 65, 68, 584 and 585 of ICTA.

3529. The commentary on paragraph 606, amending section 575 of ITEPA, applies substantially here, with the necessary modifications for the fact that this section deals with social security income rather than a pension. This income does not benefit from the 10% deduction provided for pension income, nor are there any special rules affecting social security income from the Republic of Ireland to be mentioned.

Paragraph 614: section 681A of ITEPA

3530. This new section of ITEPA provides a similar exemption for consular employees' foreign social security benefits to that in section 771 of this Act.

3531. This new section is based on section 322 of ICTA and brings into ITEPA the exemption for income within subsection (1A)(d) of that section. This is income that was previously charged under Schedule D Case V. This section now brings the exemption for foreign benefits into ITEPA under which the income would be charged if it were not exempt.

3532. The commentary on section 771 of this Act (relevant foreign income of consular officers and employees) applies to this new section of ITEPA also when read as for foreign benefits.

Schedule 2: Transitionals and savings etc.

Part 1: General provisions – continuity of the law

3533. These paragraphs ensure continuity of the law, despite the fact that this Act repeals and rewrites provisions.

3534. Paragraph 2 makes clear that the proposition about the continuity of the law in paragraph 1 does not apply to changes in the law made by this Act.

3535. The paragraphs in this Part stand instead of section 17(2) of the Interpretation Act 1978 and provide a comprehensive set of transitional arrangements.

Part 2: Changes in the law

3536. This paragraph allows anyone affected by a minor change in the law made by this Act to elect that the change does not apply to events occurring before 6 April 2005. This allows the Act to be applied as soon as possible without imposing charges retrospectively.

3537. The Act applies for the purposes of income tax. But it makes numerous consequential amendments to corporation tax. So corporation tax is also provided for here.

Part 3: Trading income

Paragraphs 22 and 23: Training courses for employees

3538. These two paragraphs ensure continuity in the training expenses tax recovery provisions in the source legislation which are rewritten in section 75. They are based on section 588 of ICTA.

3539. Paragraph 37 of Schedule 7 to ITEPA keeps sections 588(5)(a) and 589(3) and (4) of ICTA in force in relation to tax years before 2003-04. It also preserves the reference to section 589(3) and (4) of ICTA in section 588(6) of ICTA in relation to such tax years.

3540. The first paragraph ensures that the rewrite of section 588 of ICTA does not stop paragraph 37 of Schedule 7 to ITEPA from working: where section 588 has effect by virtue of paragraph 37 of Schedule 7 to ITEPA the amendments do not apply in relation to the section.

3541. The second paragraph ensures continuity in the case of determinations of an employer's income tax liability for the tax years between the dates that ITEPA and the rewrite of section 588 of ICTA come into force. Those determinations will be made on the assumption that a deduction is allowed under section 588(3) of ICTA. Doubt might arise whether section 75 applies in such cases: section 75(1) says that the section applies if an employer's liability has been determined on the assumption that a deduction is allowed under section 74.

3542. The effect of the transitional is that even though a deduction has been allowed under section 588(3) of ICTA, section 75 will operate if there is a later breach of section 311(4)(a) or (b) of ITEPA.

3543. If the expenditure is incurred on or after 6 April 2005, the employer's right to a deduction will arise under section 74 and section 75 will operate if there is a later breach of section 311(4)(a) or (b) of ITEPA.

3544. *Sub-paragraph (1)(c)* of the second paragraph makes it clear that this transitional does not apply if an assessment has already been made before the rewritten provisions come into force.

Paragraph 48: Apportionment of profits or losses to tax years before tax year 2005-06 – basis periods

3545. Section 883 provides that the Act takes effect for income tax purposes for the tax year 2005-06. For trade profits taxed under Chapter 2 of Part 2 of this Act the income chargeable for 2005-06 is determined by reference to the basis period for that tax year.

3546. Chapter 15 of Part 2 of this Act sets out the rules for relating basis periods to periods of account. In the case of an established trade the basis period for 2005-06 will usually be the 12 month period of account ending in the year 2005-06. That period of account will not normally form the basis period for any other tax year.

3547. But if the trade has just started it may be necessary to apportion the result of a period of account. For example, if a trade starts on 1 January 2005 and the first accounts are made up to 31 December 2005 that period of account will form the following basis periods:

- tax year 2004-05 basis period 1 January 2005 to 5 April 2005; and
- tax year 2005-06 basis period 1 January 2005 to 31 December 2005.

3548. Section 72 of ICTA, rewritten as section 203 allows the profits for the basis period 1 January to 5 April 2005 to be arrived at by apportionment.

3549. In calculating the amount of overlap relief, (see section 204), it is important that the same figure of taxable profit is attributed to the period 1 January 2005 to 5 April 2005 for both tax years.

3550. The purpose of this paragraph is to allow the profits of a period of account that straddles 6 April 2005 to be calculated using the rewritten legislation even though tax years earlier than 2005-06 will be affected. This Act includes a number of minor changes in the law. Without this paragraph it would be necessary for traders to take account of those changes only for the tax year 2005-06.

3551. If a taxpayer does not want the new law to apply to a transaction that occurred before 6 April 2005 he or she can elect for the old legislation to continue to apply.

Paragraph 50: Profits or losses of a trade, profession or vocation previously chargeable in accordance with section 65(1) of ICTA

3552. This transitional provision relates to *Change 1* in Annex 1. The profits of a trade, profession or vocation may exceptionally not be charged in accordance with section 65(3) of ICTA (because they are not "immediately derived" from it). In that case this Act may produce a change from assessment on a tax year basis to assessment on the basis of the profits of a basis period. This transitional provision ensures that profits are not assessed twice.

Paragraph 51: Profits of mines, quarries and other concerns not chargeable by reference to a basis period

3553. Section 55 of ICTA, rewritten as section 12, provides that the profits of certain concerns are taxed under Schedule D Case I. It is not clear in the source legislation whether or not the basis period rules rewritten as Chapter 15 of Part 2 of this Act apply to these profits. It is possible that some taxpayers may be returning the profits by reference to the full amount arising in the tax year and not by reference to the period of account ending in the basis period for the tax year.

3554. Section 12 makes clear that all the Schedule D Case I rules apply including the basis period rules. This paragraph deals with the transition to that regime if the taxpayer has not used the basis period rules in the tax year 2004-05. Deeming the trade to start on 6 April 2005 means the taxpayer will be taxed on the full amount of the profit arising in the tax year 2005-06 and no part of that profit will also be taxed in the earlier year.

3555. If a taxpayer has arrived at the profits for the tax year by apportioning the profits of periods of account the paragraph also allows the taxpayer to use the rules in this Act to calculate the profits in any part of the period that straddles 6 April 2005.

Paragraph 55: Averaging profits of farmers and creative artists

3556. This transitional provision relates to *Change 60* in Annex 1. It preserves a taxpayer's right (if one exists under ICTA) to claim averaging for 2004-05 and 2005-06 even if one of those years is the year in which the taxpayer starts or ceases to carry on the trade, profession or vocation.

Paragraph 58: Adjustment on change of basis: paragraph 12 of Schedule 22 to FA 2002

3557. This transitional provision relates to *Change 62* in Annex 1. It preserves the FA 2002 spreading arrangements if an election has been made under the FA 2002 rules.

Paragraph 59: Adjustment on change of basis: section 104 of ICTA

3558. Section 109 of ICTA provides a special relief for individuals born before 6 April 1917 who are chargeable to tax under section 104 of ICTA. The relief takes the form of a fractional reduction in the amount charged under section 104 of ICTA. This transitional provision replaces the relief with an exemption. So section 109 of ICTA is repealed without being rewritten. See *Change 156* in Annex 1.

Part 4: Property income

Paragraph 62: Apportionment of profits or losses to tax years before tax year 2005-06

3559. Section 21(2) of ICTA, rewritten as section 270 provides that income from a property business is taxed on the full amount of the profit arising in the tax year. If the taxpayer does not prepare accounts to 5 April it may be necessary to apportion accounts made up to a different date to calculate the amount arising in the tax year. Section 72 of ICTA, rewritten as section 275, applies to the profits of a property business through section 21A(2) of ICTA and allows the profits of the period of account to be apportioned to tax years.

3560. Section 883 provides that the Act takes effect for income tax purposes for the tax year 2005-06. This paragraph provides that the profits of a period of account that straddles 6 April 2005 are calculated by reference to the rewritten legislation even though years earlier than 2005-06 will be affected. This Act includes a number of minor changes in the law. Without this paragraph it would be necessary for taxpayers to take account of those changes only for 2005-06.

3561. If a taxpayer does not want the new law to apply to a transaction that occurred before 6 April 2005 he or she can elect for the old legislation to continue to apply.

Part 5: Savings and investment income: general

Paragraph 78: Open-ended investment companies: saving for powers to make provision corresponding to provisions applicable to unit trusts

3562. Section 152 of FA 1995 enables regulations to be made for securing that the Tax Acts and TCGA and some other enactments have effect in relation to open-ended investment companies, their holdings and assets and transactions relating to them in a way corresponding to that in which they have effect in relation to unit trusts. However, this Act rewrites the effect of some of the regulations made under this power as free-standing provisions without reference to unit trusts. (See sections 373 to 375 and sections 386 to 388). So this saving is necessary to preserve the power in section 152 of FA 1995 so that regulations may continue to be made for achieving any purpose that could be achieved by such regulations before enactment of those sections, because after their enactment they will not be provisions that relate to unit trusts.

Paragraph 80: Deeply discounted securities: deemed transfers of strips on 5th April

3563. Paragraph 14(4) of Schedule 13 to FA 1996 provides that a strip of a government security is deemed to be transferred on 5 April and reacquired the following day. This is rewritten in section 445 of this Act as a disposal and reacquisition on the same day. See *Change 87* in Annex 1. This change will not work as it should for the tax year beginning 6 April 2005, when this Act first has effect, because while paragraph 14(4) of Schedule 13 to FA 1996 will deem a disposal on 5 April it will have been repealed on 6 April. There will therefore be no deemed reacquisition.

3564. This provision ensures that the strip will be deemed to have been reacquired on 6 April 2005.

Paragraphs 82 and 83: Profits from deeply discounted securities: saving for charities' losses and Profits from deeply discounted securities: saving for pension trustees' losses

3565. These two provisions rewrite paragraph 7(1) and (3) of Schedule 13 to FA 1996. These sub-paragraphs deal with losses on deeply discounted securities incurred by charities and pension trustees where the securities have been held since 26 March 2003 and are listed on a recognised stock exchange. Because these provisions are likely to be of extremely limited application they have been relegated from Chapter 8 of Part 4 of this Act (deeply discounted securities) of this Schedule.

Paragraph 84: Exclusion of deeply discounted securities from section 711 to 718 of ICTA (accrued income profits)

3566. Section 710(3) of ICTA lists securities which are excluded from the accrued income scheme in Chapter 2 of Part 17 of ICTA. Section 710(3)(f) of ICTA (securities which are relevant discounted securities within Schedule 13 to FA 1996) has been consequentially amended by Schedule 1 to this Act to refer to deeply discounted securities within Chapter 8 of Part 4 of this Act.

3567. Before FA 2003, paragraph 11 of Schedule 13 to FA 1996 was the only exclusion of relevant discounted securities from the accrued interest scheme. As part of the provisions for removing loss relief on relevant discounted securities, paragraph 5(2)(c) of Schedule 39 to FA 2003 repealed paragraph 11 of Schedule 13 to FA 1996 and added relevant discounted securities to the list of securities outside the accrued income scheme in section 710(3)(f) of ICTA.

3568. But paragraph 6(1)(b) of Schedule 39 to FA 2003 repeals paragraph 11 of Schedule 13 to FA 1996 only in relation to a *loss* on a relevant discounted security on or after 26 March 2003 and applies section 710(3)(f) of ICTA only in relation to *losses* on or after that date.

3569. Moreover paragraph 6(2)(b) of Schedule 13 to FA 1996 provides a saving for changes introduced by paragraphs 5(2) and (4) of that Schedule if the security is quoted on a recognised stock exchange and has been held continuously since before 27 March 2003. In those circumstances paragraph 7 of Schedule 13 to FA 1996 continues to apply.

3570. The complex position that emerges is:

- section 710(3)(f) of ICTA applies only where losses arise unless the loss arises on a quoted security held since before 27 March 2003; and
- paragraph 11 of Schedule 13 to FA 1996 continues to apply for all gains but also for losses arising on a quoted security held since before 27 March 2003.

3571. It serves no purpose to have one provision applying to gains and another to losses and the repeal of paragraph 11 of Schedule 13 to FA 1996 and insertion of section 710(3)(f) of ICTA suggest that this was not the intention.

3572. This paragraph therefore applies section 710(3)(f) of ICTA for all disposals after 6 April 2005.

Paragraph 85: Gains from contracts for life insurance etc: foreign policies of life insurance

3573. This paragraph preserves the status of certain foreign policies of life insurance as *qualifying policies* under Schedule 15 to ICTA where the policy had that status prior to the amendment of section 553(2) and (7) of ICTA by section 55(8) of FA 1995. That amendment removed qualifying policy status from policies which depended for it on satisfying the condition in paragraph 24(4) (rather than paragraph 24(3)) of Schedule 15 to ICTA. Some foreign policies were issued by insurers who were, at that time, subject to UK tax under section 445 of ICTA and such policies were only qualifying policies within the meaning of Schedule 15 to ICTA by virtue of paragraph 24(4) of that Schedule. This paragraph is based on section 55(8) of FA 1995.

3574. Where this paragraph applies, the provisions mentioned in section 474(2) apply to the policy in question. But an individual or trustee who is chargeable on a gain arising in respect of such a policy will get the income tax allowance provided by section 530 where condition B in section 531 is met.

Paragraph 86: Gains from contracts for life insurance etc: exclusion of pension policies

3575. Chapter 9 of Part 4 of this Act anticipates the amendment by FA 2004 of Part 14 of ICTA (pension schemes, social security benefits, life annuities etc.), so that it uses the descriptions which will be substituted from 6 April 2006. This paragraph preserves the original descriptions in the unamended source legislation for the tax year 2005-06.

Paragraphs 87 and 88: Gains from contracts for life insurance etc: rights partially assigned

3576. FA 2001 introduced rules, inserted as section 546A of ICTA, to determine what assignments are regarded as taking place when certain assignments of part or a share of the rights under a policy or contract are assigned. Paragraph 87 ensures that any question of what is or is not an assignment of such a part or share, in relation to times before section 546A of ICTA applies, is determined without regard to section 505 (which rewrites section 546A of ICTA). This paragraph is based on section 83 of FA 2001.

3577. FA 2001 also amended Chapter 2 of Part 13 of ICTA so that an assignment of rights under the policy or contract before 6 April 2001 which is not for money or money's worth is ignored. Paragraph 88 ensures that such assignments which occurred before that date continue to be valued as they were valued prior to the amendments of FA 2001 if the value of such an assignment is material to the operation of Chapter 9 of Part 4 of this Act. This paragraph is based on section 83 of FA 2001.

Paragraph 89: Gains from contracts for life insurance etc: regulations providing for relief where foreign tax chargeable

3578. This paragraph preserves the original scope of the powers in section 56(3) of FA 1995 which are rewritten in section 534. It is based on section 56(3) of FA 1995.

Paragraph 90: Gains from contracts for life insurance etc: pure protection group life policies

3579. FA 2003 amended the law in respect of group life policies to ensure that such policies do not give rise to gains chargeable under Chapter 2 of Part 13 of ICTA. Provision was also made to disregard as a chargeable event any event happening before 9 April 2003, if it happened in respect of a particular type of group life policy (a "pure protection group life policy"). This paragraph preserves that disregard should it be necessary to consider, for the purposes of Chapter 9 of Part 4 of this Act, whether any event happening before that date in relation to such a policy has been a chargeable event. This paragraph is based on paragraph 3 of Schedule 34 to FA 2003.

Paragraph 91: Gains from contracts for life insurance etc: assessment of trustees etc

3580. This paragraph preserves the commencement date for the FA 1998 amendments to Chapter 2 of Part 13 of ICTA (liability of trustees in respect of gains from life policies etc.), so that the FA 1989 rules on the assessment of trustees (as amended by paragraph 411 of Schedule 1 to this Act) do not refer to gains from chargeable events before 6 April 1998. This paragraph is based on paragraph 7 of Schedule 14 to FA 1998.

Paragraphs 92 and 93: Transactions in deposits

3581. Paragraph 92 is based on section 56(3) of ICTA. It preserves a commencement rule for the source legislation rewritten in Chapter 11 of Part 4 of this Act should there be any extant pre-7 March 1973 certificates of deposit. See the commentary on that Chapter in Volume 2 of these Explanatory Notes.

3582. Paragraph 93 is based on paragraph 6 of Schedule 8 to FA 1992. It preserves a commencement rule for the source legislation rewritten in Chapter 11 of Part 4 of this Act should there be any extant pre-16 July 1992 uncertificated deposits.

Paragraph 94: Disposals of futures and options involving guaranteed returns: certain pre-6th February 1998 transactions

3583. This paragraph ensures that section 564 (deemed disposal where futures run to delivery or options are exercised) will not apply where the transaction took place before 6 February 1998.

Paragraph 95: Disposals of futures and options involving guaranteed returns: rates of tax for pension trustees

3584. This paragraph modifies Condition C in section 568 (special rule for certain income of trustees) for the tax year 2005-06. It rewrites paragraph 7(2)(c) of Schedule 5AA to ICTA as it stands before the amendments made by FA 2004, which only apply for the tax year 2006-07 onwards.

Part 6: Savings and investment income: insurance contracts and policies made before certain dates

Overview

3585. This Part of Schedule 1 applies for the purposes of Chapter 9 of Part 4 of this Act.

3586. The paragraphs in this Part set out the further rules that apply to policies issued in respect of insurances made or contracts made before certain dates. The paragraphs appear in the chronological order of those dates. These rules largely reflect the commencement provisions applying to the various amendments to the source legislation.

3587. Part 7 of this Schedule contains further rules that apply in respect of policies and contracts pre-dating 17 March 1998 that may be personal portfolio bonds.

3588. Other transitional provisions in respect of Chapter 9 of Part 4 of this Act are provided in Part 5 of this Schedule.

Paragraph 96: Pre-20th March 1968 policies and contracts excluded from Chapter 9 of Part 4

3589. This paragraph excludes certain policies and contracts from the scope of Chapter 9 of Part 4 of this Act. It is based on section 539 of ICTA.

3590. *Sub-paragraph (2)* removes that exclusion where the policy or contract is varied after the relevant date in certain circumstances. This is a common feature of the chargeable event gains regime. It prevents the exploitation of policies and contracts which benefit from a particular rule in relation to a specific date, where the later variation could increase the value of that benefit to a degree not contemplated by the provision.

3591. *Sub-paragraph (3)* restricts the effect of sub-paragraph (2) where the variation was made by 31 December 1968 to comply with certain provisions for qualifying policies (as at that time, under the predecessor to Schedule 15 of ICTA).

Paragraph 97: Pre-27th March 1974 policies and contracts: disapplication of section 500(c)

3592. This paragraph reflects the commencement provisions in the source legislation for sections 500(c) and 501, which treat certain loans as part surrenders of a policy or contract. It is based on section 548(1) of ICTA.

Paragraph 98: Pre-27th March 1974 contracts: disapplication of section 531(3)(c)

3593. This paragraph reflects the commencement provisions in the source legislation for the treatment of gains from certain contracts for a life annuity. It is based on section 547(5A) of ICTA.

Paragraph 99: Pre-10th December 1974 contracts for a life annuity: disapplication of section 484(1)(d)

3594. This paragraph reflects the commencement provisions in the source legislation for the treatment of death as giving rise to a surrender of the rights under a contract for a life annuity. It is based on section 542(2) of ICTA.

Paragraph 100: Pre-14th March 1975 policies and contracts: calculation of gains under section 507

3595. This paragraph applies to policies and contracts which are more than 20 years old. Premiums paid on such policies 20 or more years ago will be 100% allowable in computations of gains, subject to the restriction this paragraph applies in respect of years beginning before 14 March 1975. It introduces, for the policies and contracts to which it applies, the concept of a "reference period", defined in *sub-paragraph (6)* as insurance years beginning after 13 March 1975. Where the paragraph applies, it affects the periodic calculation under section 507. It is based on section 546(1) of ICTA.

3596. *Sub-paragraph (3)* limits by reference to that reference period the period within which certain assignments contribute amounts in the calculation under section 507 of the "net total value" of rights assigned.

3597. *Sub-paragraphs (4)* and *(5)* amend the calculation to allow a portion of each premium paid before the reference period and during the reference period in the total of "net total allowable payments". The portion allowed cannot exceed 100% of a premium paid in a year falling wholly in the reference period. If the premium was paid in an insurance year beginning before the reference period, the allowable amount diminishes the earlier the premium was paid. For each such premium, one-twentieth is "lost" for each year beginning before the reference period, back to and including the year the premium was paid.

Paragraph 101: Pre-25th March 1982 replacement policies: disapplication of section 542

3598. This paragraph is based on paragraph 20(4) of Schedule 15 to ICTA. A replacement policy issued before 25 March 1982 is not treated as a single policy with the one it replaced, but as a freshly issued policy in, for example, the calculation of "N" in section 536 (calculations for top slicing relief).

Paragraph 102: Certain pre-26th June 1982 policies and contracts excluded from Chapter 9 of Part 4

3599. Before FA 1983, gains on "second hand" life insurance policies and life annuity contracts (that is, where all the rights had previously been assigned for money or money's worth) were subject to capital gains tax rather than income tax. The gain was computed under capital gains tax rules.

3600. This paragraph preserves that treatment so long as none of the events set out in *sub-paragraphs (3)* to *(5)* occurs after 23 August 1982. Should such an event occur, the policy or contract comes again within the scope of Chapter 9 of Part 4 of this Act. The paragraph is based on sections 540, 542 and 544 of ICTA.

3601. *Sub-paragraphs (5)* to *(9)* provide that certain loans made by, or by arrangement with, the issuer of the policy or contract to, or at the direction of, an individual bring the assigned policy or contract back into the scope of Chapter 9 of Part 4 of this Act. They ensure that the treatment of such loans corresponds with the rules (including exceptions) in section 501.

3602. Sub-paragraph (6) ensures that the individual mentioned in sub-paragraph (5) is within the scope of that provision even where the rights under the policy or contract are held under a charitable trust that individual created (although a gain would not be attributed to that individual under section 465 in such circumstances).

3603. Sub-paragraph (9) ensures that the loan bringing the policy back within the scope of Chapter 9 of Part 4 of this Act is treated as a part surrender by virtue of section 500.

Paragraph 103: Certain pre-18th November 1983 policies not foreign policies of life insurance

3604. This paragraph is based on section 553A of ICTA. The paragraph reflects the commencement provisions for the source legislation.

3605. The exclusion of a policy to which this paragraph applies from the scope of Chapter 9 of Part 4 of this Act is lost if the policy is varied in certain ways. See the commentary above on the similar provision in paragraph 96 (pre-20th March 1968 policies and contracts excluded from Chapter 9 of Part 4).

3606. See also the commentary below for paragraph 111 (certain pre-17th March 1998 policies not foreign policies of life insurance).

Paragraph 104: Certain pre-23rd February 1984 policies not foreign capital redemption policies

3607. This paragraph is based on section 553(10) of ICTA. That section defines a "new offshore capital redemption policy" (the equivalent term in the source legislation for a "foreign capital redemption policy"). This paragraph reflects the commencement provisions for that source legislation. See also the commentary for paragraph 113 (certain pre-23rd March 1999 policies not foreign capital redemption policies).

Paragraph 105: Pre-14th March 1984 policies: disregard of amounts deducted and repaid after tax relief by deduction from premiums abolished

3608. Certain amounts were treated under section 72(9) of FA 1984 as additional premiums paid on 5 August 1984 only. This treatment arose exceptionally from the abolition of the right to deduct tax relief from premiums paid to the insurer and applied for limited purposes (which did not include the calculation of chargeable event gains). This paragraph ensures that such amounts are disregarded in computing gains for the purposes of certain calculations in Chapter 9 of Part 4 of this Act. It is based on section 541(6) of ICTA.

Paragraph 106: Certain pre-20th March 1985 policies: application of section 529(1)

3609. This paragraph is based on section 553(5) of ICTA. It reflects the insertion by FA 1985 of an exception to rules introduced by FA 1984. The FA 1984 rules provided for the reduction of gains where the policy holder was not UK resident during all or part of the policy period (see section 528 of this Act).

3610. The exception applies when the policy is held at the time of the chargeable event by one or more non-UK resident trustees.

3611. The paragraph reverses the exception made by section 529 if the policy was held by such a trustee or trustees on 19 March 1985 and the policy was issued in respect of an insurance (for a policy of life insurance) or contract (for a capital redemption policy) made on or before that date.

3612. The paragraph also repairs an omission in the source legislation which would exclude a capital redemption policy from the benefit of the paragraph. In the source legislation, the reduction under section 553(3) of ICTA is only made if, under section 553(5A)(a) of ICTA, the policy was *issued in respect of an insurance* made before 17 March 1998. The term used in that paragraph is only apt for a policy of life insurance, although section 553(5) of ICTA covers capital redemption policies too, and the opening words of section 553(5) of ICTA are apt for both since they just refer to "the policy". Instead of saying "issued in respect of an insurance made", section 553(5)(a) of ICTA should have also have referred to a capital redemption policy "issued in respect of a contract made". In practice, section 553(5) of ICTA is interpreted as if it referred also to the making of contracts for capital redemption policies.

Paragraph 107: Pre-14th March 1989 qualifying policies: application of section 485(2)(b) and (3)(b)

3613. This paragraph reflects the commencement provisions for paragraph (b) in section 485(2) and (3). Paragraph (b) affects the incidence of chargeable events, in respect of a qualifying policy, where the rights under the policy are held as security for a debt owed by a company. This paragraph is based on section 540(5A) of ICTA.

3614. But the modification by this paragraph of section 485(2) and (3) is removed (and the incidence of chargeable events thereby increased) if the pre-14th March 1989 policy is varied in certain ways. See the commentary above on the similar provision in paragraph 96 (pre-20th March 1968 policies and contracts excluded from Chapter 9 of Part 4). *Sub-paragraphs (2)* and *(3)* are based on section 539(9) of ICTA.

Paragraph 108: Pre-14th March 1989 policies and contracts: application of section 501

3615. This paragraph is based on section 548(3A) of ICTA. It limits the application of section 501 (loans by insurers giving rise to part surrenders) where:

- the policy or contract dates from before 14 March 1989; and
- the rights under the policy or contract were held in circumstances such that a company would be liable to tax under section 547(1)(b) of ICTA on a gain arising on that policy or contract.

3616. *Sub-paragraphs (2)* and *(3)* remove the limitation on the scope of section 501 if the policy is varied in certain ways. See the commentary above on the similar provision in paragraph 96 (pre-20th March 1968 policies and contracts excluded from Chapter 9 of Part 4). These sub-paragraphs do not apply to a life annuity contract. They are based on section 539(9) of ICTA.

Paragraph 109: Contracts in accounting periods beginning before 1st January 1992: disapplication of sections 530and539(3)

3617. This paragraph modifies the application of a number of provisions in Chapter 9 of Part 4 of this Act to certain life annuity contracts. The contracts affected are defined by reference to dates in 1974 (as regards the contract) and 1992 (as regards the insurer). Between those dates, the investment profits of the insurer in respect of such contracts did not bear UK tax. These contracts are therefore treated similarly to foreign policies and contracts. The paragraph is based on sections 547 and 549 of ICTA.

3618. *Sub-paragraphs (2)* and *(3)* deny such contracts the income tax allowance etc provided by section 530 unless either section 532 or section 534 applies. Certain other life annuity contracts are also denied that allowance (subject to the same exceptions) by section 531.

3619. This sub-paragraph does not apply in the computation of top slicing relief. The effect of this is to give equal, rather than more favourable treatment under that relief, compared to that given to policies and contracts whose underlying investment profits have borne UK tax.

3620. *Sub-paragraph (4)*, however, provides that the tax relief due under section 539 for a corresponding deficiency may extend to rates other than the higher rate for such a contract. This recognises the fact that a gain on a calculation event in respect of such a contract will have been charged at the starting and lower rates as well as the higher rate (where applicable).

3621. *Sub-paragraph (5)* amplifies the source legislation by providing a definition of "accounting period". The term is used in Chapter 2 of Part 13 of ICTA (see section 547(5A)(b) of ICTA) but the meaning there has to be assumed, given that the terms of reference of the definition in section 834(1) of ICTA (which refers to section 12 of that Act) do not include that Chapter as it applies for income tax purposes.

Paragraph 110: Certain pre-17th March 1998 policies: application of section 529(1)

3622. This paragraph deals with a similar circumstance to that in paragraph 106 (certain pre-20th March 1985 policies: application of section 529(1)). It is based on section 553(5A) of ICTA.

3623. FA 1998 introduced an exception which limits the availability of the reduction of a gain for periods of non-UK residence on the part of the policy holder (see section 528), where the policy of life assurance or capital redemption policy is held by a foreign institution (see the definition of that term in section 468(5)).

3624. The paragraph reverses the exception made by section 529 if the policy was held by a foreign institution on 16 March 1998 and the policy was issued in respect of an insurance (for a policy of life insurance) or contract (for a capital redemption policy) made on or before that date.

3625. As in paragraph 106 (certain pre-20th March 1985 policies: application of section 529(1)), this paragraph repairs an omission in the source legislation which would exclude a capital redemption policy from the benefit of the paragraph.

Paragraph 111: Certain pre-17th March 1998 policies not foreign policies of life insurance

3626. This paragraph reflects the fact that the commencement provisions for the source legislation relevant to the paragraph (a) and paragraph (b) elements of the definition of a "foreign policy of life insurance", in section 476(3), use different dates. It is based on section 553A of ICTA.

3627. *Sub-paragraph (1)* effectively states the general rule that policies issued in respect of an insurance made before 17 March 1998 are not foreign policies of life insurance unless certain conditions are met. This ensures that policies falling within the paragraph (b) element of the definition do so only if they are issued in respect of an insurance made on or after that date.

3628. The sub-paragraph then identifies the conditions which disapply the basic rule. These are where policies are within the paragraph (a) element of the definition (subject to the commencement provisions in paragraph 103 (certain pre-18th November 1983 policies not foreign policies of life insurance)).

3629. As was the case for paragraph 103 (certain pre-18th November 1983 policies not foreign policies of life insurance), the paragraph is based on section 553A of ICTA.

3630. *Sub-paragraphs (2)* and *(3)* disapply the general rule in sub-paragraph (1) if the policy is varied in certain ways. See the commentary on the similar provision in paragraph 96 (pre-20th March 1968 policies and contracts excluded from Chapter 9 of Part 4).

Paragraph 112: Pre-17th March 1998 policy or contract: UK resident trustees

3631. This paragraph reflects the commencement provisions for the source legislation, which deals with the liability of UK resident trustees. It is based on paragraph 7 of Schedule 14 to FA 1998.

3632. In addition to the usual provision in *sub-paragraph (3)* defining the policies and contracts, gains from which are not to be attributed to trustees, and the usual reservation in *sub-paragraph (4)* for policies and contracts subsequently varied, *sub-paragraph (1)* prescribes a date condition and a settlor condition.

Paragraph 113: Certain pre-23rd March 1999 policies not foreign capital redemption policies

3633. This paragraph reflects the fact that the commencement provisions for the source legislation relevant to the paragraph (a) and paragraph (b) elements of the definition of a "foreign capital redemption policy", in section 476(3), have different dates. It is similar in approach to that in paragraph 111 (certain pre-17th March 1998 policies not foreign policies of life insurance). As was the case for paragraph 104 (certain pre-23rd February 1984 policies not foreign capital redemption policies), the paragraph is based on sections 553(10) and 553B of ICTA.

3634. The paragraph sets out a general rule that policies issued in respect of an insurance made before 23 March 1999 are not foreign capital redemption policies, unless conditions are met which only affect policies within the paragraph (a) element of the definition in section 476(3). This ensures that policies falling within the paragraph (b) element of the definition do so only if they are issued in respect of a contract made on or after that date.

3635. Those conditions, under which an older policy is a foreign capital redemption policy, are that the policy is within the paragraph (a) element of the definition, subject to the commencement provisions in paragraph 104 (certain pre-23rd February 1984 policies not foreign capital redemption policies).

Paragraph 114: Pre-9th April 2003 contract or policy: UK resident trustees

3636. This paragraph reflects the commencement provisions for the source legislation which introduced the provision rewritten as condition C in section 467(5). It is based on section 547(4A) of ICTA.

3637. *Sub-paragraphs (2)* and *(3)* define the policies and contracts, gains from which benefit from this exception to the scope of section 467, and disapply the exception in *sub-paragraph (1)* if the policy or contract is varied in certain ways. (See the commentary above on the similar provision in paragraph 96 (pre-20th March 1968 policies and contracts excluded from Chapter 9 of Part 4).) These sub-paragraphs are based on paragraph 12 of Schedule 34 to FA 2003.

3638. *Sub-paragraphs (3)* and *(4)* incorporate a correction to the source legislation, so that it applies in the case of a life annuity contract as it does in the case of a policy of life insurance or a capital redemption policy. Paragraph 12(4)(a) of Schedule 34 to FA 2003 finishes with the words "(any exercise of rights conferred by *the policy* being regarded for this purpose as a variation)". It should refer to *the policy or contract*.

3639. No distinction between policies and contracts was intended and it is clear from the opening words of paragraph 12 of Schedule 34 to FA 2003, which refer to "A policy or contract", that both are in mind. This paragraph makes clear that, if rights conferred by a contract for a life annuity made before 9 April 2003 are exercised on or after that date, the contract is regarded as having been varied. These sub-paragraphs are based on paragraph 12 of Schedule 34 to FA 2003.

Paragraph 115: Pre-9th April 2003 contract or policy: loans to trustees

3640. This paragraph reflects the commencement provisions for the source legislation which added loans to trustees to the scope of the provisions rewritten in sections 500(c) and 501. It is based on paragraph 9 of Schedule 34 to FA 2003.

Paragraph 116: Pre-9th April 2003 contract or policy: excepted group life policies

3641. This paragraph is based on paragraph 4 of Schedule 34 to FA 2003. *Sub-paragraphs (1)* and *(4)* of this paragraph carry the benefit of paragraph 4(1) of Schedule 34 to FA 2003 for certain group life policies through the date (6 April 2005) from which this Act has effect. The policies in question were taken out before 9 April 2003, and would not otherwise satisfy the conditions in sections 481 and 482 for the exclusion provided by section 480, but had benefited under paragraph 4(1) of Schedule 34 to FA 2003.

3642. Paragraph 4(1) of Schedule 34 to FA 2003 provided a period in which, subject to conditions, a group life policy, not satisfying the conditions in section 539A of ICTA for exclusion under section 539(2)(f) of ICTA from the scope of Chapter 2 of Part 13 of that Act, could be varied to comply with section 539A of ICTA. That paragraph also provided that such a policy, if varied, would be treated as having complied with those conditions.

3643. *Sub-paragraphs (2)* and *(3)* similarly preserve the treatment of a replacement policy and the replaced policy under paragraph 4(3) of Schedule 34 to FA 2003 as a single policy, where the replacement was made to comply with section 539A of ICTA.

Paragraph 117: Pre-3rd March 2004 contract or policy: calculation of deficiencies

3644. This paragraph reflects the commencement provisions for the restriction in section 541 of relief for a deficiency under section 539 by reference to gains for which the individual in question has been liable to tax. It is based on section 140 of FA 2004.

3645. As is usual, the benefit of this paragraph is lost if the policy or contract is varied in certain ways after the relevant commencement date.

Paragraph 118: Pre-1st January 2005 contracts for immediate needs annuities: income tax treated as paid

3646. FA 2004 placed certain annuities in a different category, for the purposes of the tax charge on insurance companies, and provided an exemption from income tax on the annuity payments (see section 725 of this Act). This paragraph ensures that any such annuities in existence at the beginning of 2005 do not, by reason of the change to the taxation rules for insurance companies, lose entitlement to the income tax allowance under section 530. It is based on section 147 of FA 2004.

Part 7: Savings and investment income: gains from contracts for life insurance etc. (personal portfolio bonds)

Overview

3647. This part of this Schedule is wholly concerned with that part of the Personal Portfolio Bonds (Tax) Regulations SI 1999/1029 (abbreviated in this commentary as “PPB(T)R”) which applies to policies and contracts in existence before 17 March 1998. It is based on regulation 3 of PPB(T)R. It also takes into account part of ESC B53 as it applies to such policies and contracts.

Paragraph 119: Pre-17th March 1998 contract or policy: conditions to be met for contract or policy not to be a personal portfolio bond

3648. This paragraph sets out the conditions to be satisfied if such a pre-17 March 1998 policy or contract is to avoid being a personal portfolio bond. It is based on regulation 3 of PPB(T)R. The “date condition” and the “non-variation condition” are similar to the commencement provisions commonly met when the scope of the chargeable event gains regime has been amended. See the notes on those paragraphs in Part 6 of this Schedule where such similar conditions apply (for example: paragraph 96 (pre-20th March 1968 policies and contracts excluded from Chapter 9 of Part 4)).

Paragraph 120: The date condition

3649. This paragraph is based on regulation 3 of PPB(T)R.

Paragraph 121: The non-variation condition

3650. This paragraph is based on regulation 3 of PPB(T)R.

Paragraph 122: The first selection condition

3651. A policy or contract must meet the first or second selection condition. This paragraph sets out the simpler of the two, that any index or property used to determine benefits under the policy or contract has, at all times in the period from 6 April 1994 (or from the commencement of the policy or contract, if later) to the date the policy or contract is being assessed against the conditions, fallen within permitted categories. The 1994 terminal date is a pragmatic reflection of the potential difficulty of establishing compliance with this condition in more distant periods. This paragraph is based on regulation 3 of PPB(T)R.

Paragraph 123: The second selection condition

3652. This paragraph is based on regulation 3 of PPB(T)R. The second selection condition applies where a policy:

- which does not meet the first selection condition; but
- whose benefits have not in fact been determined by reference to an index or property outside the permitted categories;
- is varied by the end of the first insurance year beginning on or after 6 April 1999 to eliminate from the determination of benefits any such index or property outside the permitted categories.

3653. In effect, the second selection condition provides a period of grace for a policy or contract to put itself into a comparable state to one meeting the first selection condition.

Paragraph 124: Policy holders becoming UK resident after 17th March 1998

3654. This paragraph defines and may extend the period of grace in the second selection condition where the holder of the policy or contract is non-UK resident on 17 March 1998 but subsequently becomes so, although *not* then intending to become permanently UK resident or to stay at least two years. It is based on regulations 3 and 5 of PPB(T)R.

3655. Where such a holder is an individual, Part 1 of ESC B53 (rewritten in part in section 465(1)) would excuse such a holder from the income tax for which that holder is liable on a gain for a tax year in which the holder is not UK resident.

3656. This paragraph (which incorporates material from Part 3 of ESC B53) seeks to give a newly UK resident holder of a policy or contract time in which to make the necessary variation to the policy or contract, so as to meet the second selection condition.

3657. *Sub-paragraph (2)* provides the terminal date by which the policy must be varied if it is to meet condition C of the second selection condition (see paragraph 123 (the second selection condition)).

3658. As the holder does not intend to become permanently UK resident, or to stay for at least two years, the variation must be carried out before the end of the first insurance year to begin after UK residence first begins by virtue of arrival after 17 March 1998 (or the first insurance year ending on 5 April 2000 or later, where that is more beneficial). Given that residence is in strictness for a year, UK residence will begin on 6 April preceding arrival. The holder may have as little as a day or two in which to make the variation. Although ESC A11 splits income in that first year of United Kingdom residence, treating income up to the day of arrival as not chargeable, and uses similar criteria regarding a person’s intentions for UK residence, it has no bearing on the operation of the rule here.

3659. *Sub-paragraph (3)* further relaxes the incidence of the special personal portfolio bond charge where a policy or contract meets the second selection condition (and otherwise meets the terms of paragraph 119) by virtue of the extended period of grace given by the modification of the second selection condition (see paragraph 123 (the second selection condition)).

3660. Until the required variation is made, and the second selection condition is met, the policy or contract may be a personal portfolio bond. An insurance year may end after the relevant date and before the variation is made, so triggering a gain under section 525 if there has been a chargeable event in that year.

3661. This sub-paragraph sets aside that gain, so that no chargeable event under section 525 occurs, and no-one is liable under sections 465 to 468. If need be, corrective action will be taken under the Self Assessment system to negate any assessment made before the variation took effect.

3662. See *Change 157* in Annex 1.

Paragraph 125: Policy holders becoming permanently UK resident after 17th March 1998

3663. This paragraph performs the same function as the preceding paragraph, with the difference that it deals with policyholders who intend to become permanently UK resident or to stay at least two years. It is based on regulation 3 of PPB(T)R.

3664. The effect of that difference of intention shows up in *sub-paragraph (2)(b)*. The terminal date by which the policy must be varied if it is to meet condition C of the second selection condition is reckoned from the policy year beginning after the relevant date of arrival in the United Kingdom, rather than that beginning after the commencement of UK residence. The holder will therefore have at least 12 months from arrival, perhaps nearly two years, in which to effect the necessary variation.

3665. *Sub-paragraph (3)* has the same effect as the equivalent sub-paragraph in paragraph 124 (policy holders becoming UK resident after 17th March 1998), but with effect over a longer period.

3666. See *Change 157* in Annex 1.

Paragraph 126: Meaning of "permitted index"

3667. This paragraph is based on regulation 3 of PPB(T)R.

Paragraph 127: Meaning of "permitted property"

3668. This paragraph is based on regulation 3 of PPB(T)R.

3669. It extends the categories of permitted property, for the purposes of paragraphs 122 and 123 (the first and second selection conditions), beyond those listed in section 520. The added categories are all stocks and shares listed or dealt with in open markets after the beginning of the period mentioned in those paragraphs. (The Alternative Investment Market succeeded the Unlisted Securities Market.)

3670. *Sub-paragraph (2)* puts a cap on stocks and shares listed on those markets which are not a recognised stock exchange, where the investment in the company exceeds 10% of:

- the issued share capital of the company; or
- the total amount of premiums paid under the policy or contract.

3671. The reference to "the total amount of premiums paid" in sub-paragraph (2)(b) is to be construed in accordance with the definitions in section 545.

Paragraph 128: Other definitions

3672. This paragraph is based on regulations 2 and 3 of PPB(T)R.

Part 8: Miscellaneous income

Paragraph 132: Income treated as income of settlor: exception for pension income

3673. Section 627 excludes benefits from relevant pension schemes from being treated as the settlor's income under section 624. The exclusion for "relevant pension scheme" in subsection (3) of that section apply for the tax year 2006-07 onwards. This paragraph gives the rules that apply for the tax year 2005-06 and represents a rewrite of section 660A(11) of ICTA as it stands before the amendments made by FA 2004.

3674. Subsection (3)(g) of section 627 refers to regulations made under the Welfare Reform and Pensions Act 1999 and its Northern Ireland equivalent although section 660A(11)(g) of ICTA simply refers to regulations made by the Secretary of State. See *Change 105* in Annex 1.

3675. *Subparagraph (4)* attracts the consequential and transitional powers for pensions in FA 2004 to the rewrite of those provisions in this Act.

Paragraph 133: Amounts treated as income of settlor: income paid to unmarried minor child of settlor

3676. Section 64 of FA 1999 amended section 660B of ICTA principally to enable a charge on the settlor to be made where a settlor's minor child benefited from a bare trust arrangement. The income arising in the trust did not have to be paid to or for the benefit of the child for a charge on the settlor to arise. It was simply sufficient for the income to be treated as the child's income. The new provision applied only where the settlement was made or entered into after 8 March 1999 or, if it was not, to income that arose from funds provided after that date. This paragraph enables the pre-amendment legislation to apply to pre-March 1999 settlements.

3677. *Sub-paragraph (3)* applies instead of *sub-paragraph (2)* where the income paid to the minor child is partly from pre-March 1999 funds and partly other funds, such as where there has been an injection of funds into the settlement after 9 March 1999.

Paragraph 134: Amounts treated as income of settlor: capital sums paid to settlor by trustees of settlement

3678. This paragraph applies where it is necessary to consider years before 1995-96 in applying the charge under section 633.

3679. Section 677(2) of ICTA excludes from income available to cover capital payments made to a settlor income within the settlement that has already been treated as the settlor's. Section 677(2) of ICTA is rewritten in section 635. *Sub-paragraphs (2)* and *(3)* rewrite the categories in section 677(2) of ICTA that only apply in respect of income arising under a settlement before the tax year 1995-96 but which may still have effect when calculating the income available up to the end of a tax year for the purposes of section 633.

3680. *Sub-paragraph (5).* This saving may still have application where the direction or assignment precedes by some years the capital payment. (Capital payments are no longer charged after 11 years or 16 years if made through a company associated with the settlement. See sections 633 and 643).

Part 9: Exempt income

Paragraph 143: Purchased life annuity payments: old determinations concerning capital elements

3681. This paragraph ensures that determinations as to the capital element of a purchased life annuity made before 6 April 2005 translate into exempt amounts for the purposes of Chapter 7 of Part 6 of this Act so that the determination continues to have effect after 6 April 2005.

Paragraph 144: Purchased life annuity payments: carry forward of excess capital elements

3682. If the amount of an annuity payment is less than the capital element calculated under the constant sum method in section 656(2) of ICTA, ESC A46 allows the excess of the capital element over the gross annuity to be carried forward to increase the capital element to be set against the next annuity payment. Section 719(5) of this Act gives statutory effect to that concession. This paragraph enables such excesses that were not absorbed by annuity payments made before the tax year 2004-05 to be carried forward by increasing the exempt amount of the first payment made after 5 April 2005. See *Change 119*.

Paragraph 145: Purchased life annuity payments: penalty for false statements

3683. This paragraph makes clear that it is the date of the statement or representation which determines which penalty provision applies.

Paragraph 146: Certain annual payments by individuals

3684. Sections 727 and 730 of this Act provide exemption from income tax in respect of certain annual payments. They are based on section 347A of ICTA. Section 347A of ICTA applies to all payments falling due on or after 6 April 2000 and also to certain payments falling due before that date but on or after 16 March 1988. Although unlikely, it is possible for payments to fall due at a time when section 347A of ICTA did not apply but to be paid after 6 April 2005. The transitional provision determines whether the exemptions apply.

Paragraph 147: Annuity payments for non-taxable consideration

3685. A payment made by an individual is not exempt from income tax in the recipient's hands under section 729 of this Act if the payment is made for non-taxable consideration unless either condition B or C in that section is satisfied. This paragraph adds a further condition which, if satisfied, renders the payment exempt in the recipient's hands.

Paragraph 148: Periodical payments of personal injury damages etc.

3686. Sections 731 and 732 provide exemptions from income tax for periodical payments in respect of damages for personal injury and annuity payments under annuities purchased under an award made under the Criminal Injuries Compensation Scheme. They are based on sections 329AA and 329AB of ICTA as amended by section 100(2) of the Courts Act 2003. Section 100(2) of the Courts Act 2003 was not in force when the Bill was introduced into Parliament. But sections 731 and 732 were rewritten on the assumption that on enactment of this Act, section 100(2) of the Courts Act 2003 would be in force. The transitional provision was added to ensure that the pre-Courts Act 2003 version of the legislation in ICTA continued in effect until such time as section 100(2) of the Courts Act 2003 was brought into effect.

Part 11: Foreign income: special rules

Paragraph 150: Relevant foreign income charged on remittance basis: income arising before the tax year 2005-06

3687. This paragraph ensures that Chapter 2 of Part 8 of this Act is not restricted in its operation to income that arose after the tax year 2004-05 (whenever the earlier income is remitted).

Paragraph 151: Relevant foreign income charged on remittance basis: delayed remittances

3688. This paragraph is based on section 585 of ICTA. It ensures that the relief given by section 835 is not restricted to income that arose after the tax year 2004-05. It also preserves the rules in section 585(4) and (5) for tax years before 1997-98 (that is, years before Self Assessment came into effect) when the basis period for many charges was a period other than the current tax year.

Paragraph 152: Relief for back-dated pensions charged on arising basis

3689. This paragraph ensures that the relief given by section 840 is not restricted to income that arose after the tax year 2004-05. See *Change 139* in Annex 1.

Paragraph 153: Unremittable income that arose before the tax year 2005-06

3690. This paragraph ensures that the relief given by Chapter 4 of Part 8 of this Act, and any withdrawal of that relief by virtue of sections 843 or 844, is not restricted to income that arose after the tax year 2004-05 or, as regards withdrawal of relief, to claims under that Chapter.

3691. The paragraph also preserves access to the jurisdiction of the Special Commissioners on an appeal involving the application of Chapter 4 of Part 8 of this Act (and of section 584 of ICTA, which that Chapter rewrites), where income arising in a year before the tax year 2005-06 is material to the appeal. This sub-paragraph is based on section 584(9) of ICTA. See *Change 142* in Annex 1.

Part 12: Other provisions

Paragraph 158: Apportionment of profits or losses to tax years before tax year 2005-06

3692. Section 871 applies to various sources of income that are taxed under Schedule D Case VI in the source legislation. It rewrites section 72 of ICTA which allows the profits of a period of account to be apportioned.

3693. The basis of assessment for income taxed under Schedule D Case VI is the full amount of the profit arising in the tax year. This is rewritten in the income charged sections for each source of income to which section 871 applies. If accounts are prepared for any of these sources it may be necessary to apportion the profits of accounts made up to a period other than the tax year to arrive at the figure of profit that arises in the tax year.

3694. Section 883 provides that the Act takes effect for income tax purposes for the tax year 2005-06. This paragraph provides that the rewritten legislation applies to a period of account that straddles 6 April 2005 even though tax years earlier than 2005-06 will be affected. This Act includes a number of minor changes in the law. Without this paragraph it would be necessary for taxpayers to take account of those changes only for the tax year 2005-06.

3695. If the taxpayer does not want the new law to apply to a transaction that occurred before 6 April 2005 he or she can elect for the old legislation to continue to apply.

Paragraph 159: General deduction rules

3696. This paragraph reflects the fact that in certain sections detailed rules have been provided for the calculation of amounts charged to tax but similar rules have not been spelled out at other places where those rules may apply. Those detailed rules in part reflect the interpretation of the source legislation in case law. This paragraph ensures that the absence of the provision of detailed rules at any point does not prejudice the continued application of existing rules for the meaning of words such as "the full amount of the income".

Schedule 3: Repeals and revocations

3697. This Schedule contains repeals and revocations of enactments including some spent enactments.

Schedule 4: Abbreviations and defined expressions

Part 1: Abbreviations of Acts

3698. Part 1 provides a list of abbreviations used in referring to other Acts.

Part 2: Index of expressions defined in this Act etc.

3699. Part 2 lists expressions defined in this Act or in other Acts.

COMMENCEMENT

3700. The substantive provisions of this Act will come into force on 6 April 2005. Section 883 provides for it to have effect:

- for the purposes of income tax, for the year 2005-06 and subsequent tax years; and
- for the purposes of corporation tax for accounting periods ending after 5 April 2005.

HANSARD REFERENCES

3701. The following table sets out the dates and Hansard references for each stage of this Act's passage through Parliament.

Stage	*Date*	*Hansard Reference*
House of Commons		
Introduction	30 November 2004	Vol. 428 Col 513
Second Reading Committee	14 December 2004	
Second Reading (formal)	20 December 2004	Vol. 428 Col 2037
Third Reading	7 March 2005	Vol. 431 Cols 1289 - 1292
House of Lords		
Introduction	8 March 2005	Vol. 670 Col 627
Second and third readings	23 March 2005	Vol. 671 Cols 324 - 335
Royal Assent – 24 March 2005		House of Lords Hansard Vol. 671 Col 412
		House of Commons Hansard Vol. 432 Col 1036

ANNEX 1: MINOR CHANGES IN THE LAW MADE BY THE ACT:

Change 1: Income taxed as trade profits: omit the words "immediately derived from" in the identification of the foreign income to which the trade profit rules apply: section 7

This change omits the words "immediately derived from" in the identification of the foreign income to which the trade profit rules apply.

Section 65(3) of ICTA deals with the calculation "under Case IV or V of Schedule D" of profits "immediately derived … from the carrying on … of any trade …". Those words date from FA 1907.

For trading income generally, this Act refers simply to the profits of a trade.

The change brings the rules for calculating all foreign trade profits (whether "immediately derived" or not) into line with the rules for calculating trade profits within Schedule D Case I. It is in line with the general approach of the source legislation in applying the same calculation rules to foreign and United Kingdom trades.

In the case of foreign trade profits that are not immediately derived from the carrying on of a trade, the income will be calculated in accordance with the trade profit rules, instead of being "computed on the full amount of the income arising" as in section 65(1) of ICTA. There is unlikely to be any practical difference.

If the foreign trade profits that are not immediately derived from the carrying on of a trade are profits of an overseas property business the profits will instead be charged as trade profits.

This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 2: Profits of mines, quarries and other concerns: section 12

This change identifies three consequences of the approach taken to the rewrite of section 55 of ICTA.

Section 55 of ICTA provides that profits arising out of land in the case of certain listed concerns shall be charged to tax under Schedule D Case I. The concerns listed include mines, quarries, railways and canals.

Section 55 of ICTA is rewritten as section 12. It treats the profits and losses of the concern as if they were the profits or losses of a trade. This has three consequences.

(1) Section 55 of ICTA does not specify how the profits to be taxed under Schedule D Case I are to be calculated. Treating the profits and losses of the concern as if they were the profits or losses of a trade makes clear that the profits are calculated in the same way as trade profits. This means that the calculation rules in Part 2 of this Act will apply. In particular the starting point for the calculation of the profits is generally accepted accounting practice.

(2) Section 55 of ICTA does not identify what profits are to be taxed for the tax year. In practice many taxpayers use the profits of the basis period. Treating the profits of the concern as if they were profits of a trade gives this practice statutory effect. A taxpayer who, under the law as it applies before the commemcement of this Act, returns the profits of the tax year can retain this treatment by adopting a 5 April accounting date.

(3) Section 55 of ICTA refers only to profits. In practice loss relief is allowed for losses of concerns as if they were trade losses. Section 12(1) gives that practice statutory effect by referring to both the profits and losses of the concern.

This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 3: Caravan sites where trade carried on: section 20

This change gives statutory effect to ESC B29 (caravan sites where there is both trading and letting income).

ESC B29 states:

"Where the proprietor of a caravan site carries on material activities associated with the operation of that site which constitute trading, there may be included as receipts of that trade any site income from the letting of pitches for static or touring caravans, and any income from letting caravans where the letting does not of itself amount to a trade.

The concession was introduced in 1984 along with the legislation subsequently consolidated in sections 503 and 504 of ICTA under which the letting of furnished holiday accommodation which does not amount to a trade is treated as a trade for certain purposes.

ESC B29 puts operators of caravan sites which include an element of trading into the same position as persons running furnished holiday letting businesses. In practice there is an element of trade, such as the operation of a site shop or the provision of leisure facilities such as a café, included in the operation of most caravan sites.

This change gives taxpayers who meet the qualifying conditions a statutory right to treat receipts from letting caravans or pitches as receipts of the trade of operating a caravan site.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 4: Surplus business accommodation: section 21

This change gives statutory effect to the Inland Revenue practice on receipts from surplus business accommodation known as Revenue Decision 9.

The case of Salisbury House Estate Ltd v Fry (1930), 15 TC 266 HL is authority for the proposition that the income tax Schedules are mutually exclusive so any amount received by a trader from the letting of premises surplus to the requirements of the trade should not be taken into account in calculating the profits of the trade but assessed separately to tax as income from property under Schedule A. Similarly, any outgoings in respect of the premises should be apportioned between the part which is let and the part used for the purposes of the trade.

In practice, the Inland Revenue does not object to a trader including receipts from letting surplus business accommodation in trade receipts provided certain conditions are met. This practice, published in the February 1994 edition of Tax Bulletin under the heading "Revenue Decisions - Schedule D Cases I and II – Letting Surplus Business Accommodation", is referred to in some in some reference books as Revenue Decision 9. The practice extends to trades within Schedule D Case V.

The conditions in Revenue Decision 9 are:

- the accommodation is temporarily surplus to the current requirements of the trade;
- part of the accommodation is used for trade purposes;
- the rental income is comparatively small; and
- the rent is in respect of the letting of surplus business accommodation only - not surplus land.

In legislating the conditions in Revenue Decision 9, section 21 sets out rules for determining whether accommodation is temporarily surplus to requirements. These are:

- that the accommodation must have been used for the purposes of the trade within the last three years (or acquired within that period);
- that the accommodation must be let for a term of not more than three years; and

- that the trader must intend to use the accommodation for trade purposes at a later date.

This gives taxpayers increased certainty as to whether the condition is met.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 5: Rents in respect of wayleaves where associated with a trade: sections 22 and 344

This change shifts the charge on rents from certain wayleaves associated with a trade from Schedule D Case V and Case VI to a charge on trade profits.

Section 120 of ICTA makes provision about rent payable in respect of “any easement enjoyed in the United Kingdom in connection with any electric, telegraphic or telephonic wire or cable” other than an easement of a kind mentioned in section 119(1) of ICTA. Section 119 of ICTA applies to certain easements which are or might be used or enjoyed in connection with any of the concerns listed in section 55 of ICTA. Those concerns include mines, quarries, certain industrial concerns, canals, docks, markets, bridges, ferries, and railways. “Rent” and “easement” both have wide meanings for this purpose (see section 119(3) of ICTA).

Section 120(1) of ICTA provides for the rent from electric-line easements to be charged under Schedule D unless other income from the land to which the easement relates is charged under Schedule A. In that case the rent is charged to tax under Schedule A, section 120(1A) of ICTA.

Section 120(1) of ICTA does not specify under which Case of Schedule D the rent is to be charged. In practice, where the easement relates to land on which a person carries on a trade, the rent is charged under Case I of Schedule D and, in other cases, under Case VI. In the absence of section 120 of ICTA the rent would be charged to tax under Schedule A. Section 120 of ICTA does not apply to rent from easements relating to land outside the United Kingdom, which is charged to tax under Schedule D Case V.

Section 120(1) of ICTA as it applies to trades is rewritten in section 22. Under section 22:

- the word “easement” is rewritten as “wayleave”. The rest of this note refers to wayleaves;
- rents from wayleaves related to land associated with a trade will be charged to income tax under Part 2 of this Act (as profits of the trade) if the taxpayer so chooses and has no other income from the land in question; and
- all other rents from wayleaves will be charged to income tax under Part 3 of this Act (property income).

This enacts the existing non-statutory practice for easements to which section 120 of ICTA applies which are associated with a trade but represents a change both in practice and in the law as respects:

- wayleaves other than those connected with “electric, telegraphic or telephonic wire or cable”;
- wayleaves relating to land outside the United Kingdom; and
- wayleaves of a kind mentioned in section 119(1) of ICTA.

Section 22 applies the same treatment to land occupied for the purposes of a profession or vocation. It also makes clear that any expenses incurred in respect of the wayleave can also be allowed as deductions in calculating the profits.

Section 119(1) of ICTA is rewritten as Chapter 8 of Part 3 of this Act. Under the law as it applies before the commencement of this Act, rent in respect of a wayleave that meets the conditions in both sections 119(1) and 120(1) of ICTA is taxed under section 119 of ICTA. Section 262(2) of this Act reverses that order of priority. This is necessary to allow the taxpayer to have such rent taxed as the profits of a trade. It will not prevent a claim for relief under section 340 of this Act as rent for an electric-line wayleave would not qualify for such relief.

All rents that are in practice charged to tax under Schedule D Case VI by virtue of section 120(1) of ICTA, as that section applies before the commencement of this Act, will be charged under section 344 (charge to tax on rent receivable for a UK electric-line wayleave).

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 6: Relationship between rules prohibiting deductions and rules allowing deductions: sections 31 and 274

This change resolves any conflict between the rules prohibiting a deduction in calculating trade profits and the rules allowing a deduction in calculating trade profits in favour of the rule allowing the deduction. But any conflict is unlikely.

Part 2 of this Act sets out a number of rules that restrict the deductions allowed in the calculation of trade profits. Each of these is a “prohibitive rule”. Sections 34 and 35 are prohibitive rules of general application. The other restrictions apply in more closely defined circumstances.

Part 2 of this Act also sets out a number of rules that allow deductions in the calculation of trade profits. Most of these rules are in Chapter 5 of Part 2 of this Act. Each of these is a “permissive rule”.

In some cases the source legislation for a permissive rule overrides a specific prohibitive rule. See, for example, section 112 of FA 1989 rewritten as section 82 which overrides section 74(1)(a) and (b) of ICTA. In other cases the source legislation provides that a deduction is allowed “notwithstanding anything in section 74 [of ICTA]”. Such a form of words overrides all the restrictive rules in section 74 of ICTA. See, for example, section 82A of ICTA rewritten as section 88. In other cases the source legislation says merely that a deduction is allowed. See, for example, section 77 of ICTA (incidental costs of loan finance) rewritten as section 59.

If the source legislation makes clear that a permissive rule overrides a specific prohibitive rule that limitation is included in the rewrite of the permissive rule. See, for example, section 82 (personal security expenses). In other cases section 31 makes clear that the permissive rule has priority over any prohibitive rule with two exceptions. The exceptions are the restriction on crime-related expenditure and the restriction on the costs of hiring a car or motor cycle.

In the case of crime-related expenditure the order of priority reflects the view that in enacting section 577A of ICTA Parliament intended that there should be no circumstances in which anyone should obtain a tax deduction by making a crime related payment.

In the case of car and motor cycle hire section 578A of ICTA makes clear that the provision restricts the amount of any deduction.

The order of priority given by section 31 will be relevant only if the expenditure is capable of falling within both a permissive rule and a prohibitive rule. This is most likely to happen in the case of one or both of the general restrictions in sections 34 and 35. In these cases the source legislation leaves no uncertainty about the extent to which the prohibitive rule is overridden. The only area of uncertainty is where the restriction is imposed by a provision other than section 74 of ICTA. For example, the restriction that section 577 of ICTA imposes on business expenditure.

It is unlikely there is scope for overlap between a specific permissive rule and a specific prohibitive rule. This is because the terms for either rule to apply are so closely defined. As a question of fact the expenditure will fall into one category or the other. But in the event of any overlap section 31 changes the law by giving priority to the permissive rule.

For example, it is unlikely that expenditure that meets the conditions for section 83 of ICTA (patent fees etc) to apply would also be business expenditure disallowed by section 577 of ICTA. If it does the source legislation is silent on which rule takes priority. Section 31 gives priority to the permissive rule.

Section 274 applies the same order of priority to the profits of a property business.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 7: Align rules for debts proving irrecoverable after trade deemed to have ceased with general rules for bad and doubtful debts: section 35

This change aligns the relief given for bad debts by section 89 of ICTA with the relief given by section 74(1)(j) of ICTA.

Section 113(1) of ICTA provides that where there is a complete change in the persons carrying on a trade the trade is deemed to cease and recommence. (Before Self Assessment the trade was also deemed to cease and recommence on a partial partnership change, unless the partners elected otherwise.)

Section 89 of ICTA provides relief for bad debts where there has been a change in the persons carrying on the trade and the trade is deemed to cease under section 113 of ICTA. It gives relief for bad debts which meet certain conditions and which are assigned to the successor to the trade. Since the trade carried on prior to the change is deemed to be different from the trade carried on after the change section 74(1)(e) of ICTA would otherwise prohibit a deduction for bad debts. The desired effect is to treat the trade as continuing as far as bad debts are concerned.

Although the aim of section 89 of ICTA is the same as that of section 74(1)(j) of ICTA (that is, to give relief for bad trade debts), there are significant differences between the two sections and the nature of the relief given. Specifically:

- section 89 gives relief for debts which are "irrecoverable", whereas section 74(1)(j) gives relief for debts which are bad or doubtful;
- the requirement for proof that a debt is bad or doubtful in section 74(1)(j) was removed by FA 1996 to assist in the introduction of Self Assessment; section 89 still has this;
- relief in section 89 is specifically related to the period in which the debt becomes in whole or in part irrecoverable; section 74 is silent on this;
- section 74(1)(j) refers to debts released as part of a "relevant arrangement or compromise"; section 89 makes no mention of this; and
- section 89 does not make specific reference to the bankruptcy or insolvency of debtors; this is referred to in section 74(1)(j)(iii).

This Act does not rewrite section 89 of ICTA. Section 89 of ICTA is not needed because the approach adopted in this Act is to focus on the person carrying on the trade rather than the trade. The effect is to extend the more generous provisions of section 74(1)(j) of ICTA to debts within section 89 of ICTA. This simplifies the law by bringing the bad debt relief provisions for income tax payers into one section.

This change is in taxpayers' favour in principle and may in practice benefit some. But the numbers affected and the amounts involved are likely to be small.

Change 8: Unpaid remuneration of employees: payment made after return submitted but within 9 months of the end of the period of account: sections 37 and 865

This change drops the requirement to make a claim for a deduction for remuneration paid after the return is submitted but within nine months of the end of the period of account in which it is charged.

Section 43(5) of FA 1989 deals with profit calculations made within nine months of the end of the period of account. Paragraph (a) requires the assumption that any remuneration unpaid at the time of the calculation will not be paid by the end of that nine month period. That means the proposed remuneration cannot be deducted in making the calculation. Paragraph (b) provides an adjustment procedure that applies when the remuneration is paid after the calculation is made but before the end of the nine month period. If a claim is made within two years of the end of the period of account the calculation may be adjusted.

This change brings the adjustment procedure into line with the normal Self Assessment rules and deals with the adjustment as an amendment to a return. Section 9ZA(2) of TMA sets a time limit for making such amendments. It is 12 months from the filing date for the relevant return.

The change alters the time available for making the adjustment from two years after the end of the period of account in every case to a date that depends on when the accounting date falls in the tax year. To be within the scope of the provision the taxpayer must submit his or her return within nine months of the end of the period of account.

In the normal case of a continuing trade and a return issued on 6 April the earliest date to which accounts can be prepared and meet this condition is 6 July in the previous calendar year. In principle the change gives taxpayers seven months extra to include the deduction in their self-assessment. The latest date to which accounts can be prepared and meet the condition is 5 April. In principle the change then gives taxpayers two months less to include the deduction in their self-assessment. In practice the return will usually be submitted at a time when it is known whether or not the remuneration has been paid within nine months of the period of accounts.

In the case of a new trade the time limit may be shorter if the period of account ends after a tax year for which it provides the basis period.

Example

A new trader makes up his or her accounts for the calendar year to 31 December 2006. These accounts form the basis period for the tax year 2005-06. If the return is issued on 6 April 2006 the latest date for amending the return is 31 January 2008. This is 11 months before the date allowed by section 43(5) of FA 1989.

This change puts the method of allowing relief on the same basis as that in paragraph 6 of Schedule 24 to FA 2003 rewritten as section 43. Schedule 24 to FA 2003 is a similar provision to section 43 of FA 1989. It denies a deduction for amounts charged in respect of employee benefit contributions unless the benefits are provided within nine months of the end of the period in respect of which they are charged.

Paragraph 6 of Schedule 24 to FA 2003 deals with the case in which the return is made before the end of the nine month period. Unlike section 43(5) of FA 1989 it does not require a claim. It provides merely that the calculation can be adjusted. This is the most appropriate way of dealing with the point under Self Assessment.

This change has no implications for the amount of tax due, who pays it or when. It affects (in principle and in practice) only administrative matters.

Change 9: Exceptions to the rule restricting deductions for business gifts: section 47

This change provides for the monetary limit on the cost of gifts excluded from the general rule prohibiting deduction for expenses incurred in providing gifts in section 45 to be increased by Treasury order.

Section 47(3) is based on section 577(8)(b) of ICTA. The £50 limit in section 577(8)(b) of ICTA (previously £10) was inserted with effect from 2001-02 by section 73 of FA 2001 in line with an increase in the corresponding VAT provision made by Treasury order.

Section 577(8)(b) of ICTA was rewritten as it applied to employees in section 358(3)(b) of ITEPA. Section 716(2) of ITEPA provides that the Treasury may by order increase, or further increase, the sum specified in various provisions in ITEPA including section 358(3)(b) of ITEPA. Incorporating a similar provision in section 47 allows the limit to be increased in line with the corresponding limits in ITEPA and in the VAT provisions by Treasury order rather than by primary legislation.

This change has no implications for the amount of tax paid, who pays it or when. It affects (in principle but not in practice) only administrative matters.

Change 10: Car hire: release of debt after debtor has ceased trading: section 48

This change reduces the amount charged as a post-cessation receipt when a debt relating to the hire of a car with a new retail value of more than £12,000 is released after the debtor has ceased trading.

Section 578A of ICTA restricts the amount which a person carrying on a trade can deduct in respect of the cost of hiring a car with a retail value, when new, of more than £12,000. The restriction takes the form of a reduction calculated by reference to the difference between the £12,000 ceiling and the retail price.

Section 578A(4) of ICTA provides that where there is a rebate of a hire charge, or a debt to which section 94 of ICTA applies is released, the amount brought into account in respect of the rebate or release is reduced in the same proportion as that in which the trading deduction was restricted.

Section 578A(4) of ICTA deals only with a continuing trade. This change extends the same treatment to debts wholly or partly released after the debtor has ceased to trade and taxed as post-cessation receipts under section 103(4) of ICTA.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 11: Car hire: hire agreements without option to purchase: section 49

This change extends the definition of “qualifying hire car” for the purpose of the restriction on the amount allowed as a deduction for the cost of hiring a car to include cars hired under a hire purchase agreement where there is no option to purchase.

Section 578A of ICTA restricts the amount which a person carrying on a trade can deduct in respect of the cost of hiring a car with a retail value, when new, of more than £12,000. Section 578A of ICTA does not apply to a car which is a “qualifying hire car” as defined in section 578B(2) of ICTA.

Section 578B(2) of ICTA defines a “qualifying hire car” as a car which is:

“(a) … hired under a hire-purchase agreement … under which there is an option to purchase exercisable on the payment of a sum equal to not more than 1 per cent. of the retail price of the car when new, or

(b) … a qualifying hire car for the purposes of Part 2 of the Capital Allowances Act (under section 82)…

The definition of “qualifying hire car” in section 578B(2) of ICTA does not extend to cars hired under a hire purchase agreement where there is no option to purchase. In practice, the Inland Revenue does not apply the restriction in section 578A of ICTA to cars hired under such agreements. This section legislates that practice by including cars hired under a hire-purchase agreement where there is no option to purchase in the definition of hire car in subsection (2)(a).

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 12: Trade profits: exclusion of double relief for interest: final variation of claim: section 52

This change makes clear when a claim under section 353 of ICTA is finally determined for the purposes of rewriting section 368(4) of ICTA.

Section 353 of ICTA provides for interest to be claimed as a relief. In limited circumstances that relief may also qualify as a deduction in calculating trade profits. Section 368(4) of ICTA provides that a trade deduction is not allowed if relief has been given under section 353 of ICTA.

Section 368(4) of ICTA is subject to section 368(6) of ICTA. That subsection provides that the references to relief given or a deduction allowed refer to relief given or a deduction allowed on a claim or in an assessment that has been finally determined.

The term "finally determined" does not fit well with Self Assessment. Section 52(5) makes clear that it means when the claim can no longer be varied. This wording is based on section 43C(4) of TMA.

This change has no implications for the amount of tax paid, who pays it or when. It affects (in principle but not in practice) only administrative matters.

Change 13: Deduction for tenant under taxed lease if land is outside the United Kingdom: sections 60 and 64

This change makes the relief available to tenants under taxed leases of land in the United Kingdom used in connection with a trade, profession or vocation available where the land is outside the United Kingdom.

Section 34 of ICTA provides that if a premium is, or certain other amounts are, payable in respect of a lease, the landlord is treated as receiving an amount by way of rent. If the premium or other amount is due to a person other than the landlord, generally that person is treated as receiving income in consequence of entering a transaction within Schedule A. Section 35 of ICTA treats a person who assigns at a profit a lease which has been granted at an undervalue as receiving income in consequence of entering into a transaction within Schedule A.

Section 65A(5) of ICTA provides that:

"the income from an overseas property business shall be computed for the purposes of Case V of Schedule D in accordance with the rules applicable to the computation of the profits of a Schedule A business.

So if the lease is of land outside the United Kingdom, sections 34 and 35 of ICTA apply by virtue of section 65A(5) of ICTA. The amount which would be treated as income of a Schedule A business in the case of land in the United Kingdom is treated instead as income of an overseas property business.

Section 87(1) and (2) of ICTA provide that if land in relation to which an "amount chargeable" arose is occupied or otherwise used for the purposes of the tenant's trade, profession or vocation, the tenant is treated in computing his or her profits as paying rent in respect of the land.

Section 87(1) of ICTA defines "the amount chargeable" as:

"(a) any amount [that] falls to be treated as a receipt of a Schedule A business by virtue of section 34 or 35, or

(b) any amount [that] would fall to be so treated but for the operation of section 37(2) or (3).

Section 87(1) and (2) of ICTA are rewritten in sections 60 and 61. The "amount chargeable" on the landlord is referred to in those sections as the "taxed receipt".

Section 65A(5) of ICTA provides that income from an overseas property business is computed for the purposes of Schedule D Case V in accordance with the rules applicable to the calculation of the profits of a Schedule A business. But section 65A of ICTA does not deem Schedule D Case V income to be income of a Schedule A business. So a receipt which falls to be taxed under Schedule D Case V by virtue of section 34 or 35 of ICTA as applied by section 65A of ICTA is not an amount which falls to be treated as "a receipt of a Schedule A business" and is not therefore within section 87(1) of ICTA.

This means that if a tenant occupies land outside the United Kingdom under a lease in respect of which the landlord has been taxed under Schedule D Case V by virtue of section 34 or 35 of

ICTA as applied by section 65A(5) of ICTA, the tenant is not entitled to relief in circumstances in which he or she would have been entitled to relief under section 87(2) of ICTA if the land had been in the United Kingdom.

Section 60 applies to land wherever it is situated and to taxed receipts brought into account in calculating the profits of an overseas property business as well as a UK property business. Section 64 limits the expenses a tenant is treated as incurring under section 61 where there is a reduction under Chapter 4 of Part 3 of this Act in a receipt of an overseas property business as well as where there is a reduction in a receipt of a UK property business.

This change will result in a tenant receiving relief by reference to a taxed receipt in respect of land outside the United Kingdom in circumstances where, under the law as it applies before the commencement of this Act, there is no entitlement to relief. But this may, in certain circumstances, reduce the amount of relief subsequently available by reference to the taxed receipt under Chapter 4 of Part 3 of this Act.

This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 14: Requiring an apportionment to be just and reasonable: sections 61, 65, 78, 93, 289, 294, 316, 471, 472, 645, 719 and 722

This change requires any apportionment that is not required by the source legislation to be made on a just and reasonable basis to be made on such a basis.

In some cases where there is an apportionment under legislation rewritten in this Act, the apportionment is required by the source legislation to be made on a just and reasonable basis. In other cases, it is required to be made only on a just basis or only on a reasonable basis, or there are no requirements. In new tax legislation it is now the practice to require an apportionment to be just and reasonable. For example, before it was replaced by ITEPA, section 140B(4) of ICTA (inserted by FA 1998) required a just and reasonable apportionment to be made of any consideration given partly in respect of one thing and partly in respect of another. There is no reason why an apportionment should not be on a just and reasonable basis. And it is desirable that all apportionments should be made on the same basis.

Accordingly, where an apportionment under legislation rewritten in this Act is not required to be made on a just and reasonable basis, the rewritten provision requires the apportionment to be made on a just and reasonable basis. The changes are as follows:

- section 87(3) of ICTA (apportionment of deemed rent attributable to part of land not occupied for the purposes of a trade, profession or vocation required to be just) (see section 61(5));
- section 87(5) of ICTA, which applies section 37(6) of ICTA (amount chargeable on the superior interest to be proportionately adjusted between parts of premises; no requirements as to the basis on which the adjustment is to be made) (see section 65(6));
- section 579(5) of ICTA (apportionment of a redundancy payment where the employee is employed in different capacities; no requirements as to the basis on which the apportionment is to be made) (see section 78(2));
- sections 80(4) and (8) and 81(5) of ICTA (apportionment of expenses between foreign trades required to be made on a reasonable basis) (see section 93(2), (3) and (5));
- section 37(3) of ICTA (apportionment of appropriate fraction of the amount chargeable on the superior interest attributable to a part of premises required to be just) (see section 289(3));
- section 37(6) of ICTA (amount chargeable on the superior interest to be proportionately adjusted between parts of premises; no requirements as to the basis on which the adjustment is to be made) (see section 294(6));

- section 30(2)(a) of ICTA (apportionment of deemed payment in respect of expenditure on sea walls, as may be just) (see section 316(2));
- section 547A(12) of ICTA (non-fractional interest in the rights conferred by a policy or contract treated as if it were such a share in the rights as may justly and reasonably be regarded as representing the interest) (see section 471(7));
- section 547A(7) of ICTA (apportionment of any property that represents property provided for the purpose of a trust and other property required to be just) (see section 472(4));
- section 660E(5) of ICTA (apportionment of any property that represents both property provided by the settlor and other property required to be just) (see section 645(1));
- section 656(3) of ICTA (in the case of certain purchased life annuities, the proportion which the capital element in any annuity payment bears to the total amount of the payment is in certain circumstances to be such as may be just, having regard to certain factors) (see section 719(8)); and
- section 656(4) of ICTA (apportionment of consideration given in connection with the grant of an annuity required to be just) (see section 722(3) and (4)).

This change makes minor amendments to a number of existing rules, but is expected to have no practical effect as it is in line with current practice.

Change 15: Restrictions on expenses under sections 61 and 292: sections 64, 65, 293 and 294

This change clarifies how expenses that a tenant is treated as incurring by reference to a taxed receipt under sections 61 or 292 are affected in cases in which there is a reduction under section 288 by reference to the taxed receipt in calculating the amount of a receipt.

Section 37(4) of ICTA provides:

"Subject to subsection (5) below, the person for the time being entitled to the head lease shall be treated for the purpose, in computing the profits of a Schedule A business, of making deductions in respect of the disbursements and expenses of that business as paying rent for those premises (in addition to any actual rent), becoming due from day to day, during any part of the period in respect of which the amount chargeable on the superior interest arose for which he was entitled to the head lease, and, in all, bearing to that amount the same proportion as that part of the period bears to the whole.

Section 37(4) of ICTA is rewritten in sections 291 and 292.

Section 37(5) of ICTA modifies section 37(4) of ICTA, if the reduced amount of a later chargeable amount has been calculated under section 37(2) of ICTA by reference to the amount chargeable on the superior interest. Section 37(5) of ICTA provides:

"Where subsection (2) above applies, subsection (4) above shall apply for the period in respect of which the later chargeable amount arose only if the appropriate fraction of the amount chargeable on the superior interest exceeds the later chargeable amount, and shall then apply as if the amount chargeable on the superior interest were reduced in the proportion which that excess bears to that appropriate fraction.

Section 37(5) of ICTA is rewritten in section 293.

The general principle behind section 37(5) of ICTA is that if part of the amount chargeable on the superior interest has been used to reduce the amount of a later chargeable amount, only the balance of the amount chargeable on the superior interest should be available under section 37(4) of ICTA. This is achieved by reducing the amount of rent that the tenant is treated as paying under section 37(4) of ICTA for the period in respect of which the later chargeable amount arose. If in the calculation under section 37(2) of ICTA the appropriate fraction of the amount chargeable on the superior interest did not exceed the later chargeable amount, section 37(4) of

ICTA does not apply. So the tenant is not treated as paying rent under section 37(4) of ICTA for the period in respect of which the later chargeable amount arose.

Section 87(5) of ICTA applies section 37(5) of ICTA if a tenant under a taxed lease is treated as paying rent under section 87(2) of ICTA in circumstances in which section 87(4) of ICTA applies.

(1) It is possible that the reduced amount of a later chargeable amount calculated under section 37(2) of ICTA by reference to more than one amount chargeable on the superior interest has been reduced to zero but that the appropriate fraction of the amount chargeable on the superior interest does not, in any one case, exceed the later chargeable amount. In these circumstances, section 37(5) of ICTA prevents any relief under section 37(4) of ICTA for the period in respect of which the later chargeable amount arose.

But it is more consistent with the principle behind section 37(5) of ICTA that if the *total* of the appropriate fractions of the amounts chargeable on the superior interest involved exceeds the later chargeable amount, rent equal to that excess should be treated as paid for the period in respect of which the later chargeable amount arose. Otherwise, that excess will not be available to provide relief under section 37(4) of ICTA. It will be lost, unless it can be used in the calculation of a reduced amount for a different later chargeable amount.

It is also possible that the reduced amount of more than one later chargeable amount has been calculated under section 37(2) of ICTA by reference to an amount chargeable on the superior interest and that the amount of each of the later chargeable amounts has been reduced to nil. In these circumstances, section 37(4) and (5) of ICTA work satisfactorily if there is no overlap between the periods in respect of which each of the later chargeable amounts arose. But it is not at all clear how section 37(4) and (5) are intended to operate if there is such an overlap.

If there is an overlap between the periods in respect of which each of the later chargeable amounts arose, it is reasonable that section 37(5) of ICTA should apply so that the *total* of the reductions in all later chargeable amounts by reference to the amount chargeable on the superior interest should be taken into account in determining how much, if any rent should be treated as paid under section 37(4) of ICTA.

Section 293(3) replaces the test that the appropriate fraction of the amount chargeable on the superior interest must exceed the later chargeable amount in section 37(5) of ICTA with the test that the “daily amount” of the taxed receipt must exceed the “daily reduction” of the lease premium receipt (as defined in section 293(6)). Section 290(6) provides that references to a reduction under section 288 by reference to a taxed receipt are to a reduction under that section as far as is attributable to the taxed receipt.

Section 293(5) deals with the application of section 37(5) of ICTA if more than one later chargeable amount has been reduced by reference to the amount chargeable on the superior interest.

Without these changes, section 293 would produce the same result as section 37(5) of ICTA if there is one taxed receipt and one lease premium receipt. These changes make section 293 work if a later chargeable amount is reduced by reference to *more than one* amount chargeable on the superior interest or an amount chargeable on the superior interest is reduced by reference to *more than one* later chargeable amount.

Section 64(2), (5) and (6) are based on that part of section 87(5) of ICTA that applies section 37(5) of ICTA. It includes similar changes to those in section 293.

(2) Section 37(6) of ICTA provides for the application of section 37(4) and (5) of ICTA if the later chargeable amount is in respect of a lease for only part of the premises subject to the head lease. Section 37(6) of ICTA is rewritten in section 294.

Section 37(6) of ICTA does not deal with the possibility that more than one lease may have been granted out of the head lease and that there may be a later chargeable amount reduced under section 37(3) of ICTA by reference to the amount chargeable on the superior interest in respect of each such lease. This is dealt with in section 294(4) .

Section 65 is based on that part of section 87(5) of ICTA that applies section 37(6) of ICTA. Section 65(4) includes a similar change to that in section 294.

The relief to which a person is entitled by reference to a taxed receipt under sections 288 and 292 is restricted by section 295 to the amount of the taxed receipt after any deductions under section 61. So if, as a result of this change, the relief to which a person is entitled is increased or decreased, this may affect the amount of relief to which somebody else is entitled.

This change is adverse to some taxpayers and favourable to others in principle and in practice. But the numbers affected and the amounts involved are likely to be small.

Change 16: Clarification of position of employees seconded to charities: section 70

This change provides that a trader who seconds an employee to a charity or educational establishment is entitled to a deduction in calculating the trade profits, irrespective of the duties undertaken by the employee while on secondment.

Section 86 of ICTA gives relief for employers who second employees to charities or educational establishments. It does this by providing that, notwithstanding anything in the general rules on deductions not allowable in section 74 of ICTA, the cost of the seconded employee:

> "shall continue to be deductible in the manner and to the like extent as if, during the time that his services are so made available…they continued to be available for the purposes of the employer's trade…

So if the costs of the employee would not be allowed under the normal rules – for example because the employee is employed on a capital project – the employer is not entitled to any deduction under section 86 of ICTA.

In practice, the costs of the secondment are allowed whatever the nature of the work carried out by the employee during the secondment. So if, for example, an employee is seconded to a medical charity to help build a hospice, the employer is allowed to deduct the cost of employing the seconded person. This change gives statutory effect to that practice.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 17: Retraining courses: deduction no longer dependent on employee's exemption: section 74

This change removes the link in the source legislation between the employee's exemption and the employer's entitlement to a deduction.

Section 588(3)(b) of ICTA permits a deduction in calculating the employer's trade profits when:

"by virtue of section 311 of ITEPA 2003, no liability to income tax arises in respect of the payment or reimbursement [of retraining course expenditure].

The requirement for the deduction to be allowed in section 74(1) is that the "relevant conditions" in section 311 of ITEPA are met. "Relevant conditions" is defined in section 74(2) which cross-refers to the detail of the conditions in section 311of ICTA. That does not include the employee's exemption from tax under that provision.

The effect is that the employer's entitlement to a deduction ceases to be dependent, in part, on the employee's exemption.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 18: Redundancy payments: legislate the practice of allowing voluntary payments made in connection with a cessation: section 79

This change legislates the practice of allowing as a deduction voluntary redundancy payments made in connection with the cessation of part of a trade.

Statement of Practice 11/81 extends the operation of section 90 of ICTA to payments in connection with the cessation of *part* of a trade. Section 79 of this Act gives effect to that practice in subsections (1) and (5).

If part of the trade continues, it would be possible to allow the deduction in the period of account in which the payment is made. But it is logical, and usually beneficial to the taxpayer, to make the deduction in the last period of account in which the part of the trade was carried on.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 19: Devolution: sections 80, 83, 110, 167, 207, 732, 755, 769, 879 and 880.

This change concerns the effect of the devolution settlements.

Scotland

The approval function in section 79(4) of ICTA conferred on the Secretary of State is exercisable in relation to Scotland by the Scottish Ministers (see SI 1999/1750 made under section 63 of the Scotland Act 1998). Section 83 of this Act reflects that transfer of functions.

In Schedule 1 to the Interpretation Act 1978 “Act” is defined to mean an Act of Parliament and “enactment” is defined as not including “an enactment comprised in, or in an instrument made under, an Act of the Scottish Parliament”. The definitions in that Schedule apply “unless the contrary intention appears” (see section 5 of the 1978 Act).

Section 581 of ICTA confers an exemption from tax in relation to foreign currency securities, including those issued by a statutory corporation. The definition of “statutory corporation” refers in a number of places to an “Act”. Because of the definition of “Act” in the Interpretation Act 1978, the definition of “statutory corporation” may not include bodies corporate established by an Act of the Scottish Parliament (ASP) (eg Scottish Water established by section 20 of the Water Industry (Scotland) Act 2002).

Section 879 of this Act widens the definition of “Act” as that term is used in section 755 to include such corporations. If this is a change in the law, it reflects current practice, and the fact that it can be assumed that the devolution settlement did not intend section 581 of ICTA to operate differently in relation to England and Wales on the one hand and Scotland on the other. The change also widens the scope of the exemption and is therefore favourable to the taxpayer.

Section 578 of ICTA confers an exemption from tax in relation to housing grants made under any enactment. Again the Interpretation Act 1978 means that it is not clear that “enactment” covers ASPs or Scottish statutory instruments.

Section 879 of this Act provides that ASPs and Scottish statutory instruments are covered by the reference to “enactment” in section 769, so that payments under them are capable of falling within the exemption in that section. If this is a change, it is in line with practice, reflects the intention of the devolution settlement and widens the scope of the exemption.

Northern Ireland

The reference to the Department for Employment and Learning in section 80 reflects the transfer of functions to that Department from the Department of Economic Development under Part II of Schedule 2 to SR (NI) 1999 No. 481.

Section 207 of this Act refers to the Department for Employment and Learning, which is the current name for the former Department of Higher and Further Education, Training and

Employment (see the Department for Employment and Learning Act (Northern Ireland) 2001).

Section 91A(6)(ba) of ICTA refers to a permit under regulations under section 2 of the Pollution Prevention and Control Act 1999. That reference was inserted by regulations made under that Act. The provision in Northern Ireland corresponding to section 2 of that Act is Article 4 of the Environment (Northern Ireland) Order 2002 (N.I. 7). An amendment along the lines of section 91A(6)(ba) of ICTA would have been ultra vires that Order because taxation is an excepted matter for the purposes of the Northern Ireland Act 1998.

In order to maintain parity of treatment throughout the United Kingdom, the definition of "waste disposal licence " in section 167(1)(c) of this Act is expanded to include a permit under any corresponding provision for the time being in force in Northern Ireland. The "corresponding provision" formula is preferred to specifying the 2002 Order. If the Order is subsequently re-enacted by the Northern Ireland Assembly, the Interpretation Act 1978 cannot be relied on to update the statutory reference.

A criminal injuries compensation scheme for Northern Ireland was established under the Criminal Injuries (Northern Ireland) Order 2002 (SI 2002/ 796 (N.I. 1)). That scheme does not fall within the current definition of "the Criminal Injuries Compensation Scheme" in section 329AB(2) of ICTA. To maintain parity of treatment throughout the United Kingdom the definition of that expression in section 732 of this Act is extended to cover the Northern Ireland criminal injuries compensation scheme.

There is doubt whether, in the application of section 581 of ICTA to Northern Ireland, "Act" covers the full range of legislation which applies or could apply to Northern Ireland. This means that, as with Scotland, it may not be clear in every case whether the definition of "statutory corporation" in that section covers corporations incorporated by, or on which functions are conferred by, such legislation.

Section 880 of this Act widens the definition of "Act" as that term is used in section 755 to include such corporations. This change in the law reflects current practice and widens the scope of the exemption, and so is favourable to the taxpayer.

Section 578 of ICTA confers an exemption from tax in relation to housing grants made under any enactment. Again it is not clear that "enactment" covers all of the different kinds of legislation which may apply to Northern Ireland.

Section 880 of this Act makes it clear that such legislation is covered by the reference to "enactment" in section 769, so that payments under such legislation are capable of falling within the exemption in that section. Again, if this is a change in the law, it is in line with practice and is taxpayer favourable.

Wales

Sections 83 and 110 of this Act refer to functions exercisable by the National Assembly for Wales. The references reflect the transfer of functions from the Secretary of State to the Assembly under the Transfer of Functions Order made under the Government of Wales Act 1998 (SI 1999/672). So far as those functions are concerned, the Order is partly superseded by this Act (and any change in the persons by whom those functions are exercisable will also have to be made by primary legislation).

The changes are in line with current practice and reflect the devolution settlements.

Change 20: Contributions to local enterprise organisations or urban regeneration companies: disqualifying benefits: section 82

This change amends the anti-avoidance rules in sections 79(3) and (9), 79A(3) and (4) and 79B(3) and (4) of ICTA.

The aim of the anti-avoidance rules is to stop traders obtaining a deduction for contributions that have strings attached. For example, a trader may give money to a local enterprise agency which is used to meet the costs of a relative setting up in business. These costs would normally not be tax deductible. So the anti-avoidance rules are designed to prevent the costs becoming tax deductible by passing the money through a local enterprise organisation.

The denial of the deduction in the source legislation is "all or nothing". This may cause a problem. For example, a trader gives £1 million to a training and enterprise council, but asks that employees be given free places on a word processing course (worth say £5000). The anti-avoidance rule bars any deduction under these provisions.

When section 79A of ICTA was enacted in 1990 an assurance was given that in a case such as this a deduction would be allowed. In practice the Inland Revenue ignores such benefits, or treats the payment as split into two, one part for the training and one for the donation.

Paragraph 47610 of the Inland Revenue Business Income Manual makes it clear that relief is not denied if the costs of obtaining the benefit provided would have been allowable as a deduction if incurred directly on an arm's length basis. So the section disallows a deduction only if there is a "disqualifying benefit".

Even if there is a "disqualifying benefit" the deduction may not be lost entirely. Instead, the deduction is restricted to take account of the benefit.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 21: Contributions to local enterprise organisations or urban regeneration companies: gifts of trading stock: charge any benefit by reference to periods of account: sections 82 and 109

This change deals with a benefit that arises to a trader in connection with:

- a contribution to a local enterprise organisation or urban regeneration company; or
- a gift of trading stock.

The benefit is charged to tax by treating the benefit as a trade receipt in the period in which it is received.

Sections 79(9), 79A(4), 79B(4) and 84A(4) of ICTA charge the benefit for the "chargeable period" in which it is received. For a person chargeable to income tax, this period is a year of assessment. If the benefit is received on a date in a tax year that is later than the accounting date, it is taxed in the same tax year as the profits of the period of account ended on that accounting date. This produces practical problems. It is in any event illogical to charge trading receipts to tax by reference to a tax year rather than a period of account.

This change will not alter the amount charged to tax. The most it will do is affect the timing of that tax liability. In a small minority of cases this could mean a different rate of tax being applied, according to individual circumstances. Any overall tax effect is likely to be negligible.

Change 22: Trade etc and other income charged on withdrawal of relief after source ceases: sections 82, 104, 109 and 844

This change treats certain amounts as post-cessation receipts and other amounts as if the source had not ceased.

Sections 79(9), 79A(4), 79B(4), 83A(4), and 84(4) of ICTA create a charge under Schedule D Case VI if the trader is not chargeable under Schedule D Case I or II in the "chargeable period" in which a benefit is received. Section 491(3) of ICTA creates a similar charge on a distribution by a mutual concern. Section 584(4) of ICTA creates a charge under Schedule D Case VI if income becomes remittable after the trade or other source of income has ceased.

This Act unpacks Schedule D Case VI charges and deals with the income where it logically belongs. In most of these cases, the income is trading income.

As regards a trade profession or vocation, by treating the benefit or distribution as a post-cessation receipt, this Act:

- allows the trader to make the same deductions as those available from other post-cessation receipts;
- makes it clear that the benefit or distribution may be earned income and relevant earnings;
- allows an election to carry the benefit or distribution back in accordance with section 257 of this Act;
- removes any possibility that the benefit is charged both by the specific rule about benefits and by any general rule; and
- preserves the loss relief position under section 392 of ICTA (by virtue of entries in the table in section 836B of ICTA, inserted by paragraph 340 of Schedule 1 to this Act).

Section 844(4) of this Act contributes to the unpacking of Schedule D Case VI charge. It treats the source of the foreign income as not having ceased, where income that was relieved under section 842 ceases to be unremittable after the source has actually ceased. The income is then charged under the provision that would apply had section 843 (withdrawal of relief) applied instead. In a very few cases, the income may be charged at a lower tax rate than was the case under section 584(4) of ICTA. The loss relief position under section 392 of ICTA is also preserved by virtue of an entry in the table in section 836B of ICTA.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 23: Patent fees paid: sections 89 and 90

This change sets out the basis on which a deduction is allowed for patent fees. It brings the timing of the deduction into line with the vast majority of deductions allowed in calculating trading income.

Section 83 of ICTA allows a deduction for “fees paid or expenses incurred” in connection with the grant of patents etc. It is thought that the “fees paid” are those paid when a patent application is made. Such fees are incurred only when they are paid. So it is unlikely that business accounts would recognise the fees until they are paid.

There is no doubt that “expenses” include “fees”.

These sections allow a deduction for all expenses on the basis of the amounts incurred. In principle the rule in these sections may allow taxpayers to take a deduction for fees earlier than the ICTA rule.

This change will not alter the amount charged to tax. The most it will do is affect the timing of the tax liability. In a small minority of cases this could mean a different rate of tax being applied, according to individual circumstances. Any overall tax effect is likely to be negligible.

Change 24: Payments to Export Credits Guarantee Department: section 91

This change allows payments to the Export Credits Guarantee Department (“ECGD”) to be deducted in calculating the profits of a trade when the expense is payable rather than when it is paid.

Section 88 of ICTA allows a person carrying on a trade to deduct “sums paid” to the ECGD in calculating the profits of that trade.

Section 91 follows accounting treatment in allowing traders to deduct a payment to the ECGD at the time it is payable.

This change will not alter the amount charged to tax. The most it will do is affect the timing of the tax liability. In a small minority of cases this could mean a different rate of tax being applied, according to individual circumstances. Any overall tax effect is likely to be negligible.

Change 25: Expenses connected with foreign trades: relax condition for family expenses: drop "functions" test: section 92

This change allows a deduction for "family expenses" if the trader's absence from the United Kingdom is partly for the purposes of a trade that is not carried on wholly outside the United Kingdom. It also drops the requirement that the taxpayer performs functions of the trade at each end of the journey.

Sections 80 and 81 of ICTA allow a trading deduction for three sorts of expenses. Each has a condition related to the purpose of the trader's absence from the United Kingdom. The expenses are:

- travelling etc expenses of the trader between the United Kingdom and a foreign trade (section 80(3) of ICTA);
- travelling expenses of the trader between foreign trades (section 81(4) of ICTA); and
- travelling expenses of the trader's family (section 80(5) of ICTA).

There is no need to have three separate conditions for these expenses.

The single condition relating to the purpose of the trader's absence is in section 92(1)(b) of this Act. It applies to all the expenses with which the section deals.

(1) The condition relating to family expenses in section 80(5) of ICTA is relaxed so that an absence for the combined purposes of a foreign trade and a United Kingdom-based trade will qualify.

(2) The condition in section 81(3) of ICTA is relaxed so that there is no need for "functions" to be performed at the place of departure.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 26: Expenses connected with foreign trades: Irish trades: section 92

This change allows a deduction for certain expenses incurred in connection with trades carried on wholly in Ireland whatever the basis adopted for the assessment of a taxpayer's other foreign income.

Section 80 of ICTA allows a deduction for the expenses that would otherwise be disallowed as not being incurred wholly and exclusively for the purposes of a trade assessable under Schedule D Case V. But it excludes an individual who satisfies the Board of Inland Revenue "as mentioned in section 65(4) [of ICTA]". That individual is assessable under Schedule D Case V on the basis of sums received in the United Kingdom (the "remittance basis").

The remittance basis does not apply to income arising in the Republic of Ireland (see section 68(1) of ICTA). So a person with other foreign income assessable on the remittance basis may have Irish income assessed on the basis of the income arising. In such a case there is no reason why the rules in section 80 of ICTA should not apply to the Irish income.

Section 92(2) of this Act makes it clear that the rules apply in calculating the profits of any trade that are not assessed on the remittance basis.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 27: Assets of mutual concerns: exclude distributions of capital gains from the charge to tax: section 104

This change defines the profits out of which a chargeable distribution is made so as to exclude distributions of chargeable gains.

Section 491(1) of ICTA excludes distributions of assets representing capital from the charge in subsection (3). Subsection (8) explains what is meant by such assets. It is generally understood that chargeable gains made by the concern do not represent capital as described in subsection (8). So distributions of such gains are within the charge in subsection (3).

Nevertheless, the Inland Revenue does not in practice seek to apply section 491 of ICTA to distributions of chargeable gains. The section adopts a positive approach to defining the distributions to which the section applies. The condition in section 104(1)(d) of this Act refers to profits of the mutual business. Chargeable gains are not profits of the mutual business and so the section reflects the current practice.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 28: Sums recovered under insurance policies, etc: section 106

This change gives statutory effect to the accountancy treatment for crediting a sum recovered under an insurance policy.

Section 74(1) of ICTA lists various items in respect of which no deduction is allowed in computing a trader’s profits including:

“(l) any sum recoverable under an insurance or contract of indemnity

A sum recovered under an insurance policy or contract of indemnity is a receipt and not therefore an item in respect of which a trader would expect to make a deduction in calculating his or her profits.

The courts have interpreted section 74(1)(l) of ICTA and the enactments from which it is derived as prohibiting the deduction of a loss or expense incurred by the trader *to the extent that* the loss or expense is recovered under an insurance policy or contract of indemnity (even where that recovery is on capital account). See, for example, Lawrence LJ’s description of the meaning of the equivalent provision in the Income Tax Act 1918[19] on page 381 of Green v J Gliksten and Sons Ltd (1929), 14 TC 364 HL:

“in arriving at the balance of profits or gains there has to be no deduction in respect of a loss which is covered by insurance to the extent by which that loss is so recovered.

Section 106 achieves the same effect as section 74(1)(l) of ICTA by bringing a capital amount recovered into account as a trade receipt rather than by prohibiting a deduction in respect of the loss or expense in respect of which it is recovered. This makes the proposition easier to understand without changing the law.

Section 74(1)(l) of ICTA requires a deduction in respect of a loss or expense to be reduced by the amount of any insurance recovery. But where the loss and the recovery fall in different periods the accountancy treatment is to deduct the loss or expense in the year in which it is incurred and to credit the recovery in the accounting period in which it arises.

In practice, the Inland Revenue allows traders to follow the accounting treatment in crediting the recovery. This informal concession is set out in paragraphs 40130 and 40755 of the Inland Revenue Business Income Manual. Section 106 gives the concession statutory effect.

This change will not alter the amount charged to tax. The most it will do is affect the timing of that tax liability. In a small minority of cases this could mean a different rate of tax being applied, according to individual circumstances. Any overall tax effect is likely to be negligible.

19 Paragraph (k) of Rule 3 of the rules applicable to Cases I and II of Schedule D

Change 29: Gifts of trading stock: drop the need for the gift to be plant and machinery in the hands of the educational establishment: section 108

This change removes the requirement that a gift to an educational establishment should qualify as plant and machinery in the hands of the educational establishment.

Section 84(1) of ICTA gives relief for the gift of an article that "qualifies as plant or machinery". Subsection (2) sets out what those words mean. The similar relief for gifts of trading stock to charities does not have the same condition. So there is no need for the gift to qualify as plant or machinery in the hands of an educational establishment.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 30: Gifts of trading stock: gifts "for the purpose of" a charity etc: section 108

This change brings the wording of the relief for a gift to a charity, a registered club or one of the special bodies listed in section 108(5) of this Act into line with that for a gift to an educational establishment.

Section 84 of ICTA allows relief for a gift of an article "for the purposes of a designated educational establishment". Those words ensure that the relief is available even if the gift is made to a person (such as a local education authority) who becomes the legal owner of the article so that it can be used in a school. In many cases the gift is not "to" the school.

Section 83A of ICTA allows similar relief for a gift "to" a charity. The section allows relief for a gift "for the purposes of" a charity, a registered club or one of the listed bodies.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 31: Gifts of trading stock: drop the need for a claim: section 108

This change removes the requirement that a taxpayer should make a claim for relief on a gift to an educational establishment.

Section 84(3) of ICTA provides that the relief does not apply unless "the donor makes a claim". The general approach of this Act is not to require a claim for a trading deduction. In this case, the relief takes the form of removing the obligation to include a trade receipt. But the same principle applies here.

The similar relief for gifts to charities in section 83A of ICTA does not require a claim. So this change makes the two reliefs consistent.

The provisions that govern claims are not the same as the provisions that govern returns. But in practice the change from making a claim to allowing the relief will have only the following consequences, which both relate to the time available for "claiming" the relief.

First, the absolute time limit for making a claim is replaced by a time limit that may vary according to the particular circumstances. That may be because the return is issued late or because the taxpayer makes a late return. Accordingly, the Inland Revenue is no longer able to refuse a claim because it is late by reference to an absolute time limit: returns time limits and sanctions will apply and they depend on the date the return was issued and submitted.

Second, error or mistake relief claims under section 33 of TMA will be possible if too much tax is paid as a result of omitting to include the relief in the tax return. Claims under section 33 of TMA must be made within five years of 31 January following the tax year to which the return relates.

This change is in taxpayers' favour in principle and may benefit some taxpayers in practice. But the numbers affected and the practical effects are likely to be small.

Change 32: Herd basis rules: meaning of "substantial part of herd": section 113(6) and section 120(7)

This change gives statutory effect to the practice of treating 20% of the herd as substantial.

A number of sections in the herd basis rules refer to "a substantial part of the herd" or "a substantial difference":

- section 118(1)(b) (sale of animals from the herd);
- section 119(1) (sale of whole or substantial part of herd);
- section 120(7) (acquisition of new herd begun within 5 years of sale);
- section 122(1)(a) (replacement of part sold within 5 years of sale); and
- section 126(1)(a) (slaughter under disease control order).

What constitutes a substantial part of the herd or a substantial difference is primarily a question of fact. But this Chapter gives statutory effect to a long-standing practice set out in paragraph 55525 of the Inland Revenue's Business Income Manual. This provides that 20% of the herd will be regarded as substantial. This does not, however, prevent a smaller percentage from being regarded as substantial.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 33: Herd basis rules: sale of whole or substantial part of herd: sections 119, 120 and 122

This change merges the rules in paragraph 3(7) to (9) of Schedule 5 to ICTA.

Paragraphs 3(7) to (9) of Schedule 5 to ICTA set out the rules relating to the sale of all or most of a herd within 12 months.

Paragraph 3(7) of Schedule 5 to ICTA applies when a herd is sold as a whole and then replaced. Paragraph 3(8) of Schedule 5 to ICTA deals with cases where the whole of a herd is sold "in circumstances in which sub-paragraph (7) above does not apply". Or when a substantial part of a herd is sold. Paragraph 3(9) of Schedule 5 to ICTA sets out rules for the circumstances where paragraph 3(8) but not 3(7) of Schedule 5 to ICTA is relevant, provided that replacement begins to take place within five years.

ICTA does not make clear how quickly a herd must be replaced in order for paragraph 3(7) - rather than paragraph 3(8) of Schedule 5 to ICTA - to apply. This Chapter merges these rules.

There are three practical differences between the application of the rules in paragraph 3(7) and those in paragraph 3(8) and 3(9) of Schedule 5 to ICTA.

First, paragraph 3(8) of Schedule 5 to ICTA directs that neither the profit nor the loss on the sale is to be taken into account. So, in effect, the farmer may obtain a tax-free gain on any profit from the sale. By contrast paragraph 3(7) of Schedule 5 to ICTA does not say how to deal with the proceeds of sale before it is known how many of the old herd will be replaced.

Second, if the farmer subsequently acquires a new production herd (which must be treated as a replacement herd) or animals to replace the part of the herd sold, paragraph 3(9) of Schedule 5 to ICTA recovers any tax-free gain made on the sale of the old animals. To achieve this the proceeds of the sale of each animal are brought into account at the time the replacement animal is acquired. By contrast paragraph 3(7) of Schedule 5 to ICTA contains no timing rule.

Third, in providing for the sale proceeds to be brought into account, paragraph 3(9) of Schedule 5 to ICTA allows the trading receipt to be reduced if the replacement animal is of worse quality than the old animal (on an enforced sale). Paragraph 3(7) of Schedule 5 to ICTA, however, does not permit such a reduction to be made.

Merging these rules removes these differences. It gives a common set of rules where a whole herd is sold, whether at once or over a period of up to a year. These are the rules set out in paragraphs 3(8) and (9) of Schedule 5 to ICTA.

Section 119 begins the process of merger by providing that in all cases where a herd or a substantial part of a herd is sold within a year the profit or loss which arises from that sale is not to be taken into account. That rule is then made subject to the rules which follow in section 120 and section 122 which concern the acquisition of a new herd or replacement of a substantial part of a herd respectively.

It is possible that merging the rules may disadvantage the farmer who sells a herd over a period of 12 months and replaces it with a new, smaller herd. In this case section 120(4) taxes the profit on the difference if the difference is not substantial. That subsection is based on paragraph 3(11) of Schedule 5 to ICTA and is consistent with herd rules viewed as a whole.

But it is arguable that paragraph 3(11) of Schedule 5 to ICTA does not apply to all disposals within paragraph 3(8) of Schedule 5 to ICTA. This is because paragraph 3(11) applies "Where the herd is sold as a whole" while paragraph 3(8) applies both if the herd is sold "either all at once or over a period not exceeding twelve months". But unless the rule in paragraph 3(11) of Schedule 5 to ICTA is applied to all cases where a herd is sold within a year it would be difficult, if not impossible, to merge the rules in paragraphs 3(7) to 3(9) of Schedule 5 to ICTA. This is because it would be necessary to distinguish between the two circumstances in paragraph 3(8) in which a herd may be sold and apply different results to the two situations. This is more likely to involve a change in the law than the approach adopted in section 120(4).

This change is adverse to some taxpayers and favourable to others in principle and in practice. But the numbers affected and the amounts involved are likely to be small.

Change 34: Herd basis elections: time limit for making election: section 124

This change relates to the time limit for making a herd basis election under paragraph 2 of Schedule 5 to ICTA.

An election must normally be made within a specified period, based on when the farmer first keeps a production herd of the particular class. The ordinary rule for farmers except those trading in partnership is set out in paragraph 2(3)(a) of Schedule 5 to ICTA. This provides that the election must be made "not later than twelve months from the 31st January next following the qualifying year of assessment". The qualifying year of assessment is then defined in paragraph 2(6) of Schedule 5 to ICTA as "the first year of assessment after the commencement year for which the amount of profits or losses … is computed for tax purposes by reference to the facts of a period during the whole or part of which [the farmer] kept such a herd".

For firms the position is slightly different. Paragraph 2(3)(b) of Schedule 5 to ICTA states that they must make an election "not later than twelve months from the 31st January next following the year of assessment in which the qualifying period of account ends". This means that, provided a partnership's first period of account extends into the second tax year, it will get longer to make an election.

Section 124 merges the two rules. This change of approach simplifies the law by having a common rule for all farmers. It sets the time limit for all farmers in the same way as for a firm, by referring to the period of account in which the herd is first kept. In most cases, this rule gives the same time limit as that in paragraph 2(3)(a) of Schedule 5 to ICTA. But it may also benefit some taxpayers by giving them longer to make the election if the first period of account in which they keep the production herd extends into a second tax year.

Example 1

A farmer starts to keep a herd of a particular class on 1 March 2006. The accounts of the farming trade are made up to 31 December annually:

- The ICTA rule: The first (basis) period in which the farmer keeps the herd is the year ended 31 December 2006. So the "qualifying year of assessment" is 2006-07 and the time limit is 31 January 2009.
- The rule in section 124: The "relevant period of account" is the year ended 31 December 2006. That ends in 2006-07. So the time limit is 12 months from 31 January 2008, that is 31 January 2009.

But, if the farmer has a period of account longer than 12 months and first keeps the herd early in the period, the time limit may change.

Example 2

A farmer starts to keep a herd of a particular class on 1 March 2006. This is in a period of account that runs from 1 January 2006 to 30 June 2007. The basis period for 2006-07 is the year ended 30 June 2006 (see section 214(4)). The basis period for 2007-08 is the year ended 30 June 2007, the new accounting date:

- The ICTA rule: The first (basis) period in which the farmer keeps the herd is the year ended 30 June 2006. So the "qualifying year of assessment" is 2006-07 and the time limit is 31 January 2009.
- The rule in section 124: The "relevant period of account" is the 18 months ended 30 June 2007. That ends in 2007-08. So the time limit is 12 months from 31 January 2009, that is 31 January 2010.

This change is in the taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 35: Herd basis elections: date from which effective: section 124(7)

This change relates to the date from which a herd basis election is effective.

For farmers, except those trading in partnership, paragraph 2(4)(a) of Schedule 5 to ICTA refers to the election having effect for the qualifying year of assessment and all subsequent periods. For partnerships the rule in paragraph 2(4)(b) of Schedule 5 to ICTA is slightly different. The election has effect for the qualifying period of account.

As explained in Change 34 this Act merges the rules for making herd basis elections. This means that for all farmers the election will take effect by reference to periods of account.

This is a minor change in the law if "period" in the definition of "qualifying year of assessment" in paragraph 2(6) of Schedule 5 to ICTA means basis period not period of account. But in practice it is interpreted as meaning period of account.

This change is in the taxpayer's favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 36: Herd basis elections: 5 year gap in which no production herd kept: section 125

This change gives statutory effect to the practice in paragraph 55630 of the Inland Revenue's Business Income Manual (BIM 55630).

Paragraph 4 of Schedule 5 to ICTA provides a special rule for herd basis elections where there is a gap of at least five years when the farmer does not keep a production herd of a particular class. The farmer is treated as never having kept such a production herd at all.

This approach sits oddly with the rule in paragraph 2(4) of Schedule 5 to ICTA that a herd basis election is irrevocable. It is not clear which rule has priority.

The Inland Revenue's practice, set out in paragraph 55630 of the Business Income Manual (BIM 55630), is to allow the farmer to decide whether or not he or she wants the herd basis rules to continue to apply. This is achieved by ignoring the previous election for the purposes of allowing the farmer to make a fresh election: farmers can either make a fresh election or do nothing. Section 125 gives this practice statutory effect.

This change is in the taxpayer's favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 37: Herd basis elections: slaughter under disease control order: section 126

This change relates to the time limit for making a herd basis election under paragraph 6 of Schedule 5 to ICTA if the whole or a substantial part of a production herd is slaughtered under a disease control order.

An election must normally be made within a specified time based on when the farmer first keeps a production herd. Paragraph 6(1) of Schedule 5 to ICTA modifies the ordinary time limit for making a herd basis election if the whole or a substantial part of a production herd is slaughtered under a disease control order.

For farmers except those trading in partnership paragraph 6(2)(a) of Schedule 5 to ICTA provides the election must be made "not later than twelve months from the 31st January next following the qualifying year of assessment". That year is then defined by paragraph 6(4) of Schedule 5 to ICTA as the first year of assessment for which the amount of the profits or losses of the trade are calculated "by reference to the facts of a period in which the compensation is relevant".

For firms the position is slightly different. Paragraph 6(2)(b) of Schedule 5 to ICTA provides the election must be made "not later than twelve months from the 31st January next following the year of assessment in which the qualifying period of account ends". Paragraph 6(4) of Schedule 5 to ICTA defines the "qualifying period of account" as "the first period of account in which the compensation is relevant".

Paragraph 6(5) of Schedule 5 to ICTA provides that compensation is deemed to be relevant in any period if is "taken into account as a trading receipt in computing the profits or losses of that or an earlier period".

Section 126 merges the two rules. This change of approach simplifies the law by having a common rule for all farmers. It sets the time limit for all farmers in the same way as for a firm by reference to first period of account in which the compensation is relevant. In most cases this rule gives the same time limit as that in paragraph 6(2)(a) of Schedule 5 to ICTA. But it may benefit some taxpayers by giving them longer to make the election if the compensation is received in a period of account that is longer than 12 months.

This change is in line with the approach adopted for the rewrite of the ordinary time limits in paragraph 2 of Schedule 5 to ICTA. Section 124 has a single rule for elections by all farmers. See Change 34.

Example

The accounts of an established farming business are made up for the period 1 January 2005 to 30 June 2006. No herd basis election is in place. In September 2005 compensation is received for a production herd slaughtered under a disease control order.

Unless the farmer is trading in partnership the time limit for making an election is 31 January 2008. The qualifying year of assessment is the tax year 2005-06. The 31 January next following this year is 31 January 2007. The election must be made within 12 months of that date.

If the farmer is a firm the time limit for making the election is 31 January 2009. The qualifying period of account ends on 30 June 2006. This ends in the tax year 2006-07. The 31 January next following this year is 31 January 2008. The election must be made within 12 months of that date.

In principle and in practice this change may benefit some taxpayers by giving them longer to make the election. But it has no implications for the amount of income liable to tax or who is liable for tax on it.

Change 38: Tax treatment of sound recordings: sections 130, 132 and 135

This change gives statutory effect to ESC B54 (tax relief on films, tapes and discs).

ESC B54 states:

"Notwithstanding section 113(2) of Finance Act 2000, master audiotapes or discs shall be deemed to be included in the definitions in section 68(2) of the Capital Allowances Act 1990. This ensures that treatment of the expenditure on production of master audio tapes or discs will continue to be treated as expenditure of a revenue nature.

Section 130 and sections 132 to 135 rewrite sections 40A to 40D of F(No 2)A 1992. Sections 40A to 40D of F(No 2)A 1992 contain rules for the tax treatment of films other than films that are "qualifying films" as defined in section 43 of F(No 2)A 1992. These rules were previously in section 68 of the Capital Allowances Act 1990 and were inserted in F(No 2)A 1992 when the Capital Allowances Act 1990 was repealed by CAA.

Before FA 2000, section 68(2)(c) of the Capital Allowances Act 1990 defined "disc" for the purposes of section 68 of that Act as "an original master film disc or original master audio disc". Section 113(2) of FA 2000 substituted a new definition of "film, tape or disc" (by reference to the definition of "film" in section 43 of F(No 2)A 1992).

Because the definitions in section 43 of F(No 2)A 1992 apply only to films - not to master audiotapes or discs - the effect of section 113(2) of FA 2000 is to exclude expenditure on master audiotapes or discs from relief under section 68 of the Capital Allowances Act 1990. This is not what was intended. So ESC B54 restores the position before section 113(2) of FA 2000.

Sections 130, 132 and 135 incorporate ESC B54 by referring to "sound recordings" in sections 130(1)(a),(2),(3) and (4), 132(1) and 135(1).

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 39: Treatment of interest in production and acquisition expenditure on films and sound recordings: section 130

This change clarifies the treatment of interest and the incidental costs of obtaining finance in calculating expenditure on the production and acquisition of films and sound recordings.

Sections 40A to 43 of F(No 2)A 1992, section 48 of F(No 2)A 1997 and sections 99 to 101 of FA 2002 contain special rules for the tax treatment of expenditure on the production and acquisition of films.

It has always been the Inland Revenue's view that interest and the incidental costs of obtaining finance should be treated as the costs of borrowing money, not the costs of producing or acquiring the film. It follows that the normal rules for deducting such expenditure should apply, rather than the special rules for production or acquisition expenditure on films. The Inland Revenue understand from discussions and consultation with the film industry that the exclusion of interest etc from production costs is accepted industry practice.

Section 130(5) gives statutory effect to the practice of excluding interest etc from expenditure on the production or acquisition of a film or sound recording.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 40: Allocation of expenditure to relevant periods: sections 135, 137 and 138

This change drops the requirement to make a claim to allocate expenditure to a relevant period under the "cost recovery" method in section 40B(5) of F(No 2)A 1992 and the special rules for preliminary expenditure and production and acquisition expenditure on a qualifying film in sections 41 and 42 of F(No 2)A 1992.

(1) Under section 40A of F(No 2)A 1992 expenditure on the production or acquisition of a film or sound recording is treated as revenue expenditure. Section 40B(4) of F(No 2)A 1992 gives the basic method for allocating expenditure to a relevant period with reference to the estimated value of that film expected to be realised in that period. This method, which is generally known as the "income matching" method, is rewritten in subsections (3) and (4) of section 135.

Section 40B(5) of F(No 2)A 1992 provides that a claim may be made to increase the amount allocated to the relevant period under section 40B(4) of F(No 2)A 1992 to the value actually realised in that period. This method, which is generally known as the "cost recovery" method, is rewritten in subsection (5) of section 135.

This change dispenses with the requirement for the taxpayer to make a claim for the "cost recovery" method to apply. Expenditure allocated under the "cost recovery" method in section 135(5) can simply be deducted in the calculation of income in the taxpayer's self-assessment return.

(2) Under section 41 of F(No 2)A 1992, a claim may be made to deduct preliminary expenditure on a film certified under the Films Act 1985 - or which was likely to qualify for certification under the Films Act 1985 if it had been completed - incurred in the relevant period, or in an earlier period, in computing the profits of a relevant period.

This change dispenses with the requirement for the taxpayer to make a claim for preliminary expenditure on a qualifying film to be allocated to a relevant period. Preliminary expenditure allocated under section 137 can simply be deducted in the calculation of income in the taxpayer's self-assessment return.

(3) Under section 42 of F(No 2)A 1992, a claim may be made to allocate up to one-third of the production or acquisition expenditure on a film certified as a qualifying film under the Films Act 1985 to the relevant period in which the film was completed and to any later relevant periods until all the expenditure has been allocated.

This change dispenses with the requirement for the taxpayer to make a claim for production or acquisition expenditure on a qualifying film to be written off over three years. Production or acquisition expenditure allocated under section 138 can simply be deducted in the calculation of income in the taxpayer's self-assessment return for the years in question.

The provisions that govern claims are not the same as the provisions that govern returns. But in practice, the only consequences of the change from claim to deduction relate to the time available for "claiming" the deduction.

The absolute time limit for making a claim is replaced by a time limit that may vary according to the particular circumstances. That may be because the return is issued late or because the taxpayer makes a late return. Accordingly, the Inland Revenue is no longer able to refuse a claim because it is late by reference to an absolute time limit: returns time limits and sanctions will apply and they depend on the date the return was issued and submitted.

This change is in taxpayers' favour in principle and may benefit some taxpayers in practice. But the numbers affected and the practical effects are likely to be small.

Change 41: Allocation of expenditure to relevant periods: sections 135 and 137

This change gives a choice of relief for preliminary expenditure on a qualifying film under either the basic rules for allocation of expenditure to a relevant period or the special rules for qualifying films.

Under sections 40A to 40D of F(No 2)A 1992, expenditure on any film or sound recording can be allocated to a relevant period under the "income matching" method in section 40B(4) of F(No 2) 1992 or the "cost recovery" method in section 40B(4) of F(No 2) 1992 as augmented by section 40B(5) of F(No 2)A 1992.

Section 42 of F(No 2)A 1992 provides that claims may be made to allocate up to one-third of the production or acquisition expenditure on a film certified as a qualifying film under the Films Act 1985 to the relevant period in which the film was completed and any later relevant periods until all the expenditure has been allocated.

Section 42(7) of F(No 2)A 1992 provides that production or acquisition expenditure in respect of a qualifying film may not be deducted under both section 40B and section 42 of F(No 2)A 92 in the same relevant period.

Section 40C(1) of F(No 2)A 1992 further provides that if production or acquisition expenditure has been allocated to a relevant period under section 42 of F(No 2)A 1992, neither that expenditure, nor any other expenditure on the production or acquisition of the same film, can be allocated to that period under section 40B of F(No 2)A 1992.

The combined effect of sections 40C and 42(7) of F(No 2)A 1992 is to give the taxpayer a choice in any relevant period between relief under the "income matching" or "cost recovery" methods in section 40B of F(No 2)A 1992 and the special rules for qualifying films in section 42 of F(No 2)A 1992.

Section 41 of F(No 2)A 1992 provides that a claim may be made to allocate preliminary expenditure on a film certified as a qualifying film under the Films Act 1985 to the relevant period in which it is incurred or a later relevant period.

Section 40C(1) of F(No 2)A 1992 does not apply to preliminary expenditure under section 41 of F(No 2)A 1992. There is no restriction in section 41 of F(No 2)A 1992 on the deduction of preliminary expenditure on a qualifying film under both section 40B and section 42 of F(No 2)A 1992 in the same relevant period equivalent to the restriction for production or acquisition expenditure in section 42(7) of F(No 2)A 1992.

It is possible therefore that the taxpayer could claim relief for preliminary expenditure on a qualifying film (but not for the same expenditure) under both section 40B and section 41 of F(No 2)A 1992.

This change removes the inconsistency between the treatment of preliminary and of production or acquisition expenditure to give the taxpayer a choice in any relevant period between relief under the "income matching" or "cost recovery" methods in section 40B of F(No 2)A 1992 and the special rules for qualifying films in sections 41 and 42 of F(No 2)A 1992.

This change has no implications for the amount of income liable to tax or who is liable for tax on it. It affects (in principle but not in practice) only when tax is paid.

Change 42: Securities held as circulating capital: section 150

This change dispenses with the requirement that securities within section 473 of ICTA must be beneficially held by the trader.

Section 473 of ICTA contains special rules for the tax treatment of certain securities held as circulating capital, the profit on the sale of which would form part of the trading profits. The effect is that that neither a profit nor a loss is crystallised on a conversion of the securities.

Persons carrying on a trade of dealing in securities on their own behalf would not normally bring a profit or loss on the sale of securities into account in calculating the profits of the trade if they were not beneficially entitled to the securities.

And there is no reason to calculate the profits of a trade carried on by a person in a fiduciary or representative capacity in a different manner from those of a trade carried on by a person beneficially.

So section 150 dispenses with the requirement that the person carrying on the business must be beneficially entitled to the shares in question. This means that section 150 will apply to transactions by trustees and by personal representatives who carry on a trade of dealing in securities as well as to individual dealers.

It also means that section 150 will apply to securities in stock lending or sale and repurchase arrangements where beneficial ownership has passed to the dealer's counterparty but where the dealer continues to account for profits and losses as if those securities had not been disposed of.

This change affects the timing of the tax liability. It is adverse to some taxpayers and favourable to others in principle and in practice. But the numbers affected and the amounts involved are likely to be small.

Change 43: Ministers of religion: deductions to be allowed in calculating profits of profession or vocation: section 159

This change extends the way in which deductions are allowed by section 332(3) of ICTA.

Section 332(3) of ICTA allows deductions from any profits, which may mean particular income receipts. It is more logical for the deductions to be made in calculating the profits of the profession or vocation, in line with the other calculating rules in Part 2 of this Act. It will no longer be arguable that a taxpayer has to match the deductions against a particular income receipt.

This allows a deduction in calculating the profits of the profession or vocation instead of requiring the taxpayer to set a deduction against a particular receipt.

Section 332(3)(c) of ICTA refers to expenses "borne" by the taxpayer. It is more logical for the deductions to be made when the taxpayer incurs the expenses, in line with other deduction rules in Part 2 of this Act. The effect of this is that a deduction may be available earlier than it is under the ICTA rule.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 44: Ministers of religion: omission of section 332(3)(a) of ICTA: section 159

This change drops section 332(3)(a) of ICTA.

Section 332(3)(a) of ICTA allows deductions for "any sums of money paid or expenses incurred by [the minister] wholly, exclusively and necessarily in the performance of his duty as a clergyman or minister". Those words are almost identical to the words of the employment income rule, in section 351 of ITEPA.

In practice, the Inland Revenue applies the more generous "wholly and exclusively" rule in section 74(1)(a) of ICTA in calculating the profits of a profession or vocation carried on by a minister of religion. This means that a deduction may be allowed for expenses that are not incurred *necessarily* or *in the performance of the duties*.

The change removes the more restrictive test for expenses and brings the statute into line with practice.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 45: Ministers of religion: alter the deduction rule in section 332(3)(b) of ICTA so that it is applied without reference to an inspector: remove the special appeals mechanism: section 159

This change applies the deduction rule without reference to an inspector. And the special appeal mechanism against the inspector's decision is removed.

Section 332(3)(b) of ICTA provides that a deduction is allowed in respect of a dwelling-house for "such part of the rent (not exceeding one-quarter) as the inspector by whom the assessment is made may allow". The inspector's decision is subject to review by the General or Special Commissioners.

These rules do not fit with Self Assessment. So the section applies the deduction rule ("a deduction is allowed for …") without reference to an inspector and without a special appeal mechanism.

This change has no implications for the amount of tax due, who pays it or when. It affects (in principle and in practice) only administrative matters.

Change 46: Combine pools payments rules: sections 162 and 748

This change combines sections 126 of FA 1990 and 121 of FA 1991.

Section 162 of this Act does not specify that payments in consequence of the 1990 reduction in pool betting duty must be made for football safety and comfort, and that payments in consequence of the 1991 reduction in pool betting duty must be made to the Foundation for Sport and the Arts. Instead payments in consequence of any reduction in pool betting duty for either purpose will qualify.

Lord Justice Taylor's report into the Hillsborough disaster, published on 18 January 1990, recommended that significant capital expenditure should be incurred to improve safety and comfort at football grounds. To facilitate this the rate of pool betting duty was reduced from 42.5% to 40% in FA 1990, in exchange for an agreement that the money saved by pools promoters would be given to the Football Trust 1990, which would use it to implement the Taylor recommendations.

The following year the government agreed to a further reduction of 2.5% in pool betting duty on condition that the money saved was paid to a charitable trust to be set up by the three main pools companies. The trust is called the Foundation for Sport and the Arts. For legal reasons connected with pool betting duty, the Foundation's main purpose is the support of athletic sports and games, but up to one third of its funds may be used to promote the arts.

The objectives of sections 120 of FA 1990 and 126 of FA 1991 are to ensure that the money saved in pool betting duty can flow through to its intended purpose in full, without tax liabilities.

Because the source sections have very similar objectives and consequences, this Act combines them.

In principle a taxpayer could divert payments from one destination to the other and still obtain a deduction, but in practice (because the payments are made under agreements with the bodies concerned) this is not possible. Even if it were possible the payments would still be supporting the defined good causes.

Section 748 of this Act adopts the same approach to rewriting section 126(3) of FA 1990 and section 121(3) of FA 1991. The payments made are not treated as annual payments.

This change is in taxpayers' favour in principle. But is expected to have no practical effect as it is in line with current practice.

Change 47: Extend pools payments treatment to the 1995 reduction: sections 162 and 748

This change extends the treatment of payments in consequence of reductions in pool betting duty so that it applies to the reduction in pool betting duty made in any year.

Pool betting duty was reduced in 1990 and 1991 in exchange for agreements that the money saved would be paid to particular good causes (the Football Trust 1990 and the Foundation for Sport and the Arts, respectively).

Sections 126 of FA 1990 and 121 of FA 1991 were enacted in order to ensure that the money could flow through to the beneficiaries without tax consequences.

In 1995 pool betting duty was reduced again, with half of the money saved to be paid to the Football Trust and the other half to the Foundation for Sport and the Arts. But no equivalent tax legislation was enacted. In practice the payments are treated in the same way as those made from the 1990 and 1991 reductions.

Section 162 of this Act allows the tax treatment to apply to payments made because of any reduction in pool betting duty, so that the 1995 reduction and any further reductions which result in payments being made to the two “good causes” are covered.

Section 748 of this Act adopts the same approach to rewriting section 126(3) of FA 1990 and section 121(3) of FA 1991. The payments made are not treated as annual payments.

This change is in taxpayers' favour in principle. But is expected to have no practical effect as it is in line with current practice.

Change 48: Waste disposal: site preparation expenditure: drop requirements to make claim and submit plans and documents: section 165

This change drops the requirements to make a claim and submit plans and documents when making deductions under section 165.

Section 91B of ICTA allows a revenue deduction for capital expenditure on preparing a waste disposal site for use. The expenditure is spread over the life of the site by means of a formula based on the total capacity of the site and the amount of that capacity which has been used.

The taxpayer must make a claim for relief under section 91B of ICTA (in such form as the Board may direct), and submit such plans and documents as the Board may require.

The requirement to submit plans and documents sits uneasily with Self Assessment - the Self Assessment record-keeping rules require taxpayers to keep such information and produce it in the event of an enquiry.

The section also drops the requirement to make a claim for relief, with the result that relief will simply be a deduction in the taxpayer’s self-assessment. Once the requirement to submit plans and documents is removed, there seems no reason to require a claim for this particular deduction as opposed to any other.

The claim under section 91B of ICTA must be made within 70 months from the end of the tax year. Removing the claim means that taxpayers will have 22 months from the end of the tax year in which to include the deduction in their self-assessment. However, error or mistake claims will be available if too much tax had been paid as a result of omitting to include the deduction on the tax return.

This change is adverse to some taxpayers and favourable to others in principle but is not expected to have any practical effect.

Change 49: Valuation of trading stock: adopt the normal self-assessment time limit for an election by connected persons: section 178

This change adopts the normal self-assessment time limit of 22 months for an election by connected persons.

This Act expresses time limits consistently. Where possible, the time limit for an election is the first anniversary of the "normal self-assessment filing date" (defined in section 878 as 31 January following the relevant tax year). The time limit for the election in section 100(1C) of ICTA was not changed to take account of the introduction of Self Assessment. So in that section the time limit for income tax is two years from the end of the tax year of cessation. This is inconsistent with most other time limits for income tax.

This change has no implications for the amount of tax paid, who pays it or when. It affects (in principle and in practice) only administrative matters.

Change 50: Deductions for unremittable amounts: sections 187 to 191

This change gives statutory effect to ESC B38 (tax concessions on overseas debts). In doing this the Act makes a number of changes to the approach in the extra-statutory concession.

ESC B38 provides relief for trade debts that cannot be remitted to the United Kingdom. It is similar in scope to section 584 of ICTA which provides relief for unremittable income arising outside the United Kingdom, including unremittable trade profits. But section 584 of ICTA does not extend to trade debts owed to, or paid to, the trader outside the United Kingdom if the profits of the trade arise in the United Kingdom. For example, debts or payments arising from export sales. The extra-statutory concession gives relief for such debts and payments.

(1) Chapter 13 of Part 2 of this Act gives statutory effect to the extra-statutory concession.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

(2) ESC B38 requires the relief to be claimed. Section 189 provides for the relief to be allowed as a deduction in calculating the taxpayer's trade profits. This not only simplifies the procedure for giving the relief; it may also reduce the time a taxpayer has to wait before the relief is given and, in certain circumstances, extend the time limit for giving the relief.

Paragraph 5(d) of the extra-statutory concession gives the time limits for making the claim. Relief can be claimed no earlier than 12 months after the end of the accounting period in which the unremittable payment was received or the unremittable debt arose. Giving the relief by means of a deduction will apply the normal self-assessment time limits.

In certain circumstances the time limit for giving the relief may be extended:

- if the notice to make a return is issued late then an amendment to a simple deduction may also be made late; and
- an error or mistake claim may be made up to (almost) six years from the end of the tax year.

This change has no implications for the amount of tax due, who pays it or when. It affects (in principle and in practice) only administrative matters.

(3) Paragraph 4 of the extra-statutory concession denies any relief for a debt to the extent that the debt is insured. Section 190(3) (restrictions on relief) denies relief only to the extent that an insurance recovery has been received in respect of the debt. Also section 191(2)(f) withdraws relief only to the extent that an insurance recovery has been received in respect of the debt.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 51: Disposal of know-how: restore an express definition of mineral deposits: sections 192 and 583

This change restores (for income tax purposes) a previous definition of "mineral deposits".

The definition of "mineral deposits" in these sections is in substance the definition that applied for the purposes of the definition of "know-how" in the source legislation for sections 192 and 583 of this Act. That definition applied before certain amendments of Chapter 1 of Part 13 of ICTA were made by CAA.

Section 531 of ICTA makes provision about the tax treatment of certain disposals of know-how. Different provision is made about disposals of know-how that has been used in the course of a trade and other disposals of know-how. The former provision is rewritten in sections 193 and 194 of this Act and the latter in sections 583 to 586.

Know-how is defined for the purposes of section 531 of ICTA as:

> "any industrial information and techniques likely to assist in the manufacture or processing of goods or materials, or in the working of a mine, oil-well or other source of mineral deposits (including the searching for, discovery or testing of deposits or the winning of access thereto), or in the carrying out of any agricultural, forestry or fishing operations.

Before certain amendments of ICTA were made by CAA, the following definition applied to the expression "mineral deposits" in that definition:

> ""mineral deposits" includes any natural deposits capable of being lifted or extracted from the earth and, for this purpose, geothermal energy, whether in the form or aquifers, hot dry rocks or otherwise, shall be treated as a natural deposit.

The history of that definition is as follows. The provisions of section 531 of ICTA derive from section 21 of FA 1968, which included the following definition:

> "(7) In this section "know-how" means any industrial information and techniques likely to assist in the manufacture or processing of goods or materials, or in the working of a mine, oil-well or other source of mineral deposits (including the searching for, discovery, or testing of deposits or the winning of access thereto), or in the carrying out of any agricultural, forestry or fishing operations.

Subsection (9) of that section required the above definition to be construed as if it were contained in Part 1 of the Capital Allowances Act 1968, so that the following definition of "mineral deposits" applied:

> ""mineral deposits" includes any natural deposits capable of being lifted or extracted from the earth.

That definition was amended by paragraph 2(3) of Schedule 13 to FA 1968, which added the words from "and, for this purpose" onwards.

The relevant provisions were consolidated in 1970 and again in 1988. Section 532 of ICTA originally provided for the definition of "know-how" to be construed as if it were contained in Part 1 of the Capital Allowances Act 1968. A reference to "the 1990 Act" was substituted by the Capital Allowances Act 1990. This attracted the definition of "mineral deposits" which is set out above in the fourth paragraph of this note, and applied throughout that Act.

CAA rewrote provisions about know-how allowances that were previously in Chapter 1 of Part 13 of ICTA. In consequence of the repeal of the Capital Allowances Act 1990, CAA also amended section 532 of ICTA so that it provides for the definition of "know-how" to be construed as if it were contained in the 2001 Act. However, no definition of "mineral deposits" applies for the purposes of CAA as a whole. So the consequential amendment failed to preserve the application of the Capital Allowances Act 1990 definition of "mineral deposits" to the remaining provisions of Chapter 1 of Part 13 of ICTA (including those on which sections 192 and 583 are based).

It is noteworthy that a version of the definition of "mineral deposits" is carried forward in CAA to apply to the rewritten material about know-how allowances. See section 452(3) of that Act.

The failure to preserve the application of the Capital Allowances Act 1990 definition of "mineral deposits" to the remaining provisions of Chapter 1 of Part 13 of ICTA is believed to have resulted from an oversight. The inclusion of a definition of "mineral deposits" in sections 192 and 583 corrects this error.

The definition of "mineral deposits" in sections 192 and 583 of this Act differs from the definition formerly in section 161(2) of the Capital Allowances Act 1990 in that the words "whether in the form of aquifers, hot dry rocks or otherwise" are omitted. The definition of "mineral deposits" in section 452(3) of CAA also omits these words. The omission was made in that Act on the basis that the words are merely illustrative and that leaving them out does not change the legal effect of the definition. They are omitted in this Act for the same reasons. A fuller discussion of this point can be found in Note 46 in Annex 2 to the Explanatory Notes to CAA.

This change clarifies the law by making it certain that the definition of "mineral deposit" continues to apply for the purposes described above.

This change clarifies the law and removes uncertainty. But it is expected to have no practical effect as it is in line with current practice.

Change 52: Basis periods etc: to allow any reasonable and consistent time basis for apportioning profits or for calculating deductible overlap profit: sections 203, 220, 275 and 871

This change involves giving statutory effect to a concessionary practice for apportioning profits or losses to different periods.

Section 72(1) of ICTA permits the apportionment of profits or losses for the purposes of Schedule D Case I, II or VI. Section 72 of ICTA is applied by section 21A(2) of ICTA for the purpose of calculating the profits of a Schedule A business.

Section 72(2) of ICTA secures that the apportionment must be by reference to days. But, by concession, taxpayers can adopt any other reasonable basis for time apportionment (described in paragraph 71025 of the Business Income Manual).

Section 203 rewrites section 72 of ICTA (so far as trades, professions and vocations are concerned); and section 275 reproduces the effect of applying that section by section 21A(2) of ICTA. Subsection (4) of each section allows the periods to be measured otherwise than by reference to days if it is reasonable to do so and the measure is used consistently. Similarly, section 871 rewrites section 72 of ICTA (in respect of profits formerly charged under Schedule D Case VI which are now listed in section 836B of ICTA), and subsection (5) of that section operates like subsection (4) of sections 203 and 275.

Section 63A(2) of ICTA provides for the calculation and deduction of overlap profit by reference to "days" and the "overlap period" is defined by section 63A(5) of ICTA as the number of days in the period in which the overlap profit arose.

Section 220 preserves that basic approach. But, by concession, taxpayers can adopt any other reasonable measure provided it is used consistently (described in paragraph 71140 of the Business Income Manual). Subsection (4) gives effect to this practice.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 53: Enterprise allowance: include in trade profits: section 207

This change involves including enterprise allowance in the calculation of trade profits.

The former Enterprise Allowance scheme provided financial assistance for unemployed people starting their own businesses. The payments are now more commonly known as business start-up allowances. These may be in variable amounts including lump sums in certain circumstances.

The original Enterprise Allowance scheme provided only for weekly payments of £40. When the scheme was changed in 1991-92 the special treatment in section 127 of ICTA applied only to business start-up payments of the sort (known as "enterprise allowance") that had been paid under the original scheme. Any lump sum business start-up payments are not of that sort. So this section does not apply to lump sum payments.

Without section 127 of ICTA the allowances would be taxed as trade profits. With the former prior year basis of assessment some profits of the first year of trading were taxed more than once. As the allowance is usually paid for the first year this might be the case for the allowance. Section 127 of ICTA was introduced to avoid this. It does so by taxing the allowance under Schedule D Case VI instead of Schedule D Case I or II, circumventing the basis period rules.

Even under the current year basis of assessment there may still be an overlap period when trading commences. So section 207(2) of this Act ensures that the allowance is taxed only once, by being included in the profits of only the first of two basis periods.

In some cases this change may lead to a delay in the assessment of the allowances. This is because they will be taken into account in a basis period of the trade rather than in the tax year in which they are received.

It will no longer be possible to set Schedule D Case VI losses against the allowances. But trading losses brought forward and terminal losses may become available against the allowances.

As the allowances will be included in the calculation of trade profits, there is no need to rewrite section 127(3) of ICTA, which treats the allowances in appropriate cases as relevant earnings.

The charge to national insurance contributions is unchanged because contributions are specifically charged on the allowances by section 15(4) of the Social Security Contributions and Benefits Act 1992. This specific charge is no longer needed and is therefore repealed.

This change is adverse to some taxpayers and favourable to others in principle and in practice. But the numbers affected and the amounts involved are likely to be small.

Change 54: Basis periods: treat accounts regularly prepared to dates near the end of the tax year as if prepared to 5 April subject to a taxpayer's opt out: sections 208, 209 and 210

This change makes automatic, subject to a taxpayer's right to opt out, the treatment under which accounts regularly prepared to dates near the end of the tax year are treated as if prepared to 5 April.

Change 55 gives statutory effect to the non-statutory practice described in paragraph 71170 of the Business Income Manual under which accounts prepared to 31 March (and 1, 2, 3 and 4 April) are treated as prepared to 5 April. That simplifies the operation of the rules by avoiding the creation of very short overlaps of basis periods - and therefore small amounts of overlap profit - during the first years of trading.

Most people with a late accounting date are likely to wish to take advantage of this rule. So section 208(3) makes it automatic unless the taxpayer "elects out".

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 55: Basis periods: to allow accounts prepared to a date near the end of the tax year to be treated as if prepared to 5 April: sections 208, 209, 210 and 220

This change allows accounts regularly prepared to 31 March or 1, 2, 3 or 4 April to be treated as if prepared to 5 April and a change of accounting date to 31 March (or 1, 2, 3 or 4 April) to be treated, for overlap relief purposes, as a change to 5 April.

The source legislation in sections 61 to 63A of ICTA distinguishes between the case where accounts are regularly prepared to 5 April and the case where they are prepared to a different date. In the latter case the rules are more complex and involve periods of overlap of basis periods (and, as a consequence, the creation of overlap profit that must subsequently be relieved) during the first years of trading.

Many taxpayers prepare accounts regularly to 31 March. In practical terms there is little difference between these cases and the 5 April cases but strictly under the source legislation, they nevertheless fall within the more complex “accounting date other than 5 April” rules.

Change 55 allows, for the purposes of the basis period rules, accounts prepared to 31 March to be treated as prepared to 5 April. That simplifies the operation of the basis period rules by avoiding the creation of very short overlaps of basis periods - and therefore of small amounts of overlap profit - during the first years of trading.

But it would be illogical to exclude from this simplification cases where the chosen accounting date would result in overlaps even shorter than those arising from an accounting date of 31 March. So accounts prepared to dates 1 to 4 April are also included.

This change gives statutory effect to the non-statutory practice described in paragraph 71170 of the Business Income Manual and prevents overlaps of less than six days.

A similar problem can arise where there is a change of accounting date. The effect of the source legislation in section 63A of ICTA is that where there is a change of accounting date that is effective for tax purposes and that change is to an accounting date of 5 April, all previous overlap profit is deductible without restriction. But taxpayers who change to a date very close to 5 April would normally be potentially subject to a minor restriction of their overlap relief.

Section 220 provides statutory authority for the non-statutory practice referred to in paragraph 71170 of the Business Income Manual. That practice allows a change of accounting date to 31 March to be treated as though it were a change to 5 April. And that allows all previous overlap profit to be deducted in the year in which such a change takes effect for tax purposes.

Again, it would be illogical to exclude change of accounting date cases where the chosen accounting date fell between 31 March and 5 April. So a change of accounting date to 1, 2, 3 or 4 April is also treated as though it were a change to 5 April.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 56: Basis periods: to allow accounts regularly prepared to a particular day in the year to be treated as if prepared to a particular date: sections 211, 212 and 213

This change allows accounts regularly prepared to a particular *day* in the year to be treated as if prepared to a particular *date*. This avoids the need to apply complex change of accounting date provisions.

In the source legislation whenever there is a change of accounting date complex rules in sections 62 and 62A of ICTA are triggered. Those rules determine when - or whether - the basis period can align with the new accounting date.

For most taxpayers changes of accounting date are relatively infrequent. But it is sometimes more practical for taxpayers to prepare their accounts to a particular day in the year - a mean date - rather than to a particular date. Examples might include the last Friday in September or the last day of the summer term. Because the resulting accounting date will be different year by year the complex change of accounting date rules would normally apply to such changes.

Change 56 allows taxpayers to prepare their accounts to a mean date without triggering the change of accounting date rules, provided certain conditions are met.

This change gives statutory effect to the extra-statutory practice authorised in paragraph 71175 of the Business Income Manual.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 57: Overlap profit (calculating a deduction): to allow the taxpayer to disregard 29 February when there is a change of accounting date to a date late in the tax year: section 220

This change, in section 220(6), allows the taxpayer to disregard 29 February in calculating a deduction for overlap profit when there is a change of accounting date to a date falling on 31 March to 5 April inclusive.

It is normally the case that, in any year where overlap relief is due, a taxpayer has the same number of days' overlap relief as there are days between his or her accounting date and 5 April.

As a result, at a change of accounting date to 5 April the overlap profit should be relieved in full under the source legislation in section 63A(1) of ICTA. But when 29 February falls in either the overlap period or the basis period given by section 62(2)(b) of ICTA, section 63A(1) of ICTA does not give the correct result. An adjustment is then necessary on cessation under section 63A(3) of ICTA.

Change 57 gives statutory effect to the practice described in paragraph 71155 of the Business Income Manual. Section 220(6)(a) allows the taxpayer to disregard 29 February in this case and the overlap relief adjustment to be made in full.

Change 55 gives statutory effect to the practice whereby changes of accounting date to dates from 31 March to 4 April inclusive may be treated as if made to 5 April. It would be illogical not to align Change 57 with that Change. So section 220(6)(b) allows taxpayers to disregard 29 February when the change is to one of those earlier dates.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 58: Averaging: foreign trades: section 221

This change allows an individual to claim averaging of profits derived from creative work carried on wholly abroad. Section 65(3) of ICTA may in fact allow a claim but the section removes any doubt.

Schedule 4A to ICTA applies to profits derived from creative works that are "chargeable to tax under Case I or II of Schedule D". The policy is to exclude profits that are charged under Schedule D Case VI because they arise from activities that do not amount to a trade, profession or vocation.

It will be rare for a UK resident individual to carry on a "creative" trade wholly outside the United Kingdom. But there is no reason why the profits of such a trade should not be averaged. And it would complicate the Act to make an exception for a foreign trade.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 59: Averaging: section 221

This change gives statutory effect to ESC A29 (relief for fluctuating profits). It treats the intensive rearing of livestock or fish on a commercial basis for the production of food for human consumption as farming for the purposes of averaging.

Averaging applies only to farming, market gardening and "creative activities". Farming is the occupation of land for the purposes of husbandry. Tax law has always drawn a distinction between profits resulting from the taxpayer's occupation of land and profits from an activity to which the occupation is merely incidental in the sense that the activity must be carried out somewhere. This is why the intensive rearing of livestock and fish (so-called "factory farming") is not farming. Such creatures do not live on or draw their sustenance from the soil because they are largely kept in buildings or tanks and so the profits from them do not arise from the occupation of land.

But ESC A29 permits the extension of the rules for averaging to the intensive rearing of livestock or fish on a commercial basis for the production of food for human consumption. It does this by extending the definition of farming for these purposes.

Section 362(1) of CAA permits a near-identical extension by defining husbandry to include the intensive rearing of livestock or fish on a commercial basis for the production of food for human consumption, in the context of defining "agricultural land". And section 115(2) of the Inheritance Tax Act 1984 permits a similar extension in the context of defining "agricultural property" provided certain conditions are met.

Section 221(3) of this Act ensures that the averaging rules apply to the intensive rearing of livestock or fish without the need to extend the definition of farming itself in section 876.

This change is in taxpayers' favour in principle. But is expected to have no practical effect as it is in line with current practice.

Change 60: Averaging: clarify the rule that a claim cannot be made in commencement or cessation year: section 222

This change ensures that a claim cannot be made in the year in which an individual partner commences or ceases to carry on a qualifying trade in partnership.

Section 96(4)(b) of ICTA provides that no claim is to be made in respect of any tax year "in which the trade is (or by virtue of section 113(1) [of ICTA] is treated as) set up and commenced or permanently discontinued." Section 113 of ICTA applies where there is a complete change in the persons carrying it on. However, it does not apply where there is a partial change, for example, when one partner leaves a firm while the others continue.

Before Self Assessment (when the rule applied only to farmers) the same rule clearly operated for farming carried on by a sole trader and farming carried on by persons in partnership. This is because a claim for averaging could be made only in respect of the profits of a sole trader or of a firm. But under Self Assessment profits are calculated as if the firm were an individual and each partner's share in the profits of the firm is then determined. The rules for determining partners' basis periods are then applied as if they were sole traders.

The intention under Self Assessment is to treat sole traders and individual partners in the same way, so that individual partners cannot make an averaging claim in relation to the year in which they start or cease to carry on a qualifying trade in partnership. It is generally accepted that the legislation achieves this result. But the words of section 96 of ICTA leave some doubt. The references to "his profits from *that trade*" in subsection (1) and to "a year of assessment in which *the trade* is … set up and commenced" in subsection (4)(b) might suggest that these references are to the partnership trade as a whole, rather than to the deemed trade carried on by the individual partner.

Section 222(4) of this Act contains the rule that an averaging claim may not be made in a tax year in which the taxpayer starts or permanently ceases to carry on the qualifying trade. This rule will apply whether the taxpayer is a sole trader or in partnership. So there is no ambiguity in the rule: it is in line with the original intention and with how it is applied in practice.

This change is adverse to some taxpayers in principle. But it is in line with the original legislation before amendment and with the intention of the amended legislation. And it is expected to have no practical effect as it is in line with current practice.

Change 61: Averaging: time limit for a further claim: section 225

This change makes clear that the full 22 month time limit applies to a further claim for averaging.

Section 96(8) of ICTA provides that a claim must be made "…*before* the 31st January next following the year of assessment…". If this precludes a claim being made on 31 January the rule falls one day short of the full 22 month time limit for the making of claims.

This Act expresses time limits consistently. Where possible, the time limit for an election is the first anniversary of the "normal self-assessment filing date" (defined in section 878 of this Act as 31 January following the relevant tax year). So section 225 makes it clear that the full 22 month time limit applies.

This change has no implications for the amount of tax paid, who pays it or when. It affects (in principle but not in practice) only administrative matters.

Change 62: Adjustment income: how an election affects later years: section 239

This change clarifies what happens to the remainder of adjustment income in the years after an election has been made to have the charge increased.

A barrister or advocate may be subject to a charge under Schedule 22 to FA 2002. The charge is spread over ten years in accordance with paragraph 11 of that Schedule. But an election may be made under paragraph 12 of the Schedule to accelerate the charge. In this Act, the spreading rule is in section 238. The election is in section 239.

Example

If there is a charge of £1200 over ten years and an election to have £300 instead of £120 charged in year 4, there is some doubt about the "additional amount" in paragraph 12(4) of Schedule 22 to FA 2002.

- If it is £300, there will be six charges of £90 ([£1200-£300]/10).
- If it is £180, there will be five charges of £102 ([£1200-£180]/10) and a final one of £30.

Policy and logic suggest the first answer but the 2002 legislation seems to suggest the second. Section 239(4) of this Act uses the "additional amount" of £180 to produce six charges of £90.

This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 63: Post-cessation receipts: design right: section 253

This change corrects an anomaly in section 104(3) of ICTA. It ensures that a lump sum received by personal representatives for the assignment of design right is not treated as a post-cessation receipt.

The policy is that a lump sum from the disposal of certain rights should not be treated as a post-cessation receipt. That is the rule in section 103(3)(b) and (bb) of ICTA. Paragraph (bb) was inserted by the Copyright, Designs and Patents Act 1988.

Section 104 of ICTA charges sums "not ... otherwise chargeable to tax" (subsection (2)). Section 104(3) of ICTA provides that, in the case of a lump sum from a patent right etc, the section does not charge sums that would have been chargeable to tax under section 103 of ICTA but for the exemption in section 103(3)(b) of ICTA. As there is no reference to the exemption in section 103(3)(bb) of ICTA a lump sum from a design right could in principle be caught by section 104 of ICTA.

This change ensures that the intended exemption applies.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 64: Post cessation receipts treated as relevant UK earnings for pension purposes: section 256

This change gives statutory effect to the practice of treating certain sums received after a trade, profession or vocation has ceased (post-cessation receipts) as relevant earnings for the purposes of making pension contributions.

Sections 103 and 104 of ICTA charge post-cessation receipts under Schedule D Case VI. This charge is rewritten in Chapter 18 of Part 2 of this Act.

Section 107 of ICTA provides that amounts charged to tax under sections 103 and 104 of ICTA shall be treated as earned income if the profits of the trade, profession or vocation would also have been treated as earned income before the cessation. This treatment is rewritten as section 256 of this Act.

If section 107 of ICTA applies to treat an amount as earned income it is Inland Revenue practice to treat that amount as relevant earnings for the purposes of retirement annuity relief or making contributions under personal pension arrangements (sections 623(2) and 644(2) of ICTA).

FA 2004 introduced a new regime for taxing pensions to take effect in April 2006. The equivalent of relevant earnings in that regime is relevant UK earnings as defined in section 189(2)(b) of FA 2004. Without the change in the law introduced by section 256 the practice described in the previous paragraph would be extended to the new regime. Section 256 anticipates this by providing that post-cessation receipts treated as earned income are also treated as relevant UK earnings for pension purposes.

Retirement annuity relief and personal pension arrangements are dealt with as a transitional measure in paragraph 60 of Schedule 2 to this Act. This is in line with the approach taken to the rewrite of other provisions affected by the new pension regime. The new rules are dealt with in the substantive section and the old rules which apply until 5 April 2006 are dealt with in the transitionals Schedule.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 65: Statutory insolvency arrangement - Scotland: section 259

This change adapts the definition of “statutory insolvency arrangements” in section 259 to Scotland.

Section 74(1)(j) of ICTA prohibits the deduction in computing the profits of a trade, profession or vocation of any debt other than:

“(i) a bad debt

(ii) a debt or part of a debt release by a creditor wholly and exclusively for the purposes of his trade, profession or vocation as part of a relevant arrangement or compromise; and

(iii) a doubtful debt to the extent estimated to be bad.

Section 74(1)(j) of ICTA is rewritten in section 35. Section 35 replaces the term “relevant arrangement or compromise” with “statutory insolvency arrangement”.

Section 74(2)(a) of ICTA defines “relevant arrangement or compromise” as a voluntary arrangement under the Insolvency Act 1986 (covering individual voluntary arrangements in England and Wales) or the Insolvency (Northern Ireland) Order 1989 (covering individual voluntary arrangements in Northern Ireland).

The omission of any reference to Scottish insolvency legislation was an oversight when section 74(2) of ICTA was inserted by section 144(2) of FA 1994. The nearest equivalent in Scotland to the Insolvency Act 1986 and the Insolvency (Northern Ireland) Order 1989 is the Bankruptcy (Scotland) Act 1985 which covers voluntary arrangements in Scotland supervised by the courts or by independent practitioners. So section 259 defines “statutory insolvency arrangement” by reference to the Bankruptcy (Scotland) Act 1985 as well as by reference to the corresponding legislation in England and Wales and in Northern Ireland cited in section 74(2) of ICTA.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 66: Priority of the charge on trade profits: the "Crown Option" and sections 261, 366 and 575

This change gives priority to the charge on trade profits if an item of income is both a trade receipt and potentially within the receipts of an overseas property business in Part 3, or within a charge to tax in Part 4 or 5 of this Act.

In the source legislation taxable income is allocated to different Schedules. The charges under these Schedules are mutually exclusive.

In addition, a small number of charges (non-schedular charges) are imposed outside the schedular system.

The scope of Schedule D is set out in section 18 of ICTA. The effect of that section (and the relevant case law) is that Schedule D is the residual Schedule. If income meets the conditions to be taxed under Schedule D and the conditions to be taxed under ITEPA 2003 or another Schedule of ICTA it will be taxed under the alternative and not under Schedule D.

But there is no order of priority between Cases I to V of Schedule D. In the event of income falling within more than one of those Cases it has long been accepted that the Inland Revenue has the option to choose under which case the income should be taxed. This "Crown Option" was not legislated until 1996 when section 28A(7B) was inserted into TMA 1970. This was done, not so much to provide explicit statutory authority for the option, but to explain how it should operate under Self Assessment.

In 2001 section 28A(7B) of TMA was replaced by section 9D of TMA. It provides that if a self-assessment return is made and alternative methods are allowed for bringing amounts into charge the Inland Revenue may determine which alternative is used. The decision of the Inland Revenue is final and conclusive.

Section 9D(2) of TMA provides that the cases where the Tax Acts allow for alternative methods for bringing amounts into charge are under either:

- Schedule D Case I or II; or
- Schedule D Case III, IV or V.

The Inland Revenue's guidelines for making the determination are published in paragraph 14035 of the Business Income Manual (BIM 14035). The income will be taxed under Schedule D Case I or II and not under Schedule D Case III, IV or V.

This Act deals with the Crown Option by providing for an order of priority between the Parts if income is capable of being taxed under more than one Part.

Section 261 provides that if income is capable of being taxed under Part 3 of this Act in respect of an overseas property business and under Chapter 2 of Part 2 of this Act it is taxed under Part 2. ICTA taxes the profits arising from an overseas property business under Schedule D Case V so section 261 gives effect to the Crown Option in respect of trades carried on wholly or partly in the United Kingdom (and to section 65A(1)(b) of ICTA in respect of trades carried on wholly abroad).

Section 366(1) gives priority to Chapter 2 of Part 2 of this Act if income falls within both Part 2 and Part 4 of this Act. This gives effect to the Crown Option in respect of income within Part 4 of this Act that is taxed in ICTA under Schedule D Cases III, IV or V. It goes beyond the Crown Option in that it gives Part 2 of this Act priority over income that would be taxed under Schedule F or as a non-schedular charge. It applies the same approach to trades carried on wholly abroad as is applied to trades carried on wholly or partly in the United Kingdom. This is consistent with the law (see section 65(3) of ICTA) and practice that the profits of both types of trade should be calculated on the same basis as far as possible.

In the case of income taxed under Schedule F the statutory authority for this approach is given by section 95(1) of ICTA (applied to trades carried on wholly abroad by section 65(3) of ICTA) .

In the case of non-schedular charges it is unlikely that there would be any overlap for income tax payers. But in theory it is possible that, for example, stock dividends (Chapter 5 of Part 4 of this Act) and gains from contracts for life assurance (Chapter 10 of Part 4 of this Act) may rank as trade receipts. Taxing such income under Part 2 of this Act accords with the policy and practice of taking trade receipts into account in calculating trade profits and not otherwise.

Part 2 of this Act provides for a charge on the profits of professions and vocations as well as a charge on the profits of trades. So section 366(1) goes beyond the ambit of ICTA by giving priority to Part 2 of this Act if the source legislation gives priority to income taxed as a trade receipt or under Schedule D Case I. For example, section 56(2) of ICTA (rewritten as section 551 (transactions in deposits)) excludes income taxed as a trade receipt from the charge under Schedule D Case VI. Paragraph 1(2)(a) of Schedule 5AA to ICTA (rewritten as section 555 (disposals of futures and options involving guaranteed returns)) excludes income taxed under Schedule D Case I or V from the charge under Schedule D Case VI . Taxing such income under Part 2 of this Act accords with the policy of taking receipts into account in calculating Schedule D Case I or II profits, although the point is most unlikely to arise in practice in relation to a profession.

Section 575 gives priority to Part 2 of this Act if income falls both within Chapter 2 of Part 2 (trade receipts) of this Act and Part 5 of this Act. In this case the only possible overlap is with income that could be taxed under Schedule D Cases III and V. So the order of priority gives effect to the Crown Option.

The order of priority in sections 366(1) and 575 allows sections 9D, 12AE(2) and 31(3) of TMA to be repealed.

This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 67: Territorial scope of charge to tax: land in Ireland: section 269

This change concerns income from land in the Republic of Ireland arising to a person whose other foreign income is assessed on the remittance basis.

The change makes it clear that businesses and transactions for generating income from land in the Republic of Ireland form part of an overseas property business of a person to whom the remittance basis applies.

The basic rule is that income arising from property in the Republic of Ireland is assessable on the basis of the amount arising (see section 68(1) of ICTA). This rule applies “notwithstanding anything in section 65 [of ICTA]”. Section 65(5) of ICTA provides for the remittance basis to apply to foreign income.

Section 65(4) of ICTA provides that section 65A of ICTA (overseas property businesses) does not apply in relation to persons to whom the remittance basis applies.

It is not clear how the rules in sections 65A and 68(1) of ICTA interact. Section 68(1) of ICTA does not refer to section 65A of ICTA. If it was Parliament’s intention that Irish income was to be assessable on the arising basis but not in accordance with section 65A of ICTA, it might be expected that section 68(1) of ICTA would apply notwithstanding sections 65 *and* 65A of ICTA.

So far as Irish income is concerned, the rule in section 65(4) and (5) of ICTA that the income of a person to whom the remittance basis applies is not to be assessed on the arising basis but on the remittance basis is not to be read literally. Section 68(1) of ICTA secures that income arising in the Republic of Ireland is assessed on the arising basis even if it arises to a person to whom the remittance basis applies.

It is likely that Parliament intended the reference to section 65A in section 65(4) to be read in this light. In other words the overseas property business rules were not to apply in relation to the *income* of a person to whom the remittance basis applies that was actually charged on the remittance basis.

Section 269 makes it clear that the overseas property business rules are to be used in calculating a person's income from Irish property even if the remittance basis applies to the other foreign income of that person.

In theory this change may allow a taxpayer to set a loss sustained in letting one Irish property against profits arising from letting another.

This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 68: Sums payable instead of rent, or as consideration for the variation or waiver of a term of a lease, for periods of 50 years or less: sections 276, 279 and 281

This change clarifies the application of the lease premium rules to sums paid instead of rent, or for the variation or waiver of a term of a lease, if the period for which the sum is paid, or the variation or waiver has effect, is 50 years or less but the duration of the lease is more than 50 years.

Section 279 is based on section 34(4) of ICTA. If under the terms of a lease a tenant is to pay a sum instead of rent, section 34(4) of ICTA treats the lease as requiring the payment of a premium for the purposes of section 34 of ICTA.

Section 34(4) of ICTA is intended to prevent a landlord avoiding a charge to income tax on rent by including in the terms of a lease provision for a lump sum to be paid instead of rent.

Section 34(1) of ICTA applies only if the duration of the lease does not exceed 50 years. Section 34(4) of ICTA does not say explicitly that it applies to leases not exceeding 50 years or that it applies irrespective of the duration of the lease. But section 34(4)(a) of ICTA provides that, in computing the profits of the Schedule A business of which section 34(4) of ICTA treats the sum payable instead of rent as a receipt, any period *other than that in relation to which the sum is paid* should be disregarded in arriving at the duration of the lease.

There is more than one way to interpret the relationship between section 34(4)(a) of ICTA and the restriction in section 34(1) of ICTA that the duration of the lease should not exceed 50 years.

Section 34(1) of ICTA could be interpreted as limiting the application of section 34(4) of ICTA to leases with a duration of not more than 50 years. This would allow a landlord to avoid income tax on rent for any period up to 50 years by receiving that rent in the form of a lump sum if it is in respect of a lease for more than 50 years.

This is not the way the legislation has been interpreted and applied in practice over many years. Ever since the legislation was first enacted in FA 1963 the Inland Revenue has interpreted section 34(4) of ICTA as applying to the receipt of a sum instead of rent for a period not exceeding 50 years *regardless* of the duration of the lease. As a result, the person by whom the sum is paid may be treated as paying rent for the purposes of relief under section 37(4) of ICTA in computing the profits of a Schedule A business or under section 87 of ICTA in computing the profits of a trade, profession or vocation.

Section 279(1)(b) follows the Inland Revenue interpretation by applying section 279 if a sum is paid instead of rent for a period of 50 years or less regardless of the duration of the lease. Because this is not explicit in section 34(4) of ICTA it may be a change in the law.

A similar point arises on section 281, based on section 34(5) of ICTA. If a tenant is to pay a sum as consideration for the variation or waiver of any of the terms of a lease, section 34(5) of ICTA treats the lease as requiring the payment of a premium.

Section 34(5) of ICTA is intended to prevent a landlord avoiding a charge to income tax on rent, or on a premium treated as rent under section 34(1) of ICTA, by altering the terms of a lease in return for the payment of a lump sum. For example, a lease on a shop might contain a condition that the property is not to be used for retail trade; the landlord then waives this condition in return for a separate consideration. Without section 34(5) of ICTA, the additional consideration would not be a premium for the purposes of section 34 of ICTA.

As in section 34(4) of ICTA, section 34(5) of ICTA does not say explicitly that it applies to leases not exceeding 50 years or that it applies irrespective of the duration of the lease. But section 34(5)(a) of ICTA provides that in computing the profits of the Schedule A business of which section 34(5) of ICTA treats the sum payable as consideration as a receipt, any period *other than that for which the variation or waiver has effect* should be disregarded in arriving at the duration of the lease.

As in section 34(4) of ICTA, there is more than one way to interpret the relationship between section 34(5)(a) of ICTA and the restriction in section 34(1) of ICTA that the duration of the lease should not exceed 50 years.

Section 34(1) of ICTA could be interpreted as limiting the application of section 34(5) of ICTA to leases with a duration of not more than 50 years. This would allow a landlord to avoid income tax on rent for any period up to 50 years by receiving a payment for the waiver or variation of the term of a lease if it is in respect of a lease for more than 50 years.

As in the case of section 34(4)(a) of ICTA, this is not the way the legislation has been interpreted and applied in practice. Ever since the legislation was first enacted in FA 1963 the Inland Revenue has interpreted section 34(5) of ICTA as applying to the receipt of a sum as consideration for the variation or waiver of a term of a lease for a period not exceeding 50 years *regardless* of the duration of the lease. As a result, the person by whom the sum is paid may be treated as paying rent for the purposes of relief under section 37(4) or section 87 of ICTA.

Section 281(1)(c) follows the Inland Revenue interpretation by applying section 281 if a sum is paid for the waiver or variation of the term of a lease for a period of 50 years or less regardless of the duration of the lease. Because this is not explicit in section 34(5) of ICTA, it may be a change in the law.

If, as a result of this change, an amount is brought into account as a receipt in respect of a sum payable under the terms of a lease instead of rent, or as consideration for the variation or waiver of a term of a lease, the tenant may become entitled to relief under sections 287 to 295 if the tenant carries on a property business or under sections 60 to 65 if he or she carries on a trade, profession or vocation.

This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 69: Identifying the profits involved where an amount is to be taken into account as a receipt in calculating the profits of a property business: sections 277, 279, 280, 281, 282, 284 and 285

This change relates to the provisions requiring an amount in respect of a premium or other sum payable in connection with a lease to be taken into account as a receipt in calculating the profits of a property business.

Section 34 of ICTA provides that if a premium is payable under the terms subject to which a lease is granted, the landlord is treated as receiving an amount by way of rent. Section 34(4) of ICTA provides that if, under the terms subject to which a lease is granted, a sum becomes payable by the tenant instead of rent or as consideration for the surrender of the lease, the lease is deemed for the purposes of section 34 of ICTA to have required the payment of a premium to the landlord. Section 34(5) of ICTA makes similar provision in the case of a sum payable by the tenant as consideration for the variation or waiver of any of the terms of the lease.

Section 34(7A) of ICTA provides that an amount treated as rent under section 37 of ICTA "shall be taken into account in computing the profits of the Schedule A business in question for the chargeable period in which it is treated as received". Section 34(1), (4)(b) and (5)(b) of ICTA specify when the rent is deemed to be received.

(1) Under section 34(6) of ICTA, if the premium - or the sum treated as a premium by section 37(4) or (5) of ICTA - is payable to a person *other than* the landlord, that person is:

"taken to have received as income an amount equal to the amount which would otherwise fall to be treated as rent and to be chargeable to tax as if he had received it in consequence of having, on his own account, entered into a transaction falling to be treated as mentioned in paragraph 1(2) of Schedule A.

Paragraph 1(2) of Schedule A in section 15(1) of ICTA provides that certain transactions are to taken to be entered into in the course of a Schedule A business. So the effect of section 34(6) of ICTA is to treat the person to whom the premium or other sum is payable as carrying on a Schedule A business and receiving an amount of income as a receipt of that business.

The receipt must be taken into account in computing the profits of that person's Schedule A business. But there is no provision specifying the period for which the receipt must be taken into account. Section 34(7A) of ICTA does not apply to such receipts as it only applies to amounts treated under section 34 of ICTA as rent.

In practice, premiums or other sums payable to a person other than a landlord are taken into account in computing the profits of the Schedule A business for the same chargeable period as if they had been payable to the landlord and the landlord had been treated as receiving rent. So sections 277(3), 279(3), 280(3) and 281(3) require an amount to be brought into account as a receipt in calculating the profits of a property business for a specified tax year whether the premium or other sum was payable to the landlord or to another person.

This change has no implications for the amount of income liable to tax or who is liable for tax on it. In principle it affects when tax is paid but is expected to have no practical effect as it is in line with current practice.

(2) Section 34(7A) of ICTA provides that an amount treated as rent under section 34 of ICTA is to be taken into account in computing the profits of the Schedule A business for the chargeable period in which it is treated as received.

Section 34(1), (4)(b) and (5)(b) of ICTA specify when the rent is deemed to be received. But it is only necessary to know when the rent is deemed to be received in order to apply the rule in section 34(7A) of ICTA. So in rewriting section 34(1) of ICTA, section 277(4) requires an amount to be brought into account as a receipt in calculating the profits of the property business for the tax year in which the lease is granted. And in the same way, sections 279(4), 280(4) and 281(4) refer to the tax year in which the sum becomes payable.

A similar point arises in sections 35 and 36 of ICTA.

Section 35(2A) of ICTA provides that an amount treated under section 35 of ICTA as income received by the person by whom the lease was assigned:

"(a) is treated as received when the consideration … becomes payable, and

(b) shall be taken into account in computing the profits of the Schedule A business in question for the chargeable period in which it is treated as received.

Similar provision is made by section 36(4A) of ICTA in relation to receipts where the terms subject to which an estate or interest in land is sold provide either that it is to be reconveyed or for the grant of a lease out of the estate or interest in land.

Again, it is only necessary to know when the receipt is received in order to apply the rule in section 34(7A) of ICTA. So in rewriting section 35 of ICTA, section 282(4) requires an amount to be brought into account as a receipt in calculating the profits of the property business for the tax year in which the consideration for the assignment becomes payable. And in the same way, sections 284(4) and 285(5) refer to the profits of the property business for the tax year in which the estate or interest is sold.

This change has no implications in principle or in practice for the amount of tax paid, who pays or when.

Change 70: Lease premiums etc: no receipt in respect of sum payable for variation or waiver of term of lease if sum due to someone other than the landlord or a person connected with landlord: section 281

This change prevents an amount being treated as a receipt of the landlord's property business, where a sum is payable by the tenant as consideration for the variation or waiver of a term of a lease to somebody other than the landlord or a person connected with the landlord.

Section 34(5) of ICTA provides:

"Where, as a consideration for the variation or waiver of any of the terms of a lease, a sum becomes payable by the tenant otherwise than by way of rent, the lease shall be deemed for the purposes of this section to have required the payment of a premium to the landlord (in addition to any other premium) of the amount of that sum …

The effect of this is that the landlord is treated under section 34(1) of ICTA as receiving an amount by way of rent.

Section 34(6) of ICTA provides that if a payment falling within section 34(1), (4) or (5) of ICTA is due to a person other than the landlord, no amount is to be treated as a receipt of any Schedule A business carried on by the landlord. It also provides that the other person is to be:

"taken to have received as income an amount equal to the amount which would otherwise fall to be treated as rent and to be chargeable to tax as if he had received it in consequence of having, on his own account, entered into a transaction falling to be treated as mentioned in paragraph 1(2) of Schedule A.

The effect of this is that the other person is treated as carrying on a Schedule A business and the amount that would have been treated as rent, if the sum had been payable to the landlord, is treated as a receipt of that business.

But section 34(7) of ICTA provides that section 34(6) of ICTA shall not apply in relation to any payment within section 37(5) of ICTA unless it is due to a person who is connected with the landlord. This means that section 34(6) of ICTA does not apply to a payment falling within section 34(5) of ICTA payable to a person who is not the landlord and is not connected with the landlord.

The position for such a payment is governed by section 34(5) of ICTA. Under section 34(5) of ICTA the lease is treated for the purposes of section 34 of ICTA as requiring the payment of a premium to the landlord, regardless of the person to whom it is paid. It follows that the landlord will be treated under section 34(1) of ICTA as receiving an amount by way of rent, even if the sum is payable to somebody who is not connected with the landlord.

The intention appears to be that in such a case nobody should be treated as receiving an amount by way of rent or income. This is how section 34(6) of ICTA is operated in practice. So section 281(1)(b) requires that in order for section 281 to apply the sum payable as consideration for the variation or waiver of a term of a lease must be due to the landlord or a person connected with the landlord.

If, as a result of this change, no amount is brought into account as a receipt in calculating the profits of the landlord's property business in respect of a sum payable by a tenant as consideration for the variation or waiver of the terms of a lease to a person other than the landlord, or a person connected with the landlord, the tenant will not be entitled to any relief under sections 287 to 295 if the tenant carries on a property business or under sections 60 to 65 if he or she carries on a trade.

This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 71: Applying the additional calculation rule to receipts in respect of sums payable for variation or waiver of term of lease: sections 281, 287, 288, 289 and 294

This change applies the provisions of Chapter 4 of Part 3 of this Act for reducing the amount of certain receipts under that Chapter to receipts in respect of sums payable as consideration for the variation or waiver of a term of a lease.

Under section 34(1), (5), (6) and (7) of ICTA if a sum becomes payable by a tenant as consideration for the variation or waiver of any of the terms of a lease, the landlord is treated as receiving a proportion of that sum as rent or, if the sum is payable to a person connected with the landlord that person is treated as receiving the same amount as a receipt of a Schedule A business. (See *Change 70*.)

When certain conditions are met, section 37(1) to (3) of ICTA provides that the amount treated as received under section 34 or 35 of ICTA is to be replaced by a smaller amount calculated under section 37 of ICTA. One of the conditions is that there must be an amount treated as a receipt of a Schedule A business by virtue of section 34 or 35 of ICTA in respect of “the head lease”. Another of the conditions is in section 37(2)(b) of ICTA, which provides that the amount to be reduced under section 37 of ICTA must be an amount treated as received under section 34 of ICTA in respect of the grant of a lease out of the headlease or under section 35 of ICTA in respect of the assignment of the headlease.

Section 37(1) to (3) of ICTA does not appear to allow a reduction in an amount treated as received under section 34 of ICTA in respect of a sum payable by the tenant as consideration for the variation or waiver of a term of a lease because such an amount is not received in respect of the “grant” of a lease as required by section 37(2)(b) of ICTA. But relief under section 37(2) and (3) of ICTA is, in practice, allowed in respect of amounts treated as received under section 34 of ICTA in respect of sums paid as consideration for the variation or waiver of a term of a lease.

Section 37(1) to (3) of ICTA is rewritten in sections 287 to 290 in which it is referred to as “the additional calculation rule”. So:

- section 281(5) provides that, if the additional calculation rule applies, the amount given by the formula in section 281(4) is to be reduced by the amount calculated in accordance with section 288;
- section 287(1) includes receipts under section 281 in the list of receipts in relation to which the additional calculation rule applies; and
- sections 288(2) (which sets out the additional calculation rule) and 289(2) (which adapts the additional calculation rule where the sublease does not extend to the whole of the leased premises) both refer to section 281.

Section 295 restricts total relief to the amount of the taxed receipt after any deductions under section 61. So if, as a result of this change, a tenant receives relief in respect of a sum payable as consideration for the variation or waiver of a term of a lease, this may reduce the amount of relief available to a subsequent tenant.

This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 72: Receipts in respect of sales with right to reconveyance and sale and leaseback transactions: sections 284 and 285

This change introduces a requirement that, for an amount to be treated as a receipt in respect of a sale with a right to a reconveyance or a sale and lease back transaction, the period between the sale and the earliest date of reconveyance or leaseback must be 50 years or less.

Section 36(1) of ICTA provides:

“Where the terms subject to which an estate or interest in land is sold provide that it shall be, or may be required to be, reconveyed at a future date to the vendor or a person connected with him, the following amount shall be deemed to have been received as income by the vendor and to have been received by him in consequence of his having entered into a transaction falling to be treated as mentioned in paragraph 1(2) of Schedule A…

Section 36(1) of ICTA further provides that the amount that the vendor is treated as having received is the amount by which the price at which the estate or interest is sold exceeds the price at which it is to be reconveyed. But if the earliest date at which it would fall to be reconveyed is two years or more after the sale, the amount of the excess is reduced by 1/50th for each complete year (other than the first) in the period between the sale and that date. This means that if the period beginning with the sale and ending with the earliest date on which the estate or interest fall to be reconveyed is 51 years or more, the amount that the vendor is treated as having received is zero. But the vendor will only discover this after carrying out the calculation required by section 36(1) of ICTA.

It is not appropriate to require the vendor to take a zero receipt into account in calculating the profits of a property business. Nor does there appear to be any reason why the period for sale and reconveyance should be 51 years, while sections 34(1) and 35 of ICTA require that the duration of the lease must not exceed 50 years. So in rewriting section 36 of ICTA, section 284(1)(b) requires that in order for section 284 to apply the period between the sale and the earliest date on which the estate or interest in land would fall to be reconveyed must be 50 years or less. This makes it unnecessary for the vendor to calculate the amount and find that it was zero.

A similar point arises in relation to section 285. Section 36(3) of ICTA provides that, where the terms of the sale provide for the grant of a lease directly or indirectly out of the estate or interest to the vendor or a person connected with him, section 36 of ICTA applies as if the grant of the lease were a reconveyance of the estate or interest. Again, the effect of section 36(1) and (3) of ICTA is that the amount treated as received by the vendor will be zero if the period beginning with the sale and ending with the earliest date on which under the terms of the sale the lease would fall to be granted exceeds 51 years.

As in the case of sales with a right to a reconveyance, there does not appear to be any reason why this period should be 51 years, rather than 50 years. So section 285(1)(b) requires that in order for section 285 to apply the period between the sale and the earliest date at which the lease would fall to be granted must be 50 years or less.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 73: Limiting the reductions in receipts under section 288 and the deductions for expenses under section 292: sections 287, 288, 289, 290, 291, 292 and 295

This change concerns the way section 37(9) of ICTA is rewritten.

Section 37(9) of ICTA provides:

“An amount or part of an amount shall not be deducted under this section more than once from any sum, or from more than one sum, and shall not in any case be so deducted if it has been otherwise allowed as a deduction in computing the income of any person for tax purposes.

The effect that section 37(9) has on the rest of section 37 of ICTA is not entirely clear. There are no references to it in the rest of the section. It is simply added at the end of the section. And the wording of section 37(9) of ICTA does not fit in well with the rest of the section.

It appears that when section 37(9) of ICTA refers to “an amount or part of an amount”, it must be referring to the amount, or any part of the amount, chargeable on the superior interest, as defined in section 37(1) of ICTA because it is this amount which determines the extent to which relief is given under section 37(2) and (4) of ICTA.

But the amount or part amount is not, strictly speaking, deducted under section 37 of ICTA at all:

- in the case of a later chargeable amount, section 37(2) and (3) of ICTA substitute a reduced amount for the amount of the later chargeable amount calculated under section 34 or 35 of ICTA; and
- under section 37(4) of ICTA a tenant is treated as paying rent, corresponding to the amount of rent the landlord is treated as receiving under section 34 or 35 of ICTA.

So while the calculation of the reduced amount of the later chargeable amount and the amount of notional rent paid depend on a part of the amount chargeable on the superior interest, no amount is "deducted" under section 37 of ICTA.

In construing section 37(9) of ICTA it is relevant to consider the rationale underlying the rest of section 37 of ICTA.

Under section 34(1) of ICTA, where there is a premium in respect of a lease and a premium in respect of a sublease granted out of that lease, the landlord under the lease and the landlord under the sublease (the tenant under the lease) will both be treated as receiving an additional amount of rent. Part or all of the premium in respect of the sublease will represent value already taxed as income in the hands of the landlord.

The purpose of section 37(2) and (3) of ICTA is to reduce the amount treated as paid under section 34(1) of ICTA in respect of the premium for the sublease by reference to the amount treated as paid under section 34(1) of ICTA in respect of the premium for the lease. It follows from this that the total amount of the reductions should be limited to the amount treated as received as rent under section 34(1) of ICTA in respect of the premium for the lease. This limit is provided by section 37(9) of ICTA.

The rationale underlying section 37(4) of ICTA is that if an amount is treated under section 34 or 35 of ICTA as rent in the hands of the recipient, the person by whom it is paid (the tenant) should also be treated as paying rent. So it is logical that the amount that the recipient is treated as receiving should be the same as the amount that the tenant is treated as paying. Generally this will be achieved by section 37(4) of ICTA, but there are circumstances in which the amount the tenant is treated as paying under section 37(4) of ICTA could exceed the amount the landlord or other person is treated as receiving under section 34 or 35 of ICTA.

It appears that the purpose of section 37(9) of ICTA is to limit the reductions in later chargeable amounts under section 37(2) and (3) of ICTA, and the amounts the tenant is treated as paying as rent under section 37(4) of ICTA, by reference to the amount chargeable on the superior interest to an amount equal to that amount. So section 295, which is based on section 37(9) of ICTA, is worded as a limit.

Section 37(9) of ICTA is difficult to construe because it does not say how it interrelates with the rest of section 37 of ICTA. Sections 287 to 290 attempt to make the relationship clear. So:

- section 290(1) defines the "unused amount" of the taxed receipt, which under section 37(9) of ICTA is the part of the amount chargeable on the superior interest that has not been "deducted";
- sections 287(5) and 288(3) ensure that there cannot be a reduction by reference to a taxed receipt ("the amount chargeable on the superior interest") in calculating the amount of a receipt if the taxed receipt does not have an unused amount. In the terminology of section 37(9) of ICTA, this would be if the whole of the amount chargeable on the superior interest had already been "deducted"; and
- section 289(4) ensures that the reduction required under section 288 by reference to a taxed receipt cannot exceed the unused amount. In the terminology of section 37(9) of ICTA, this ensures that "deductions" exceeding the amount chargeable on the superior interest cannot be made.

Section 291(4) imposes a similar limit on deductions for expenses under section 292. Sections 291 and 292 are based on section 37(4) of ICTA.

Section 295 restricts total relief to the amount of the taxed receipt. A tenant is entitled to relief only if the taxed receipt by reference to which the relief could be given has an "unused amount". So by reducing the unused amount of the taxed receipt, the relief which each tenant receives by reference to a taxed receipt may reduce the amount of relief to which a later tenant is entitled.

This change is adverse to some taxpayers and favourable to others in principle and in practice. But the numbers affected and the amounts involved are likely to be small.

Change 74: Deduction for expenditure on energy-saving items: drop the requirement for a claim: section 312

This change removes the requirement for a formal claim to relief for qualifying expenditure on energy-saving items.

Section 31A of ICTA allows a revenue deduction for capital expenditure meeting certain conditions on energy-saving items.

Section 31B(3) of ICTA requires a claim for relief under section 31A of ICTA. This requirement sits uneasily with Self Assessment and the general approach of this Act is not to require a claim for reliefs given as deductions in calculating profits of a trade or property business.

So section 312 drops the requirement to make a claim for relief, with the result that relief will be given by a deduction in the calculation of income in the taxpayer's return. This simplifies the position and makes the administration of the relief consistent with trading and property income deductions generally.

The provisions that govern claims are not the same as the provisions that govern returns. But in practice the change from claim to deduction will have only the following consequences, which both relate to the time available for "claiming" the deduction.

First, the absolute time limit for making a claim is replaced by a time limit that may vary according to the particular circumstances. That may be because the return is issued late or because the taxpayer makes a late return. Accordingly, the Inland Revenue is no longer able to refuse a claim because it is late by reference to an absolute time limit: returns time limits and sanctions will apply and they depend on the date the return was issued and submitted.

Second, the time limit available to make the "claim" will normally reduce. That is because, as a formal claim, the time limit for a claim under section 31B of ICTA is (almost) 70 months from the end of the relevant tax year (section 43(1) of TMA) whereas as a deduction in a return the filing date time limit applies - normally (almost) ten months after the relevant tax year (section 8(1A) of TMA) or, for amendments to returns, 12 months after the filing date (section 9ZA(2) of TMA). However, error or mistake relief claims under section 33 of TMA will be possible if too much tax is paid as a result of omitting to include the deduction in the tax return. Claims under section 33 of TMA must be made within five years of 31 January following the tax year to which the return relates.

This change is adverse to some taxpayers and favourable to others in principle but is not expected to have any practical effect.

Change 75: Meaning of "relevant period" in sections 325 and 326: non-resident companies: section 324

This change defines the "relevant period" by reference to the tax year for non-resident companies liable to income tax in respect of furnished holiday accommodation. That removes any doubt as to how the source legislation applies to such companies.

The provisions in Chapter 6 of Part 3 of this Act define lettings that can qualify for special tax advantages. They are based on section 504 of ICTA. To qualify, certain conditions have to be met during a particular test period – the "relevant period" in section 324.

Section 504(4) of ICTA deals with non-company cases. The test period is defined by reference to the tax year.

Section 504(5) of ICTA deals with company cases. The test period is defined by reference to the accounting period.

Those subsections reflect the different chargeable periods for income tax (the tax year) and corporation tax (the accounting period).

Section 324 is based on section 504(4) of ICTA so the "relevant period" for all persons within this Act is defined by reference to the tax year. But because this Act applies to non-resident companies liable to income tax, that does not replicate directly the source legislation. If the concept of "accounting period" can apply for income tax purposes, the source legislation defines the test period for such companies by reference to their accounting period by virtue of section 504(5) of ICTA.

The change is to define the "relevant period" for non-resident companies that are within the charge to income tax by reference to the tax year. This is appropriate because non-resident companies not within corporation tax are liable to Schedule A income tax on the profits of the tax year and not the profits of an accounting period (sections 11 and 21(2) of ICTA). It brings non-resident companies into line with all other income tax payers in this respect. Doing so reflects the Inland Revenue view of how this legislation is intended to work. And it reflects, as far as can be established, wider views on, and current practice in, interpreting the section.

This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 76: Furnished holiday accommodation: permitted longer-term occupation: section 325

This change alters the period during which, in order to qualify for the special tax treatment of the commercial letting of furnished holiday accommodation, the accommodation must not be occupied for more than 31 days at a time.

Section 504(3) of ICTA provides:

"(3) Accommodation shall not be treated as holiday accommodation for the purposes of this section unless–

(a) it is available for commercial letting to the public generally as holiday accommodation for periods which amount, in the aggregate, to not less than 140 days;

(b) the periods for which it is so let amount in the aggregate to at least 70 days; and

(c) for a period comprising at least seven months (which need not be continuous but includes any months in which it is let as mentioned in paragraph (b)) it is not normally in the same occupation for a continuous period exceeding 31 days.

It is not clear whether a "month" for the purposes of paragraph (c) means a calendar month (in the sense of January, February, etc) or any period of one month. It is also not clear whether any breaks in the period of at least seven months can fall at any time or must divide the period into periods of whole months. The better view seems to be that any period of a month during which the accommodation is commercially let to members of the public as holiday accommodation must not overlap with any period during which it is continuously in the same occupation for more than 31 days.

A further uncertainty is whether, for the purposes of paragraph (c), the time that the accommodation is "let as mentioned in paragraph (b)" is 70 days or (which is the better view) all the time that it is commercially let to the public generally as holiday accommodation.

On the latter reading, section 504(3)(c) of ICTA secures that accommodation is not let as holiday accommodation if it is let for more than 31 days continuously (otherwise than because of circumstances that are not normal). Section 325(4) gives effect to this reading.

This reading also reduces to less than five months the total periods during which the accommodation can be in the same occupation for more than 31 days. This can operate capriciously to extend the period of "at least seven months" where the holiday lettings are spaced out throughout the year and not concentrated in a few months.

In section 325(5), the requirement in section 504(3)(c) of ICTA is relaxed so that the periods for which the accommodation is continuously in the same occupation for more than 31 days must not amount to more than 155 days (the aggregate length of the five longest months) during the relevant period (see section 324). This means that the period during which any occupation of the accommodation must be on a short-term basis:

- need not be composed of whole months but can be made up of non-consecutive days; and
- is never extended beyond 155 days.

So, where two or three days of a holiday letting fall in a particular month, the requirement in section 325(5) of this Act (unlike section 504(3)(c) of ICTA) does not restrict what can be done with the accommodation during the rest of the month (provided that the condition is satisfied over the relevant period as a whole).

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 77: Furnished holiday accommodation: period over which lettings are averaged: section 326

This change alters the period during which lettings are averaged for the purpose of treating infrequently let property as qualifying holiday accommodation from the tax year to the relevant period (as defined in section 324).

Subsections (6) to (8) of section 504 of ICTA allow averaging where a taxpayer lets both furnished holiday accommodation and accommodation that would be holiday accommodation if the test in section 504(3)(b) of ICTA were satisfied in relation to it (the "under-used accommodation"). The requirement in section 504(3)(b) of ICTA is that the accommodation is commercially let to members of the public for at least 70 days. Section 504(4) of ICTA says that that requirement must be determined by reference to a period (called the "relevant period" in section 326) which is:

- the tax year; or
- if the accommodation was not let in the year before (or the year after), one year beginning with the first letting (or one year ending with the last letting) in the tax year.

Where the taxpayer elects for averaging, section 504(7) of ICTA treats the under-used accommodation specified in the election as qualifying holiday accommodation if the average of the number of days during the "tax year" for which the furnished holiday accommodation and the under-used accommodation was let is at least 70.

If the relevant period for particular accommodation is not the tax year, the accommodation may have been let for more than 70 days during the "relevant period" but not for more than 70 days during the "tax year". But because the figures averaged in section 504(7) of ICTA are the numbers of days let during the "tax year", specifying the accommodation in an election could not raise the average number of days of letting during that year above 70.

In rewriting section 504(7) of ICTA, section 326(4) provides that the average is to be taken by reference to days during the "relevant period".

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 78: Deduction of management expenses of owner of mineral rights: omission of condition that expenses are "necessarily" incurred: section 339

This change deals with the omission of the requirement that the allowable expenses of managing mineral rights are necessarily incurred.

Section 121(1) of ICTA makes provision for expenses of management and supervision to be deducted from amounts chargeable to income tax in respect of mineral rents and royalties. The section requires that the expenses are disbursed "wholly, exclusively and necessarily".

Section 121(1) of ICTA is rewritten as section 339. That section does not reproduce the condition that the expenses must be "necessarily" incurred. There is no evidence as to how this test is applied in practice but it is not obvious how it could be enforced. The extensive body of case law on the meaning of expenses being incurred "necessarily" applies to income formerly taxed under Schedule E (now taxed as employment income under ITEPA). That case law establishes that each and every holder of the office or employment would have to incur the expense.

That is not a test that can be sensibly applied to income taxed under Schedule D Case VI. It is most unlikely that the "necessarily" restriction is applied in practice and this section recognises this by omitting "necessarily".

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 79: Distributions made by UK companies: section 366

This change alters the test for bringing a distribution received from a UK company, or a payment representative of such a distribution, into account in calculating the profits of a trade from one based on the underlying shares to one based on the character of the receipt or payment.

Section 95 of ICTA sets out the circumstances in which a distribution made by a UK company, or a "payment which is representative of" a UK distribution, is brought into account in calculating the profits of a trade.

Section 95 of ICTA operates by determining whether the recipient of a distribution is a dealer in relation to that distribution. This is tested by reference to whether the proceeds of a notional sale by the recipient of the shares in respect of which the distribution is received would be taken into account in calculating the profits of the trade of the recipient.

This approach is a legacy of the origin of section 95 of ICTA. Section 95 of ICTA is derived from section 54 of FA 1982. Section 54 of FA 1982 was concerned with the tax treatment of a dealer from whom a company purchased its own shares. In that context it was logical to focus on the shares rather than on the distribution. But this has the problem not only that the sale is theoretical but also that the shares may not be held by the dealer when the distribution is received. It is no longer the logical approach now that section 95 of ICTA applies to all distributions received by share dealers.

So section 366(1) has the effect that a distribution received from a UK company, or a payment representative of such a distribution, is dealt with under Chapter 2 of Part 2 of this Act if that distribution or payment is a trade receipt.

The Inland Revenue believe it is highly unlikely that a distribution or payment could be a receipt of a trade unless the proceeds of any sale of the shares giving rise to the distribution would also be treated as a receipt of that trade. But if this is not the case, the change is likely to be favourable to taxpayers as the treatment of trading income is generally more favourable than the treatment of investment income.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 80: Building society dividends: payment of dividends treated as interest: section 372

This change provides for building society dividends (whether paid gross or net) to be charged to tax as interest and not as dividends.

A building society dividend paid in respect of a shareholding in the society does not strictly constitute interest. However, building society shares are more similar in nature to interest-bearing deposits than to normal company shares and this is reflected in their tax treatment.

Section 477A(9) of ICTA provides that building society dividends paid *without deduction of tax* are regarded as paid by way of interest for the purpose of Schedule D. The implication appears to be that they are accordingly charged to tax as interest.

However, where building society dividends are paid *under deduction of tax*, either by virtue of section 349(3A) or section 477A(1) of ICTA, the source legislation does not specifically charge the dividends to tax as interest. Section 349(3A) of ICTA simply requires that tax be deducted from building society dividends paid on quoted securities. Section 477A(5) of ICTA appears to bring dividends that fall within section 477A(1) of ICTA into Schedule D Case III, but falls short of specifically charging the dividends to tax as interest.

So, apart from dividends paid gross, the source legislation does not specifically charge building society dividends to tax as interest, although in practice that is how dividends paid under deduction of tax are dealt with. In practice, all building society dividends within those sections of ICTA are charged to tax as interest.

Accordingly, section 372(1) provides that "Any dividend paid by a building society is treated as interest for the purposes of this Act" without distinguishing between dividends paid gross or net.

This change has no implications for the amount of tax paid, who pays it or when.

Change 81: Industrial and provident society payments: section 379

This change provides for share interest payable by registered industrial and provident societies to be treated as interest.

Section 486(4) of ICTA provides that share interest is chargeable under Schedule D Case III. The definition of "share interest" in section 486(12) of ICTA is "…any interest, dividend, bonus or other sum….". Section 486(4) of ICTA also provides that loan interest is chargeable under Schedule D Case III, as it would be in any event. As loan interest is true interest, which will be taxed under section 369 of this Act, there is no need to refer to it in this provision. There are three possible ways of dealing with share interest: include a specific tax charge for it, charge it under the same Chapter as interest or treat it as interest.

The rationale behind the source legislation is that this type of payment is much the same as an interest return on an investment. But it is not necessarily true interest and it is not likely to fall within any of the other types of income within Schedule D Case III. The approach adopted is consistent with that taken for other items of income; while these payments are not interest, they are taxed as if they were interest. So section 379(1) provides that such a payment "…is treated as interest for income tax purposes…". This technically goes further than merely taxing it under the same Schedule and Case as interest.

This change has no implications for the amount of tax paid, who pays it or when.

Change 82: Funding bonds: charge to tax as interest: section 380 and paragraph 168 of Schedule 1

This change replaces the charge to tax under Schedule D Case VI, which operates in particular circumstances where funding bonds are issued but it is impracticable to retain any bonds on account of income tax, with a charge on all funding bonds as interest and extends the exemption from income tax for charities to cover the income otherwise within the replaced charge.

Section 582(1) of ICTA provides that where funding bonds are issued to a creditor in respect of any liability to pay interest on certain debts, the issue of the bonds is treated as if it were the payment of an amount of that interest equal to the value of the bonds at the time of issue. Where a person would be required to deduct tax from the payment if it were an actual payment of interest, bonds to a value equal to the tax on the interest are to be retained and tendered in satisfaction of the tax (see section 582(2)(a) of ICTA).

So section 582(1) of ICTA generally treats the issue of funding bonds as a payment of interest and they are taxed accordingly. But there is one situation where funding bonds are charged to tax under Schedule D Case VI, rather than as interest. Section 582(2)(b) of ICTA provides that where it is "impracticable" to retain bonds the recipient is instead chargeable to tax under Schedule D Case VI. As section 582(1) of ICTA treats funding bonds as a payment of interest for all purposes of the Taxes Acts, applying a different charge under Schedule D Case VI in just one situation has no particular logic and adds an unnecessary complication. So the separate charge has not been reproduced. Section 380 ensures that all issues of funding bonds are charged to tax as interest, irrespective of the circumstances in which they are issued.

The substituted section 392 of ICTA in paragraph 168 of Schedule 1 to this Act preserves the possibility of loss relief being claimed as a deduction from this income. (It is not considered that a loss could arise in a transaction where a charge is imposed under section 582 of ICTA.)

Section 505(1)(c)(ii) of ICTA, which allows a charity exemption for income taxed under Schedule D Case III, has been amended so as to refer to all income within section 380 whether formerly Schedule D Case III or Case VI.

This change has no implications for the amount of tax paid, who pays it or when, except that the extension of the exemption for charities' income is in taxpayers' favour in principle and may benefit some in practice, although the numbers affected and the amounts involved are likely to be small.

Change 83: Discounts: charge to tax as interest: section 381

This change provides for discounts taxed in the source legislation under section 18(1)(b) of ICTA and Schedule D Case III (b) to be taxed as interest.

Discounts have been part of the charge to tax under Schedule D Case III since at least 1805. Several tax cases have considered aspects of their tax treatment including the difficulties in determining the nature of a "discount" as compared with "interest". It has emerged from this case law that while the line between the terms can be difficult to identify, they are distinguishable in nature.

Discounts are nevertheless taxed in much the same way as interest. They are charged to tax on the person receiving or entitled to the discount: see section 59(1) of ICTA. Similarly, income tax is computed on the full amount of the income arising within the year of assessment without any deduction: see section 64 of ICTA.

Chapter 2 of Part 4 of this Act includes a specific charge to tax for interest which is extended to include other types of income which, in the source legislation, are treated as interest.

Section 381 provides that discounts, other than discounts in deeply discounted securities within Chapter 8 of Part 4 of this Act, are taxed under Chapter 2 of Part 4 of this Act as interest, so removing the necessity to distinguish between them for the purposes of the charge to income tax. It follows that the separate charge for these discounts is not rewritten in this Act.

This change has no implications for the amount of tax paid, who pays it or when.

Change 84: Dividends etc from UK resident companies: tax credits etc where dividends etc received by companies who pay income tax: sections 397, 399 and 400

This change involves applying sections 231(1) and (3) and 233(1) and (1A) of ICTA as if references to companies did not include companies receiving distributions in a fiduciary or representative capacity.

Section 6(2) of ICTA recognises that income may arise to a company:

- in a beneficial capacity; or
- in a fiduciary or representative capacity.

Broadly speaking, section 6(2) of ICTA prevents income tax applying to income arising to companies in a beneficial capacity. And section 8(2) of ICTA provides that corporation tax applies to profits arising to a company beneficially but excludes profits arising to a company in a fiduciary or representative capacity from corporation tax. The result is that a corporate trust is subject to income tax. The exception to this is that a non-UK resident company's profits are charged to income tax rather than corporation tax, even where it is beneficially entitled to them, except where UK permanent establishment business is involved. (See section 6(2)(a) of ICTA.)

Section 231(1) of ICTA provides that where a company resident in the UK makes a qualifying distribution and the person receiving the distribution is another such company (ie a UK resident company) or a person resident in the UK (not being a company), then the recipient of the distribution is entitled to a tax credit.

Section 231(1) of ICTA makes it clear that a UK resident company is entitled to a tax credit.

Section 231(3) and (3AA) of ICTA describe how the tax credit may be used. It may either be set against an income tax liability under section 3 of ICTA or against the person's income tax liability on total income for the tax year in which the distribution is made.

Section 231(3) of ICTA expressly excludes UK resident companies because it only applies to a person "not being a company resident in the United Kingdom".

It is unnecessary for section 231(3) and (3AA) of ICTA to extend to corporation tax and apply to UK resident companies liable to that tax because such companies do not pay corporation tax on qualifying distributions (see section 208 of ICTA). But, unless it is a mere nominee, a UK resident company receiving a distribution in a fiduciary or representative capacity is charged to income tax on the aggregate of the distribution and the tax credit (see paragraph 2 of Schedule F in section 20(1) and section 835(6)(a) of ICTA). So section 231(3) of ICTA excludes such a company from setting its tax credit against its income tax liability.

In practice, however, the Inland Revenue look at the capacity in which a company is acting and treat a company receiving a distribution in a representative or fiduciary capacity, and hence liable to income tax on it, as if it were an individual receiving it in that capacity. So, in effect, the words "a company resident in the United Kingdom" in section 231(3) of ICTA are taken to refer only to a UK resident company acting in a beneficial capacity. Therefore companies acting in a fiduciary or representative capacity are taken to fall within that section and so may use their tax credits. Section 397(2) gives effect to this by not excluding UK resident companies from claiming.

Similar difficulties arise over the wording of sections 233(1) and (1A) of ICTA.

Section 233(1) of ICTA provides for recipients of distributions to be treated as having paid income tax at the Schedule F ordinary rate on the amount of the distribution. It is expressed to apply if in a tax year the income of any person "not being a company resident in the United Kingdom" includes a distribution, in respect of which that person is not entitled to a tax credit.

So, on a literal interpretation of the phrase "not being a company resident in the United Kingdom" in section 233(1) of ICTA, all UK resident companies whether they are acting in a beneficial or in a fiduciary or representative capacity are excluded. But again because section 233(1) of ICTA is about income tax it does not need to exclude companies subject to corporation tax and it fails to deal with companies receiving distributions in a fiduciary or representative capacity.

In practice, however, the exclusion is only treated as applying to UK resident companies receiving distributions in a beneficial capacity. So a UK resident company acting in a fiduciary or representative capacity and falling within section 233(1) of ICTA is treated as having paid income tax under section 233(1). Sections 399(1) and (2) and 400(1) and (2) rewrite section 233(1) of ICTA and give effect to the practice by not excluding UK resident companies.

Section 233(1A) of ICTA follows on from section 233(1) of ICTA, but deals only with qualifying distributions. It provides that where the income of any person "who is not a company" and is non-UK resident includes a qualifying distribution in respect of which the person is not entitled to a tax credit, so much of the distribution as is comprised in:

(a) income on which the person is treated as having paid income tax at the Schedule F ordinary rate under section 233(1)(a) of ICTA, or

(b) income to which section 686 of ICTA applies (discretionary accumulation and maintenance trusts),

is treated for the purposes of those provisions as if it were grossed up at that rate. And for the purposes of those provisions income tax is treated as having been paid at that rate on it.

Again, strictly a non-UK resident company acting in a fiduciary or representative capacity does not fall within section 233(1A) of ICTA as it is a company. It can only fall within section 233(1) of ICTA (and so would not be subject to grossing-up). But, in practice, the same approach is followed for companies receiving the distribution in a fiduciary or representative capacity as with sections 231(1) of ICTA and 233(1) of ICTA. So section 233(1A) of ICTA is taken to apply to all non-residents, whether individuals or companies receiving the distributions in such a capacity. Section 399(3) and (4) follow this approach in rewriting section 233(1A) of ICTA without any exclusion for such companies.

In principle, this change is in taxpayers' favour so far as it relates to sections 231(3) and 233(1) of ICTA and is adverse to some taxpayers so far as it relates to section 233(1A) of ICTA. But it is expected to have no practical effect as it is in line with current practice.

Change 85: Stock dividends from UK resident companies: the net amount of stock dividends: section 412

This change relates to the simplification of the rules concerning the net amount of stock dividends.

Under section 249(4) of ICTA an individual is taxed on "income of an amount which, if reduced by an amount equal to income tax on that income at the Schedule F ordinary rate …, would be equal to the appropriate amount in cash". The expression "appropriate amount in cash" is defined in section 251(2) to (4) of ICTA. This covers a variety of possible situations.

Where the stock dividend is simply chosen in lieu of an ordinary cash dividend (that is, the stock dividend falls within section 249(1)(a) of ICTA), "the appropriate amount in cash" is the amount of the alternative cash dividend, unless that is substantially different from the share capital's market value. If it is substantially different (whether more or less), "the appropriate amount in cash" is that market value (see section 251(2)(a)(i) and (b) of ICTA). Statement of Practice A8 explains that the Inland Revenue generally regard a difference of 15% of the market value as substantial, but are normally prepared to allow a difference of 17%.

Where the stock dividend is bonus share capital (that is, the stock dividend falls within section 249(1)(b) of ICTA), the situation is more complicated.

If there is a related cash dividend (a separate cash dividend, payable in respect of a different class of shares in the company, the amount of which determines, or is determined by, the quantity of share capital issued as stock dividend), "the appropriate amount in cash" is the amount of that related cash dividend, unless that is substantially different from the share capital's market value. If it is substantially different (whether more or less), "the appropriate amount in cash" is that market value (see section 251(2)(a)(ii) and (b) of ICTA).

For these purposes, however, if there is also an accompanying cash dividend (a cash dividend in respect of the *same* shares as the stock dividend) the amount of the related cash dividend is treated as reduced by the amount of the accompanying cash dividend (see section 251(4) of ICTA).

If there is no related cash dividend, "the appropriate amount in cash" is the share capital's market value (see section 251(2)(b) of ICTA).

The provisions in ICTA are pretty complex, particularly where the stock dividend is bonus share capital. But, leaving aside the reduction under section 251(4) of ICTA, the general effect is to tax the cash dividend alternative or something not substantially different from the market value of the share capital.

Therefore in rewriting these provisions the rules which apply where the amount of the alternative cash dividend is not used have been modified so that, for a stock dividend taken in lieu of an ordinary cash dividend, it is clearly stated in section 412(2) that in the case of an issue of share capital in lieu of a cash dividend where the difference between the cash dividend alternative and the market value of the share capital exceeds 15% of that market value, the market value is taken instead. In addition, the rule in section 251(2)(a)(ii) and (4) of ICTA is omitted so that under section 412(3) for a stock dividend which is bonus share capital, the net amount will always be the share capital's market value.

This change is adverse to some taxpayers and favourable to others in principle and in practice. But the numbers affected and the amounts involved are likely to be small.

Change 86: Deeply discounted securities: deemed acquisitions at market value where deemed disposals on conversion of securities or transfer by personal representatives to legatees: section 441

This change provides that in the case of two sorts of disposals that are treated as made for amounts equal to market value, conversions of relevant discounted securities into other such securities and transfers by personal representatives to legatees, the corresponding acquisitions are treated as acquisitions for the same amounts.

Paragraph 1 of Schedule 13 to FA 1996 charges profits realised from the discount on a relevant discounted security and provides that the profit is realised when a person transfers such securities or becomes entitled to a payment on their redemption.

In four cases Schedule 13 to FA 1996 provides for a transfer of a relevant discounted security to be treated as made at market value and for the corresponding acquisition of the security to be treated as made at that value. They are transfers made on the death of a holder, transfers made otherwise than by a bargain at arm's length, transfers between connected persons and transfers for a consideration which is not wholly in money or money's worth. (See paragraphs 4(2), 8(2) and 9(2) of that Schedule.)

Paragraph 6(7) of Schedule 13 to FA 1996 also provides that where personal representatives transfer relevant discounted securities to legatees the personal representatives are treated as obtaining an amount equal to the securities' market value, and under paragraph 5 of Schedule 13 to FA 1996 where such securities are converted into shares or other securities the conversion is to constitute the redemption of the securities and "to involve a payment" on the redemption of an amount equal to the market value of the shares or securities. But no specific provision is made about the price that the legatees are treated as paying for the securities, nor the acquisition cost of any relevant discounted securities obtained as the result of a conversion of such securities. In practice, however, in both these cases the market value of the securities is taken as being an amount paid in respect of the acquisition of the security, and so is taken into account in calculating the profit or loss on a subsequent disposal of the securities.

Section 441 fills these gaps by providing that a person acquiring these securities on any of the transfers that are treated as occurring at market value or on the conversion of such securities into other such securities is treated as doing so by the payment of their market value.

In the case of the acquisition by legatees the only alternative for acquisition cost if the gap is not filled appears to be that the legatees acquire the securities for no cost. In that case the change would always be favourable to the taxpayer. In the case of the acquisition on conversion there are perhaps two possible alternatives if the gap is not filled. These are that the securities are acquired for no cost or acquired for the acquisition cost of the securities which are converted. If the securities are treated as acquired for no cost the effect is favourable to the taxpayer. If the original acquisition cost of the converted securities is used the effect would usually be favourable, but may not be in rare cases.

This change is favourable to most taxpayers in principle but may be adverse in rare cases. But it is expected to have no practical effect as it is in line with current practice.

Change 87: Strips of government securities: acquisitions and disposals: section 445

This change alters the time at which strips of government securities held at 5 April that are deemed to be transferred at market value on that day are re-acquired. The reacquisition is deemed to be immediate, rather than to occur on 6 April.

Paragraph 14(4) of Schedule 13 to FA 1996 provides that a person holding a strip of a government security on 5 April in any tax year is deemed to have transferred it on that day. (Strips are defined in paragraph 15(1) of Schedule 13 to FA 1996, and the definition is rewritten in section 444 of this Act.) The rule in paragraph 14(4) of Schedule 13 to FA 1996 only applies if no other disposal occurs on 5 April and ensures that anyone holding a strip is taxed, year by year, on the increasing value of the strip. The purpose of paragraph 14(4) of Schedule 13 to FA 1996 was to prevent strips becoming a tax avoidance vehicle, since otherwise investors might choose to invest in strips of securities, rather than in the securities themselves, so as to defer their tax liabilities instead of being taxed on interest from the securities year by year.

Under paragraph 14(4)(c) of Schedule 13 to FA 1996, the strip which is deemed to be transferred on 5 April is deemed to be reacquired on the next day (6 April), for its value on the day of the transfer (5 April).

There does not appear to be any reason for this delay of one day. It is simpler to provide that the strip is treated as disposed of and immediately reacquired and doing so removes the scope for confusion in the source legislation caused by the reacquisition on 6 April being deemed to be at the value of the strip on 5 April. It also removes the scope for confusion where there is an actual disposal on 6 April. Therefore, in rewriting paragraph 14(4)(c) of Schedule 13 to FA 1996, section 445(3) provides for strips that are treated as disposed of on 5 April at market value to be treated as having been immediately reacquired for the same amount, rather than being reacquired on the following day for that amount. Paragraph 80 of Schedule 2 to this Act preserves the position in the source legislation for strips held on 5 April 2005, so that they are deemed to have been reacquired on 6 April 2005 at market value on that day.

The change has no implications for the amount of tax paid, who pays it or when.

Change 88: Gains from contracts for life insurance etc: individuals who are not resident in the United Kingdom in the tax year not liable for tax: sections 465 and 539

This change gives statutory effect to part of Part 1 of ESC B53.

Section 547(1)(a) of ICTA provides that gains under Chapter 2 of Part 13 of ICTA are deemed to form part of an individual's total income for the tax year in which the chargeable event giving rise to the gain occurred if any of the following conditions are met. They are:

- that the rights under the policy or contract in question are vested in the individual as beneficial owner;

- that the rights under the policy or contract are held on trusts created by the individual; or
- that the rights are held as security for a debt owed by the individual.

Section 547(1)(a) of ICTA applies wherever the individual is resident. (Section 549 of ICTA (corresponding deficiency relief) applies similarly.) But Part 1 of ESC B53 provides that the Inland Revenue will not pursue liability to tax on a gain that is treated as income of an individual who is not resident in the UK at any time during the tax year in which the gain is chargeable.

Section 465 gives statutory effect to this part of the concession by providing that an individual is only liable for tax under Chapter 9 of Part 4 of this Act, which rewrites Chapter 2 of Part 13 of ICTA, if the individual is UK resident in the tax year in which the chargeable gain arises.

Under section 549 of ICTA certain deficiencies are allowable as deductions if, had such an excess as is mentioned in section 541(1)(a) or 543(1)(a) of ICTA arisen, it would have been treated as a gain and would form part of the individual’s total income for the final year of the policy in question. In rewriting this relief for deficiencies, section 539 provides for the relief to apply also where the gain would form part of the individual’s total income apart from the condition in section 465 requiring UK residence, so that a non-UK resident individual continues to be eligible for the relief despite the new condition. But in some circumstances the effect of the condition in section 465 may be to reduce the amount of relief to which an individual is entitled. This will happen if an individual was not liable at all for earlier gains because of the operation of the condition, and so they did not form part of the individual’s total income as required by section 541(4)(b) of this Act (calculation of deficiencies).

This change is broadly in taxpayers' favour in principle. But it is expected to have little practical effect as it is in line with current practice. It may reduce the amount of relief for deficiencies. But the numbers affected and the amounts involved are likely to be small.

Change 89: Gains from contracts for life insurance etc: disregard of alteration of terms of old life insurance policies where insurer stops collecting premiums: sections 488 and 489

This change gives statutory effect to part of ESC A96.

Alterations in the terms of a life insurance policy may simply have the effect of varying the terms of the policy or they may result in the replacement of the policy. The result of varying the terms or replacing the policy may be that a charge to tax will arise on later events, such as the surrender or maturity of the policy, which would not otherwise have arisen. For example, this could occur because after the alteration the policy is no longer a qualifying policy, as defined in Schedule 15 to ICTA. (Qualifying policies are normally outside the chargeable event gains regime in Chapter 2 of Part 13 of ICTA.) It could also occur because the alteration causes a policy which was entirely outside the chargeable event regime or particular provisions of it to be brought within it. For instance, this could happen where the policy commenced before 20 March 1968 (the date of introduction of the chargeable event gains regime).

ESC A96 is concerned with a particular sort of alteration in terms of policies. It is sometimes uneconomical for insurers to collect premiums on old policies because of the small sums involved. If they agree to stop collecting such premiums, that may be an alteration in the terms of the policies. But ESC A96 provides that, for the purposes of the chargeable event gains regime in Chapter 2 of Part 13 of ICTA, an alteration in the terms of a life insurance policy should be ignored if it results from a decision by an insurer to stop collecting premiums on a number of policies of the same description because it is no longer economically viable to do so. ESC A96 only applies where the policy was issued at least twenty years before the alteration and the alteration is not itself a chargeable event. (ESC A96 also provides for such alterations to be ignored for the purposes of Schedule 15 to ICTA (qualifying policies).)

Sections 488 and 489 give statutory effect to the concession so far as they provide that such alterations are ignored for the purposes of determining whether a chargeable event has occurred in relation to a policy or contract.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 90: Gains from contracts for life insurance etc: allowing the deduction of gains previously charged on related policies to be made in calculating later gains: section 491(5)

This change enables gains charged on an earlier chargeable event in respect of a policy of life insurance to be deducted in calculating the gains from a later chargeable event in respect of a related policy.

Section 541 of ICTA provides the rules for computing chargeable event gains on policies of life insurance and is expressed in section 541(1) of ICTA to apply to “any policy of life insurance”, which is referred to later as “the policy”.

Section 541(1) of ICTA provides that premiums previously paid under the policy are deductible in calculating chargeable event gains. Section 541(5)(b) of ICTA provides that in relation to premiums references to “the policy” include references to “any related policy, that is to say, to any policy in relation to which the policy is a new policy within the meaning of paragraph 17 of Schedule 15 to ICTA, and any policy in relation to which that policy is such a policy, and so on”. (Under Schedule 15 to ICTA a “new policy” is created when one policy is issued in substitution for or on the maturity of another policy by way of an option conferred by the other policy.) So section 541(5)(b) of ICTA ensures that premiums paid in respect of one policy are allowed as a deduction in computing the gain on the second or later policy to which the first policy is related.

Section 541(1) of ICTA also allows the amount treated as a gain on the happening of previous chargeable events in relation to a policy to be deducted in calculating the chargeable event gains in respect of the policy. But section 541(5)(b) of ICTA only deals with the deduction of premiums in respect of related policies and does not make any corresponding provision about such gains on the happening of previous chargeable events in respect of related policies. This appears to have been an oversight and, in practice, gains in respect of related policies are deducted from a final gain on a second or later policy.

Section 491 gives effect to this practice by providing in subsection (2) that “PG” (defined as any gains on a previous calculation event in relation to the policy or contract) are to be deducted in calculating the gains, and then providing in subsection (5) that the reference to the policy in the definition of “PG” includes related policies, as defined in subsection (6).

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 91: Gains from contracts for life insurance etc: disregard of trivial inducement benefits: section 497

This change gives statutory effect to part of ESC B42 under which small non-monetary inducements to enter into insurance contracts are disregarded for the purposes of Chapter 2 of Part 13 of ICTA.

Gifts may be offered by insurers to attract insurance business. These may take a variety of forms, including small consumer goods, store vouchers and discounts offered by travel agents etc.

Under section 541(1) of ICTA on the happening of a chargeable event the amount or value of any relevant capital payments in respect of a life policy may be brought into the computation of the chargeable gain. Such payments are defined in section 541(5)(a) of ICTA so as to include, broadly, any sum or other benefit of a capital nature. This could include the value of gifts. Similar provisions apply in the case of life annuity contracts and capital redemption policies (see sections 543(1) and (3) and 545(3) of ICTA).

ESC B42 prevents non-monetary gifts, not exceeding £30 in value in aggregate, that are made as an incentive in connection with an insurance from being brought into the calculation of the chargeable gains. (It also prevents such gifts from being taken into account in determining if a policy is a qualifying policy within Schedule 15 to ICTA.)

Section 497 gives statutory effect to the concession so far as it prevents such gifts being brought into the computation of a gain. Section 497(3) also provides that the £30 limit may be increased by an order made by the Treasury.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 92: Gains from contracts for life insurance etc: removal of requirement for calculation under section 546(1) of ICTA to be made annually: section 498

This change replaces the requirement that the calculation under section 546(1) of ICTA should be made annually with a requirement that it should be made only where relevant partial surrenders and assignments of rights under insurance policies and contracts have occurred.

Under sections 540(1)(a)(v), 542(1)(c), 545(1)(d) and 546C(7)(a) of ICTA, a chargeable event is treated as occurring at the end of a policy year where the calculation mentioned in section 546(1) of ICTA produces an “excess”. In broad terms, the calculation compares the proceeds of a part surrender or part assignment of rights in the policy or contract that has occurred in the policy year with a portion of the premiums or other consideration paid under it to date.

Section 546(1) of ICTA requires that calculation to be performed “as at the end of each year” (that is, successive 12 month periods beginning with the making of the insurance or contract: see section 546(4) of ICTA). But unless an assignment for money or money’s worth or a surrender has occurred during the policy year, the calculation cannot show a gain, and so will be otiose for the purposes of Chapter 2 of Part 13 of ICTA.

The requirement to carry out that calculation is rewritten primarily in section 498, which is expressed only to apply if there has been an assignment for money or money’s worth or a surrender of a part of or share in the rights under a policy or contract in an insurance year. (“Insurance year” is defined in section 499 which mirrors section 546(4) of ICTA.)

This change has no implications for the amount of tax due, who pays it or when. It affects (in principle and in practice) only administrative matters.

Change 93: Gains from contracts for life insurance etc: treating taking a capital sum under a contract for a life annuity as a surrender of a part of the rights under the contract for all purposes: section 500

This change involves treating the taking of a capital sum under a contract for a life annuity as a surrender of part of the rights under the contract for all purposes of Chapter 2 of Part 13 of ICTA, and not just for sections 542 and 543 of ICTA.

Sections 542 and 543 of ICTA deal respectively with chargeable events in respect of life annuity contracts and the computation of gains in respect of such contracts. Under section 542(2) of ICTA, where a contract provides for the payment of a capital sum as an alternative to annuity payments, the taking of the capital sum is treated as a surrender in whole or part of the rights under the contract. Section 542(2) of ICTA is expressed as applying for the purposes of sections 542 and 543 of ICTA. But, in fact, it is section 546 of ICTA which deals with the calculations which have to be made to see if a gain has arisen on part surrenders or assignments, although section 542(1)(c) of ICTA refers to such calculations under section 546 of ICTA and lists an excess in such a calculation as a chargeable event for such contracts. Section 546(1) of ICTA is expressed to apply for the purposes of section 542 of ICTA. But the result is that it is not entirely clear whether the taking of a capital sum in these circumstances is a surrender for the purposes of section 546 of ICTA or the alternative regime for taxing excesses under section 546 of ICTA that now applies under sections 546B to 546D of ICTA.

In practice, the taking of a capital sum is treated as a surrender in whole or part of the rights under the contract for the purposes of the calculations under sections 546 and 546B to 546D of ICTA. Section 500(b) clarifies the position by providing that the taking of a capital sum is treated as a partial surrender for the purposes of the whole of Chapter 9 of Part 4 of this Act (which corresponds to Chapter 2 of Part 13 of ICTA). So it reflects current practice.

This change provides a clarification of the law. But it is expected to have no practical effect as it is in line with current practice.

Change 94: Gains from contracts for life insurance etc: enactment of regulations about personal portfolio bonds in primary legislation: sections 515 to 526

This change replaces regulations about personal portfolio bonds made by the Treasury under section 553C of ICTA with provisions in primary legislation, and cuts down the power in section 553C of ICTA as a result.

Section 553C of ICTA confers a wide power on the Treasury to use regulations to impose a yearly charge to tax in relation to personal portfolio bonds. It permits the regulations to make provision about matters such as the method by which the charge to tax is imposed and its administration. The section defines "personal portfolio bond", but the regulations can in effect make certain modifications to that definition. In particular they can prescribe property and indexes which may be selected without a policy or contract being a personal portfolio bond.

The regulations under section 553C of ICTA are rewritten in Chapter 9 of Part 4 of this Act, so far as they apply in relation to income tax. Section 516 defines "personal portfolio bond", for example, and sections 518 to 521 make provision about the kinds of index or property which may be selected without a policy or contract being a personal portfolio bond. Sections 522 to 524 set out the method for calculating the charge to tax on personal portfolio bonds. The regulations continue to apply in relation to corporation tax.

Section 526 contains a power to make regulations about certain matters in relation to the personal portfolio bond provisions in Chapter 9 of Part 4 of this Act. The power is more limited than the power in section 553C of ICTA. This reflects the fact that provision about personal portfolio bonds has now been made in the regulations and in this Act.

The only matter that can be dealt with in regulations under section 526 is the administration of the charge to tax on personal portfolio bonds. Any other changes to the personal portfolio provisions in this Act need to be made in primary legislation.

This matter can be dealt with in the regulations themselves or by modifications to Chapter 9 of Part 4 of this Act or Chapter 2 of Part 13 of ICTA. Chapter 2 of Part 13 of ICTA includes certain administrative provisions which apply in relation to income tax. So section 526 includes a power to amend those provisions as they apply to personal portfolio bonds.

The power in section 526 for regulations to be made which amend primary legislation reflects the power under section 553C of ICTA to amend the regulations about personal portfolio bonds, and to exclude or apply (with or without modifications) other provisions of Chapter 2 of Part 13 of ICTA in relation to personal portfolio bonds.

This change has no implications for the amount of income liable to tax, who pays it, or when. It affects only the method by which the provisions on personal portfolio bonds may be amended in the future.

Change 95: Gains from contracts for life insurance etc: reductions for sums chargeable to tax apart from section 547(1) of ICTA: section 527

This clarifies the meaning of the exception from the charge to tax under section 547(1) of ICTA given by section 547(2) of ICTA for any amount chargeable to tax apart from section 547(1) of ICTA.

Section 547 of ICTA deals with the method of charging chargeable event gains to tax. This differs according to the person who is interested in the policy. For example, under section 547(1) of ICTA where the rights in a policy or contract are held by an individual as beneficial owner the gain forms part of the individual's total income. However, section 547(2) of ICTA states "Nothing in subsection (1) shall apply to any amount which is chargeable to tax apart from that subsection.".

In practice, the words "amount which is chargeable to tax" in section 547(2) of ICTA are taken to mean the amount of the receipts and credits taken into account for the purposes of ascertaining the overall taxable profit under another provision, rather than the actual amount that is charged to tax under another provision, which in the case of a trader, for instance, will be the net profits of the trade.

Section 527 which rewrites section 547(2) of ICTA makes it clear that the amount chargeable to tax under Chapter 9 of Part 4 of this Act is reduced by the amount of the receipt or other credit item that is taken into account in calculating the amount on which income tax is charged otherwise than under Chapter 9 of Part 4 or the amount on which corporation tax is charged.

This change provides a clarification of the law. But it is expected to have no practical effect as it is in line with current practice.

Change 96: Gains from contracts for life insurance etc: reduction in gains where non-UK resident trustees hold policy: section 529

This adopts the conditions for trustees' residence in section 110 of FA 1989 for the purposes of the disapplication of the rule in section 553(3) of ICTA about reduction of gains chargeable under Chapter 2 of Part 13 of ICTA where the policy was held by non-UK resident trustees.

Section 553(3) of ICTA provides that in the case of new non-resident policies and new offshore capital redemption policies (as defined in section 553(10) of ICTA) the gain that would otherwise arise under section 541 or 546C(7)(b) of ICTA is reduced to the proportion of it that corresponds with the proportion of the period during which the policy has been in force that the policyholder was resident in the United Kingdom.

Under section 553(5) of ICTA if, when the gain arises or at any time during that period, the policy is or was held by a trustee resident outside the United Kingdom or by two or more trustees *any of whom* is or was so resident, the reduction under section 553(3) of ICTA is only made if -:

(a) the insurance was made before 20 March 1985; and

(b) on 19 March 1985 the policy was held by a trustee who was so resident or, as the case may be, by two or more trustees any of whom was so resident.

However, the residence of a body of trustees is now generally determined by section 110 of FA 1989, so that if at least one of them is and at least one of them is not UK resident, they are all treated as UK resident or not UK resident according to the rule in section 110(1) of FA 1989, regardless of their individual status. Under section 110(6) of FA 1989, that section only applies for the tax year 1989-90 and subsequent years, so it would not apply to determine the trustees' residence for section 553(5) of ICTA before that time.

Section 529(1) rewrites section 553(5) of ICTA for insurances made on or after 20 March 1985. Section 529 (1)(b) disapplies section 528 (the rewritten section 553(3) of ICTA) if, when the gain arises or at any time during the policy period, the policy is or was held by non-UK resident trustees. So the trustees are looked at as a group, rather than individually. Section 529(2) applies section 110 of FA 1989 whenever the policy period starts. Therefore the same test for the trustees' residence will apply throughout.

This change provides a clarification of the law. But it is expected to have no practical effect as it is in line with current practice.

Change 97: Gains from contracts for life insurance etc: clarification of entitlement to credit for income tax at the lower rate in the case of certain foreign life insurance policies: section 531(5)

This change clarifies the interpretation of section 553A(3) of ICTA, making it clear that an individual who is chargeable on gains from certain foreign life insurance policies is treated as having paid income tax at the lower rate under section 547(5) of ICTA.

Under section 547(1)(a) of ICTA a gain treated as arising on a chargeable event may be treated as part of an individual's total income. Section 547(5) of ICTA provides that the individual is treated as having paid income tax at the lower rate on the amount so treated. This is subject to some complex exceptions which deny the relief to certain foreign contracts and policies.

Section 547(6) of ICTA denies the benefit of section 547(5) of ICTA to certain life annuity contracts except where section 547(6A) and (7) of ICTA apply. (The exception in section 547(6A) of ICTA is not relevant here.) Section 547(7) of ICTA disapplies section 547(5) of ICTA for gains in connection with policies issued by a friendly society in the course of tax exempt life or endowment business, except so far as calculating top slicing relief under section 550 of ICTA is concerned.

Section 553 of ICTA makes provision about certain foreign policies. Section 553(6) of ICTA denies the benefit of section 547(5) of ICTA to new non-resident policies and new offshore capital redemption policies subject to similar exceptions to those that apply to section 547(6) of ICTA. (The exception in section 553(6A) of ICTA corresponds to that in section 547(6A) of ICTA and is not relevant here.) Section 553(7) of ICTA disapplies section 553(6) of ICTA where a new non-resident policy meets the conditions in paragraph 24(3) of Schedule 15 to ICTA (policies which are part of the insurer's UK taxed business).

Section 553A of ICTA makes provision about a further class of "foreign policy" (policies issued as part of the overseas life assurance business of a UK insurer). Section 553A(1) of ICTA provides that these are treated as if they were new non-resident policies, and so they would come within the terms of section 553(7) of ICTA if they met the conditions in paragraph 24(3) of Schedule 15 to ICTA. But section 553A(3) of ICTA provides that section 553(7) of ICTA does not apply to gains arising on new non-resident policies.

However, the intention was that section 553A(3) of ICTA should only apply to policies treated as new non-resident policies under section 553A(1) of ICTA and in practice that is how it is interpreted. Otherwise, section 553(7) of ICTA would be otiose.

Section 553(7) of ICTA is rewritten in section 531 so that it continues to apply to foreign policies of life insurance (see section 531(3)), other than those which meet the conditions in section 531(5) and (6). Section 531(5) refers to policies within paragraph (a) of the definition of a "foreign policy of life insurance" in section 476(3) of this Act. Policies that are foreign policies by virtue of section 553A of ICTA are covered by paragraph (b) of that definition and so they are excluded.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 98: Gains from contracts for life insurance etc: removal of requirement for claims for top slicing relief: section 535(1)

This change removes the requirement that a claim must be made for relief to be given under section 550 of ICTA in respect of tax on gains under Chapter 2 of Part 13 of ICTA.

Although a gain that is chargeable under Chapter 2 of Part 13 of ICTA will accrue over the life of an insurance, the whole of the gain will usually fall to be charged in one tax year. Higher rate tax liability may therefore arise when there would have been no such liability had the gain been spread throughout the period of the insurance. To compensate for the effect of assessing a gain in a single year, section 550 of ICTA provides for relief to be given. The relief only applies where there is a charge to higher rate tax and it is the chargeable event gain itself which brings the taxpayer into the higher rate field.

Section 550(1) of ICTA provides that the relief is given on the making of a claim to the Board of Inland Revenue. In practice, however, relief under section 550 of ICTA is given automatically, just as relief for deficiencies under section 549 of ICTA is given, and the requirement for a claim for relief is ignored.

Therefore in rewriting section 550 of ICTA, section 535(1) provides that a person is entitled to relief in the relevant circumstances, but does not require that a claim be made before the relief is given.

This change has no implications for the amount of tax due, who pays it or when. It affects (in principle and in practice) only administrative matters.

Change 99: Gains from contracts for life insurance etc: definition of "insurance company": section 545(1)

This change introduces a definition of "insurance company" for the purposes of the chargeable event gains regime in Chapter 2 of Part 13 of ICTA.

Although Chapter 2 of Part 13 of ICTA contains several references to insurance companies, it does not define "insurance company". This is inconsistent with more recent legislation using the term "insurance company" which does provide a definition. See, for instance, section 333B(9) of ICTA (insurance element of individual savings accounts), which was inserted by FA 1998 and amended by the Financial Services and Markets Act 2000 (Consequential Amendments) (Taxes) Order 2001 (SI 2000/3629). In practice, the definition in section 333B(9) of ICTA is the one used for the purposes of Chapter 2 of Part 13 of ICTA too.

Accordingly, that definition has been adopted in section 545(1) for the purposes of the whole of Chapter 9 of Part 4 of this Act.

This change provides a clarification of the law. But it is expected to have no practical effect as it is in line with current practice.

Change 100: Gains from contracts for life insurance etc: definition of "market value": section 545(1)

This change involves defining "market value" for the purposes of the provisions which relate to gains from contracts for life insurance etc.

Section 541(3) of ICTA provides that where an assignment of the rights under a policy of life insurance takes place between connected persons, it is deemed to have been made for a consideration equal to the market value of the rights assigned. Section 543(2) of ICTA applies the same rule to an assignment of the rights conferred by a contract for a life annuity between connected persons. "Market value" is not defined for either purpose.

The definition of "market value" in section 545(1) is by reference to section 272 of TCGA but it also mentions section 273 of that Act. Section 272(1) of TCGA defines the "market value" of assets as the price which those assets might reasonably be expected to fetch on a sale in the open market. The remainder of section 272, and section 273, of TCGA provide some further guidance about the operation of the rule in different contexts.

The definition of "market value" reflects the ordinary common sense meaning of that term, and so how that term as it relates to Chapter 2 of Part 13 of ICTA would otherwise be understood.

The intention behind sections 541(3) and 543(2) of ICTA is that the consideration that would have been payable on an arm's length transaction is brought into account. The definition of "market value" makes this clear.

Similarly, where it is necessary for the purposes of Chapter 2 of Part 13 of ICTA to value property other than cash transferred to an insurance company in satisfaction of a premium, the price the property would achieve on an open market sale will be used. Again the definition will clarify that this is the approach taken in Chapter 9 of Part 4 of this Act.

This change provides a clarification of the law. But it is expected to have no practical effect as it is in line with current practice.

Change 101: Disposals of futures and options involving guaranteed returns: foreign non-trading income: section 555

This change provides for profits and gains, other than trading profits, that arise from disposals of futures and options involving guaranteed returns and fall within Schedule D Case V to be charged to tax under Chapter 12 of Part 4 of this Act (which rewrites Schedule 5AA to ICTA: disposals of futures and options involving guaranteed returns).

Paragraph 1(2) of Schedule 5AA to ICTA excludes from the charge under that Schedule "so much of any profits or gains arising to a person from a transaction as are charged to tax in his case under Case I or Case V of Schedule D". It appears that the intention in mentioning Schedule D Case V was to exclude foreign trade profits, rather than all income that falls into Schedule D Case V.

Following the decision in Cooper v Stubbs (1925), 10 TC 29 CA, profits of the kind charged by Schedule 5AA to ICTA would fall into Schedule D Case VI if they were from a source in the United Kingdom and not trading profits. So if such profits arose from a foreign possession other than a trade, they would be chargeable under Schedule D Case V. However, income from such dealing is extremely unlikely to arise outside the United Kingdom in the hands of a United Kingdom resident.

Section 128(1) of ICTA exempts from any charge to tax under Schedule D "any gain arising to a person in the course of dealing in commodity or financial futures or in qualifying options, which is not chargeable to tax in accordance with Schedule 5AA to ICTA and apart from [that section] would constitute profits or gains chargeable to tax under Schedule D *otherwise than as the profits of a trade*".

The result of a person's gains of this kind being exempted by section 128 is that the person's outstanding obligations under any futures contract entered into in the course of the dealing in question and any qualifying option granted or acquired in the course of it are regarded under section 143(1) of TCGA as chargeable assets, so that gains on their disposal fall within that Act.

Therefore if all gains from disposals of futures and options involving guaranteed returns that are foreign income within Schedule D Case V, other than those that constitute trade profits, are excluded from the charge under Schedule 5AA to ICTA by paragraph 1(2) of that Schedule, they are exempted from income tax, only to be treated as capital gains. There is no obvious reason why income of this sort should have been treated in this way. So it appears that paragraph 1(2) of Schedule 5AA to ICTA should have excluded from the charge under that Schedule only profits or gains charged to tax under Schedule D Case I or Case V "as the profits of a trade", so as to correspond with the wording of section 128(1) of ICTA.

Schedule 5AA to ICTA is rewritten in Chapter 12 of Part 4 of this Act and the charge in section 555 does not exclude foreign profits and gains from disposals. The former residual charge under Schedule D Case V on foreign profits and gains from disposals that are not trading profits is rewritten in Chapter 8 of Part 5 of this Act. Since the charge in section 687 of that Chapter only applies to income not otherwise charged to income tax, it will not apply to foreign profits charged under Chapter 12 of Part 4. So they will fall solely within that Chapter. The exemption under section 128 of ICTA is rewritten in section 779 but will not apply to these foreign profits, since it only applies to income within Chapter 8 of Part 5 of this Act.

This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 102: Guaranteed returns on futures and options: associated companies: section 561

This change relates to the omission of references to associated companies in paragraph 5(3) and (4) of Schedule 5AA to ICTA.

Schedule 5AA to ICTA (guaranteed returns on transactions in futures and options) originally applied for both income tax and corporation tax purposes. Paragraph 5 of Schedule 5AA explains the meaning of references in the Schedule to the return from one or more disposals. Under paragraph 5(1)(a) these are references to the return on investment represented by the total net profits and gains arising from the disposal or disposals.

Paragraph 5(2) of Schedule 5AA provides that where profits and gains are realised on more than one disposal by associated persons those profits or gains are treated as realised by the same person. Paragraph 5(3) then explains when persons are associated for the purposes of paragraph 5(2). The definition includes persons who are or have been associated companies (see paragraph 5(3)(b) and (3)(c)), and "associated company" is defined in paragraph 5(4) by reference to section 416 of ICTA.

FA 2002 amended Schedule 5AA to ICTA so that it does not apply for corporation tax purposes with effect for accounting periods beginning after 30 September 2002. It repealed most references in the Schedule to companies. Although Schedule 5AA continues to apply to companies liable to income tax, companies are only so liable if they are acting in a fiduciary or representative capacity or are non-resident. The extension of the definition of associated person to include associated companies was not originally intended to refer to companies liable to income tax (although it could do so) and appears to have been overlooked when Schedule 5AA was amended in 2002. The provisions about when persons are associated for this purpose in section 561(3) to (6) does not include association by companies.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 103: Charge on income treated as arising from foreign holdings: foreign dividend coupons: section 570

This change clarifies two points in rewriting section 18(3B) of ICTA. First, that a "bank in the United Kingdom" means a bank's office in the United Kingdom, whether the bank is resident in the United Kingdom or abroad. Second, that a "dealer in coupons in the United Kingdom" means a coupon dealer carrying on business in the United Kingdom, whether the dealer is resident in the United Kingdom or abroad.

Section 18(3B) of ICTA provides that a charge under Schedule D Cases IV or V arises on the sale or other realisation of coupons for foreign dividends by a "…bank in the United Kingdom…" which pays over the proceeds or carries them to an account. This is interpreted by the Inland Revenue to mean the office in the United Kingdom of a bank, whether that bank is incorporated in the United Kingdom or abroad. Similarly, a sale of such coupons to a "…dealer in coupons in the United Kingdom…" is taken to mean a coupon dealer carrying on business in the United Kingdom, whether resident in the United Kingdom or abroad.

Section 570 is based principally on section 18(3) and (3B) of ICTA. It treats income as arising from foreign holdings where a dividend coupon attached to the holding is (a) sold or otherwise realised by a bank in the United Kingdom, or (b) sold to a coupon dealer in the United Kingdom by someone other than a bank or coupon dealer. So subsection (3) of the section refers to "… a bank's office in the United Kingdom…" and subsection (4) refers to a person "…dealing in coupons in the United Kingdom…" in rewriting section 18(3B) of ICTA.

Where section 18(3B) of ICTA does not apply then section 730 of ICTA may apply to tax the coupon sales to income tax under Schedule D Case VI. An alternative interpretation to "in the United Kingdom" may, depending on circumstances, take a sale of coupons out of one provision and into another. Whether more tax is paid as a result of being taxed under section 570 of this Act or section 730 of ICTA depends on the taxpayer's own circumstances.

This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 104: Death of a seller of patent rights: time for serving notice: sections 593 and 862

This change relates to the correction of an omission to revise, in connection with the Self Assessment reforms, the time limit for serving a notice under section 525(2) of ICTA.

Section 525(2) of ICTA sets a period within which the personal representatives of a seller of patent rights who has died may claim a reduction in the tax payable out of the estate. The claim must be made "not later than 30 days after notice has been served on them" of the charge falling to be made under section 525(1) of ICTA.

The system of Self Assessment for personal tax applied from the tax year 1996-97 onwards. Schedule 21 to FA 1996 contained amendments of provisions setting time limits for claims, elections etc to align them with the time limits for certain actions under the Self Assessment system, such as the filing of tax returns. The normal time limit for filing a personal return containing a self-assessment is 31 January following the tax year to which the return relates.

When a person dies, his personal representatives are responsible for making any Self Assessment return for the year of death and agreeing and settling all tax liabilities up to and including the year of death. It therefore makes sense to align the time limit in section 525(2) of ICTA with the normal Self Assessment time limit.

Schedule 21 to FA 1996 did not amend the time limit in section 525(2) of ICTA. This omission has been corrected by revising the time limit in the rewritten legislation.

This change has no implications for the amount of tax due, who pays it or when. It affects (in principle and in practice) only administrative matters.

Change 105: Settlements: approved pension arrangements: section 627 and paragraph 132 of Schedule 2

This change provides for pension arrangements prescribed by regulations made under the Welfare Reform and Pensions Act 1999 and the Welfare and Reform and Pensions (Northern Ireland) Order 1999 to fall within the definition of a "relevant pension scheme", benefits of which are not treated as income of the settlor. This is in place of a pension arrangement of any description which may be prescribed by regulations made by the Secretary of State under section 660A(11)(c) of ICTA (and section 660A(11)(g) for 2005-06).

Section 660A(1) of ICTA treats as income of the settlor income arising under a settlement from property in which the settlor retains an interest. But Section 660A(9)(c) of ICTA provides that a benefit under a relevant pension scheme will not be treated as the settlor's income. Section 660A(11) of ICTA defines a relevant pension scheme. This includes (subsection (11)(c)) "a pension scheme of any description which may be prescribed by regulations made by the Secretary of State".

The exclusion from the settlements charge for benefits from certain pension schemes was introduced into the settlements legislation by paragraph 26 of Schedule 13 to FA 2000 as section 660A(11). Section 660A(11)(g) of ICTA included within the approved arrangements pensions prescribed by regulations made by the Secretary of State. Paragraph 28 of Schedule 35 to FA 2004 amended these provisions for the tax year 2006-07 onwards but retained the exemption for pensions prescribed by regulations previously in section 660A(11)(g) of ICTA. The purpose of section 660A(11)(g) of ICTA was to provide the powers for regulations to be made by the Secretary of State. The wording of paragraph 26 of Schedule 13 to FA 2000 was borrowed almost in its entirety from section 11(2) of the Welfare Reform and Pensions Act 1999. But, in error, section 83 of that Act, which provides the supporting legislation for such regulations, was not legislated in FA 2000.

As a result, the powers in section 660A(11)(g) of ICTA and, following FA 2004, subsection 11(c) are inadequate to make regulations. However the intention was that regulations made under section 660A(11)(g) of ICTA (and hence also, for the tax year 2006-07 onwards, section 660A(11)(c) of ICTA) should be the same as those made under section 11(2)(h) of the

Welfare Reform and Pensions Act (currently the Occupational and Personal Pension Schemes (Bankruptcy) (No 2) Regulations SI 2002/836) and in practice the pension arrangements in these regulations are accepted under section 600A(11)(g) of ICTA.

Rather than rewrite in Chapter 5 of Part 5 of this Act the powers in section 83 of the Welfare Reform and Pensions Act, it is considered simpler to include directly the arrangements within the regulations made under that Act. A reference to the equivalent legislation for Northern Ireland (Article 12(2)(h) of the Welfare and Reform and Pensions (Northern Ireland) Order 1999) has also been included. The relevant regulations here are in SI 1999/3417 (N.I.11).

The reference in section 660A(11)(g) (and (11)(c)) of ICTA to "Secretary of State" is not rewritten as it is, as a result of this change, unnecessary.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 106: Beneficiaries' income from estates in administration: set off of excess of allowable estate deductions in the final tax year of the administration period: beneficiaries with absolute interests: section 660

This change provides for any amounts that are allowable against the aggregate income of the estate in calculating the residuary income of the estate in the tax year in which the administration period ends, but cannot be so allowed because they exceed that income, to be set off against the amount in respect of which the beneficiary with an absolute interest is taxable or, if there is more than such beneficiary, for a just and reasonable part to be set off.

Section 697(1A) of ICTA provides that where the deductions for any year exceed the aggregate income of the estate, the excess shall be carried forward and treated as an allowable deduction in the following year. Clearly, this is not possible in the tax year in which the administration period ends. In practice, however, excess deductions may be set off against any residuary income of the estate which has not been paid out. (This is often necessary since personal representatives may incur a high proportion of expense on the estate towards the end of the administration period, for example, because of the billing of legal or accountancy fees at the end.)

In rewriting section 697(1A) of ICTA, section 660(3) of this Act reflects that practice by providing for a person's basic amount of estate income for that year (that is, the person's share of the residuary income of the estate that has not yet been paid out) to be reduced by the excess deductions. If there is more than one absolute interest in the residue of the estate at the end of the administration period a just and reasonable part of the excess is subtracted.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 107: Beneficiaries' income from estates in administration: exclusion of income from specific dispositions and income from contingent interests from the aggregate income of the estate: sections 664 and 666

This change excludes income from specific dispositions and income from contingent interests from the aggregate income of an estate (which is used to compute the residuary income of an estate and hence affects the amount of estate income that is chargeable to tax where a person has an absolute interest in the estate) and from the deductions made in determining the residuary income of the estate.

The aggregate income of the estate is defined in section 701(8) of ICTA as:

"the aggregate income from all sources (for the tax year in question) of the personal representatives of the deceased as such, treated as consisting of –

(a) any such income which is chargeable to United Kingdom income tax by deduction or otherwise, such income being computed at the amount on which tax falls to be borne for that year; and

(b) any such income which would have been so chargeable if it had arisen in the United Kingdom to a person resident and ordinarily resident there, such income being computed at the full amount thereof actually arising during the year, less such deductions as would have been allowable if it had been charged to United Kingdom income tax;

but excluding any income from the property devolving on the personal representatives otherwise than as assets for the payment of the debts of the deceased.

Property that is the subject of a specific disposition is available for the payment of the deceased's debts and so is not excluded. However, under section 697(1)(b) of ICTA "the amount of any of the aggregate income of the estate for [a tax year] to which a person has on or after assent become entitled by virtue of a specific disposition either for a vested interest during the administration period or for a vested or contingent interest on the completion of the administration" is deductible from the aggregate income of the estate for that year in calculating the amount of the residuary income of an estate for that year. The Scottish version of this provision omits the words "on or after assent" and the words following "specific disposition": see section 702(b) of ICTA. But the inclusion of the words "on or after assent" for the rest of the United Kingdom means that much of the income of the specific disposition will form part of the aggregate income. The result is that the measure of the income taken to be available to residuary beneficiaries is inflated.

In practice, the Inland Revenue allow all income from specific dispositions to be deducted from the aggregate income of the estate in calculating the residuary income of the estate. But it is considered simpler for it merely to be excluded from what counts as the aggregate income and not to be deducted from it. Accordingly, the definition of "the aggregate income of the estate" in section 664 contains an exclusion for all income from specific dispositions to which a person is or may become entitled at subsection (5)(a). In consequence, the deduction for this income in section 697(1)(b) of ICTA and its adaptation for Scotland in section 702(b) of ICTA are not rewritten.

Since tax is treated as having been paid at the basic rate on this income, any reduction in the income taken to be available to beneficiaries as a result of this change will result in beneficiaries who pay tax at rates above the basic rate paying less tax, but those not liable to income tax, or liable to tax only at rates below the basic rate, may not be able to reclaim so much tax.

This change is adverse to some taxpayers and is favourable to others in principle and in practice. But the numbers affected and the amounts involved are likely to be small.

Change 108: Beneficiaries' income from estates in administration: removal of the requirement for interest to be annual and a charge on residue to be deductible in calculating the residuary income of the estate: section 666

This change removes the requirements for interest to be annual and a charge on residue in order to be deductible from the aggregate income of the estate in calculating the residuary income of the estate.

The deductions that are allowable in ascertaining the amount of the residuary income of an estate for a tax year are set out in section 697(1)(a) and (b) of ICTA. Section 697(1)(a) of ICTA refers to "the amount of any annual interest, annuity or other annual payment [for the year] which is a charge on residue …". There is a definition of "charges on residue" in section 701(6) of ICTA which is adapted for Scotland in section 702(d) of ICTA.

So far as the requirement for the interest to be annual is concerned, historically tax legislation has distinguished between short interest (which was not usually deductible) and annual or yearly interest (which was usually deductible). FA 1969 abolished the general relief for interest paid by taxpayers. However, specific provision was made for relief to continue to be allowed in respect of interest on borrowings for certain purposes. Annual or yearly interest continued to be significant as there was a requirement that tax was deducted from certain payments of yearly interest. But under the law as it applies before the commencement of this Act, interest, whether short or annual, may be deducted as an expense in computing the profit or loss of a trade for tax purposes if incurred wholly and exclusively for business purposes. (This is subject to certain restrictions on the deduction of annual interest paid to a person not resident in the United Kingdom and there is still a requirement to deduct tax in certain circumstances in relation to annual interest under section 349(2) of ICTA. For example, where the payment is to a person whose usual place of abode is outside the United Kingdom.)

So far as deductions in calculating residuary income of an estate are concerned, there is no reason, in principle, why short interest paid by the personal representatives should not be deductible. The historic distinction between short interest and annual interest no longer applies in tax legislation generally so it is difficult to justify here.

The other requirement in section 697(1)(a) of ICTA is that the payment of annual interest must be a charge on residue. “Charges on residue” are defined in section 701(6) of ICTA as certain specified liabilities properly payable out of the estate, as well as interest payable in respect of them. The definition is wide enough to include all interest ever likely to be paid by personal representatives, so the requirement that the payment is a charge on residue is otiose for interest.

Therefore, section 666(2)(a) of this Act, which rewrites section 697(1)(a) of ICTA, omits the requirements for interest to be annual and a charge on residue before it can be deducted from the aggregate income of the estate to calculate the residuary income of the estate. As a consequence, all interest paid by the personal representatives will be deductible, except for interest on unpaid inheritance tax which is expressly disallowed by section 233(3) of the Inheritance Tax Act 1984.

Since tax is treated as having been paid at the basic rate on this income, any reduction in the income taken to be available to beneficiaries as a result of this change will have the result that beneficiaries who pay tax at rates above the basic rate will pay less tax, but those not liable to income tax, or liable to tax only at rates below the basic rate, may not be able to reclaim so much tax.

This change is adverse to some taxpayers and is favourable to others in principle and in practice. But the numbers affected and the amounts involved are likely to be small.

Change 109: Beneficiaries’ income from estates in administration: how reduction in share of residuary income of estate under section 697(2) and (3) of ICTA operates for successive absolute interests: section 671

This change relates to the reduction in the share of the residuary income of the estate required where the amounts actually paid during or payable at the end of the administration period in respect of an absolute interest are less than the share of the residuary income for all tax years and clarifies how the reduction is to be made in cases where the absolute interest has been held successively.

Under section 697(2) of ICTA on the completion of the administration of an estate in which a person has an absolute interest, a comparison is made between the aggregate benefits received in respect of that interest and the aggregate for all years of the residuary income of the person having that interest. If the aggregate of the benefits is less than the aggregate of the residuary income, the amount of the shortfall is to be applied in reducing the person’s residuary income for the tax year in which the administration is completed. If that does not exhaust the amount of the shortfall, the remainder is used to reduce the previous tax year’s residuary income, and so on for previous tax years. (Section 697(2) of ICTA is rewritten in section 668 of this Act.)

Section 697(4) of ICTA provides that if a different person had an absolute interest in the residue at any time in the administration period “the aggregates mentioned in [section 697(2) of ICTA] shall be computed in relation to those interests taken together, and the residuary income of that other person also shall be subject to reduction under [section 697(2) of ICTA]”. This is too vague to indicate how the reduction is to be made under section 697(2) of ICTA where there is more than one person with a share of the residuary income of the estate available to be reduced.

One possibility would be for the reduction to be apportioned in some way between the absolute interest holders. But it is not at all obvious how such an apportionment would work because section 697(2) of ICTA requires the excess for the final tax year of the administration period to be used to reduce the last absolute interest holder’s residuary income in the previous tax year.

So it is not apparent whether that would have to be done before any other person's reduction was made. The other holder or holders of the interest may have held it several tax years before the final year.

Section 671(5) and (6) of this Act provide for the reduction to be made in these circumstances. Section 671(6) provides that the last absolute interest holder's share of the residuary income should be reduced first. If there is still an excess of residuary income over the gross amount of all sums paid during or payable at the end of the administration period after going through all the years that the final holder had the interest, the excess is then applied to the residuary income of the previous holder for the last tax year that that person had the interest and then to earlier tax years (and earlier absolute interest holders as appropriate) working backwards.

This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 110: Beneficiaries' income from estates in administration: requirement for apportionments where the parts of the residuary estate in which successive interests subsist do not wholly correspond: section 676

This change introduces a requirement for just and reasonable apportionments to be made in cases involving successive interests in the residuary estate where the part of the residuary estate in which a succeeding interest subsists does not wholly correspond with the part in which the preceding interest subsisted.

The taxation of successive interests in the residue of an estate is dealt with in section 698 of ICTA. Section 701(11) of ICTA provides that where different parts of the estate are the subject of different residuary dispositions, Part 16 of ICTA has effect in relation to each of those parts with the substitution for references to the estate of references to that part of the estate. (This is rewritten as a general rule for the interpretation of Chapter 6 of Part 5 of this Act in section 649(4)). But there is no provision for situations where the residuary estate in which a later holder acquires an interest was not all subject to the interest held by a previous holder or is only a part of the residuary estate in which a previous holder held an interest.

Section 676 of this Act provides that in such cases such apportionments as are just and reasonable are to be made.

This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 111: Beneficiaries' income from estates in administration: omission of section 695(6) of ICTA: section 678

This change relates to the omission of section 695(6) of ICTA, which requires that where relief is given to a person with a limited or discretionary interest in a foreign estate for United Kingdom income tax borne by the income of the estate, the person's total income should include an amount corresponding to the relief.

Section 695(5) of ICTA enables a beneficiary of a foreign estate who is entitled to a limited interest in the residue of the estate and is charged to tax for a tax year in respect of income from the estate to claim relief if any of the aggregate income of the estate has borne United Kingdom income tax. Section 698(3)(b) of ICTA applies this also to beneficiaries who are charged in respect of income paid from the estate under a discretion.

Section 695(6) of ICTA (which is also applied by section 698(3)(b) of ICTA) provides that where the relief is given "such part of the amount in respect of which [the beneficiary] has been charged to income tax as corresponds to the proportion mentioned in [section 697(5) of ICTA] shall, for the purposes of computing his total income, be deemed to represent income of such amount as would after deduction of income tax be equal to that part of the amount charged". (The proportion referred to is the proportion that the amount of the beneficiary's income that has borne United Kingdom income tax, less the tax, bears to the amount of the aggregate income of the estate, less United Kingdom income tax.) The meaning of this provision, which originated while surtax was still charged, is now obscure, and it is particularly difficult to see how it could operate in the context of Self Assessment. Consequently, in practice it tends to be ignored. Therefore it is not being rewritten in this Act.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 112: Exempt income: savings certificates: unauthorised purchases involving multiple certificates: sections 692(2) and 693(5)

This change enables multiple savings certificates to be regarded as authorised in part where an unauthorised number of certificates has been purchased, and so confers exemption on the income from the part that is so regarded.

The Treasury limit the number of savings certificates of any particular issue that a person is permitted to purchase. The limits are stated in the prospectus for each issue.

The income from savings certificates is exempt from income tax under section 46 of ICTA. However, the exemption only applies to certificates purchased within the permitted limits. Section 46(3) of ICTA provides that the exemption does not apply to savings "... certificates ... purchased ... in excess of the amount which a person is for the time being authorised to purchase ...". It is not entirely clear how this would work in the case of multiple certificates. (These are certificates which represent a number of individual unit certificates.)

For example, if the maximum number of certificates permitted is 100, X holds 80, and then purchases a multiple certificate of 50, section 46(3) of ICTA appears to prevent the exemption from applying to the second multiple certificate. However, in practice, the second certificate is treated as 50 individual certificates, so that 20 would be treated as authorised and 30 as unauthorised.

Sections 692(2) and 693(5) of this Act reflect this practice by providing that certificates are authorised "so far as" their acquisition was not prohibited by regulations made by the Treasury limiting a person's holding or, in the case of Ulster Savings Certificates, such regulations made by the Department of Finance and Personnel.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 113: Exempt income: Ulster Savings Certificates: section 693

This change gives statutory effect to ESC A34 (certificates encashed after death of registered holder).

Income from Ulster Savings Certificates (USCs) is exempt from income tax if the conditions in section 46(3) and (4) of ICTA are met.

Under section 46(3) of ICTA the exemption does not apply to certificates purchased in excess of the maximum number prescribed by the Department of Finance and Personnel in Northern Ireland. Under section 46(4) of ICTA the holder must be resident and ordinarily resident in Northern Ireland:

- either when the certificates are repaid; or
- where the holder purchased the certificates, at the time of purchase.

So, if the holder did not purchase the certificates, but, say, inherited them, the exemption would apply only if the holder satisfied the residence condition at the time of repayment.

ESC A34 therefore extends the exemption so if the deceased holder of the USCs was resident and domiciled in Northern Ireland at the time the certificates were purchased, but the personal representative, or the beneficiary who inherited the USCs was not, the exemption is still available. It provides -:

"Accumulated interest on Ulster savings certificates held by persons resident and domiciled in Northern Ireland is exempt from income tax (TA 1988 s 46). Where repayment is made after the death of the holder, exemption is allowed if the deceased was resident and domiciled in Northern Ireland at the time of purchase.

Until 1981, the residence condition for the exemption was that the holder had to be "resident and domiciled" in Northern Ireland (see section 96 of ICTA 1970), although in practice this was interpreted as "resident and ordinarily resident". The wording of the legislation was amended by section 34 of FA 1981 to bring it into line with the practice. The ESC was introduced in 1958 and has not been amended, so it is still phrased in terms of the pre-1981 legislation, although, in practice, it is now operated in line with the post-1981 wording, so that the reference in the ESC to "domiciled" is read as "ordinarily resident".

Section 693(4) of this Act gives statutory effect to the concession.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 114: Individual investment plans: non-resident insurance companies: sections 697 and 698(6)

This change extends the provisions in section 333A of ICTA to cover non-resident insurance companies and omits section 333B(4) of ICTA (so far as income tax is concerned).

Sections 333 to 333B of ICTA contain powers for the Treasury to make regulations providing for the income of individuals from investments held in certain types of investment plan to be exempt from income tax. Section 333A of ICTA provides that the regulations may include certain requirements to be fulfilled by a "European institution" or a "relevant authorised person" if it is to be a "plan manager".

Section 333B(4) of ICTA provides for regulations to be made about non-resident insurance companies appointing United Kingdom tax representatives. So far as income tax is concerned, this provision does much the same for non-resident insurance companies as section 333A of ICTA does for European institutions. This duplication is unnecessary: it was never intended that non-resident insurance companies should be subject to substantially different requirements from European institutions. Indeed, some non-resident insurance companies may be European institutions, which increases the scope for confusion.

So, in rewriting these provisions, section 333A of ICTA has been extended to cover non-resident insurance companies and section 333B(4) of ICTA has been omitted, so far as income tax is concerned. Section 697(2)(c) provides that "foreign institution" includes "…an insurance company which is non-UK resident".

This has four effects.

- The provisions rewritten from section 333A of ICTA will apply only to non-resident insurance companies which are plan managers, whereas section 333B(4) of ICTA applies for all non-resident insurance companies.
- The more specific language of section 333A of ICTA is substituted for the general formula in section 333B(4)(a) of ICTA, see sections 697 and 698.
- The scope of the provision is restricted to the "prescribed duties" (rewritten as "specified" duties, see section 697(1)) referred to in section 333A(2), (3) and (4), whereas section 333B(4) of ICTA applies to any duties.
- The powers which may be conferred and the liabilities which may be imposed are restricted to those covered by section 333A(10) of ICTA, rather than those covered by section 333B(4)(b) of ICTA (see section 698(6)).

This change has no implications for the amount of tax paid, who pays it or when.

Change 115: Exemptions: venture capital trust dividends: conditions for shares where share reorganisations have occurred: section 712

This change treats shares acquired as a result of a company reorganisation as satisfying the condition requiring them to have been acquired for genuine commercial reasons.

In order to qualify for the income tax exemption for distributions from venture capital trusts ("VCTs") the shares in respect of which the distributions are made must satisfy certain conditions. The conditions are set out in paragraph 7(3) of Schedule 15B to ICTA. These include that:

- the shares were acquired "for bona fide commercial purposes and not as part of a scheme or arrangement the main purpose of which, or one of the main purposes of which, is the avoidance of tax" (paragraph 7(3) (a)(ia)); and
- they are not "shares acquired in excess of the permitted maximum for any year of assessment" (paragraph 7(3)(a)(ii)).

The first of those conditions was added by section 70 of FA 1999, and only has effect for shares acquired after 8 March 1999.

Paragraph 8(3) and (4) of Schedule 15B to ICTA apply where shares in VCTs are acquired in circumstances in which they are required by TCGA to be treated as the same assets as other shares. This covers the situation where there has been a reorganisation, for example, a bonus issue of shares or an issue of shares falling within sections 135 and 136 of TCGA. Under paragraph 8(3) and (4) of Schedule 15B to ICTA new shares acquired as a result of the reorganisation etc. are treated as being acquired within the permitted maximum i.e. as meeting the condition in paragraph 7(3)(a)(ii) of Schedule 15B to ICTA if the old shares were within the permitted maximum. However, no reference is made to the first of the conditions mentioned above i.e. the bona fide commercial purposes test.

For the issue of new shares to fall within sections 135 and 136 of TCGA, section 137(1) of TCGA must be satisfied. Section 137(1) of TCGA will only be satisfied if *the share reorganisation was effected* for bona fide commercial reasons and not as part of a scheme or arrangement the main purpose (or one of the main purposes) of which is the avoidance of tax liability. So, in practice, the Inland Revenue treat such new shares as having been *acquired* for bona fide commercial purposes as so meeting both conditions mentioned above.

Section 712 of this Act applies the same rules about new shares meeting the genuine commercial purposes condition as are applied about the permitted maximum condition.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 116: Interest from FOTRA securities held on trust: section 715

This change gives statutory effect to a practice relating to interest arising from FOTRA securities held on trust.

FOTRA exemptions apply where gilt-edged securities are in the beneficial ownership of persons who are not ordinarily resident in the United Kingdom. The source legislation, principally section 154 of FA 1996, is rewritten in Chapter 6 of Part 6 of this Act. The beneficial ownership test lies within the definition of "FOTRA security": as it is part of the exemption condition of the securities. (See, in particular, section 22 of F(No 2)A 1931).

Although in the case of bare trusts and trusts with an interest in possession, it is fairly clear where the beneficial ownership lies, in the case of discretionary or accumulation trusts it can be difficult to apply the beneficial ownership test. In some types of trust the beneficial ownership of an asset is, in effect, in suspense. In others, while it may be clear where the beneficial ownership lies, it may belong to a different person from the person entitled to the income.

In practice, where interest from FOTRA securities held in trust arises to trustees and none of the beneficiaries of the trust is ordinarily resident in the United Kingdom, the beneficial ownership test is regarded as met whatever kind of trust is involved and no account is taken of whether the trustees themselves are resident or ordinarily resident. So if all the potential beneficiaries of a discretionary or accumulation trust (that is, those who have the right, at the discretion of the trustees, to benefit from the trust income or accumulated income) are not ordinarily resident in the United Kingdom, the FOTRA beneficial ownership test is treated as having been met.

Section 715 of this Act gives effect to this practice. So, for the purposes of determining whether interest arising from a FOTRA security held in trust is exempt from income tax under section 714 of this Act, it is to be assumed that the security is in the beneficial ownership of a person who is not ordinarily resident if none of the beneficiaries of the trust is resident when the interest arises. (See section 715(1) and (2)). Section 715(3) defines "beneficiaries of the trust" widely so as to cover all potential income beneficiaries of discretionary and accumulation trusts. Section 715(4) brings in beneficiaries receiving accumulated income.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 117: Exempt income: purchased life annuity payments: claim for exemption of capital element of purchased life annuity: section 717(3)

This change relates to the rewriting in this Act (and so as primary legislation) of the requirement in regulation 4 of the Income Tax (Purchased Life Annuities) Regulations 1956 SI 1956/1230 for a claim to be made to obtain the benefit of section 656(1) of ICTA.

Case law has established that the whole of an annuity payment received by an annuitant is chargeable to income tax. (See, for example, the judgment of the Lord President (Inglis) in Coltness Iron Co v Black (1881), 1 TC 287 CS, which was cited with approval by Lord Wilberforce in CIR v Church Commissioners for England (1976), 50 TC 516 HL[20].) However, section 656(1) of ICTA provides for a part of an annuity payment made under a purchased life annuity to be treated as capital (the "capital element"). The effect is that, so far as it consists of the capital element, the annuity payment is exempt from income tax.

To obtain the benefit of section 656(1) of ICTA, an annuitant has to make a claim under regulation 4 of the Income Tax (Purchased Life Annuities) Regulations 1956 SI 1956/1230. Section 658(4) of ICTA provides that the regulations may "make provision for the time limit for making any claim for relief from or repayment of tax". But that is the only specific reference to a claim in the primary legislation. So that it is clear to a reader of the exemption that it is subject to a claim, the implied requirement for a claim in regulation 4 is rewritten in section 717(3) of this Act. Accordingly, the power in section 658(3) of ICTA to make regulations about this is not rewritten. As a result, the requirement for a claim cannot be revoked or amended by regulations.

This change has no implications for the amount of tax due, who pays it or when. It affects (in principle and in practice) only administrative matters.

Change 118: Exempt income: purchased life annuity payments: method of calculating exempt part of purchased life annuity: section 719

This change alters the method of calculating the exempt part of an annuity payment where both the term of the annuity and the amount of the annuity payment depend on some contingency other than the duration of human life, and gives statutory effect to ESC A46.

Section 656(1) of ICTA provides for a part of an annuity payment made under a purchased life annuity to be treated as capital (the "capital element"). The effect is that, so far as it consists of the capital element, the annuity payment is exempt from income tax.

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The way in which that exempt part is calculated varies according to the type of annuity involved, but the legislation is very jumbled and does not distinguish the different types very clearly.

By definition (see section 657(1) of ICTA) the term of a purchased life annuity is always dependent on the duration of a human life. The amount of the annuity payment might also be dependent on the duration of a human life. And the term or the amount (or both) might also be dependent on some other contingency (a “non-life contingency”).

There are two basic approaches to the calculation of how much of any annuity payment is exempt. Which approach applies is, in general, determined by whether or not the amount of the annuity payment depends on some non-life contingency. Where the amount does depend on a non-life contingency, a constant sum is exempt (assuming the period covered by each payment is the same) - see section 656(2) of ICTA. But where the amount of the payment does not depend on a non-life contingency, a constant proportion of each payment is exempt - see section 656(3)(a) to (c) of ICTA.

Where not only the amount of the annuity payment but also the term of the annuity (in addition to depending on the duration of human life) depends on a non-life contingency, section 656(3)(b) and (e) of ICTA provide for the exempt part of each payment to be computed as a constant proportion. “[T]hat proportion shall be such as may be just, having regard to subsection (2) above and to the contingencies affecting the annuity.”

As section 656(2) of ICTA recognises, actuarial techniques do not provide any mechanism for calculating the (exempt) capital element as a constant proportion of an annuity where the amount of the annuity is dependent on a non-life contingency. So the calculation envisaged by section 656(3)(b) and (e) of ICTA is not possible. Actuarial techniques do, however, provide a route to calculating a capital element as a constant monetary sum. It is possible, therefore, where both the amount and the term depend on a non-life contingency, to calculate the (exempt) capital element as a constant monetary sum (rather than as a constant proportion). Accordingly, section 719(4) provides for the constant sum method to apply in this case.

If the exempt capital element is so calculated, it is then possible for the amount of the exempt part to exceed the amount of a particular annuity payment. (See *Change 119* in Annex 1.) To cover that situation the carry forward of excess exempt amounts allowed by ESC A46 has been extended to annuities of this sort. The result is that the excess may be carried forward and added to the exempt part of the next payment. (See section 719(5).)

This change is adverse to some taxpayers and favourable to others in principle. If the amount of the annuity payment increases at a rate greater than that assumed for the purpose of calculating the capital element, the constant proportion approach favours the taxpayer. If the rate of increase falls below that predicted, the constant sum approach is to the taxpayer’s advantage. In practice, it is expected to have no effect because this type of annuity has not been met in practice and remains no more than a hypothetical possibility.

Change 119: Exempt income: purchased life annuity payments: carry forward of excess exempt capital element in purchased life annuity payment: section 719 and paragraph 144 of Schedule 2

This change gives statutory effect to ESC A46.

Section 656(1) of ICTA provides for a part of an annuity payment made under a purchased life annuity to be treated as capital (the “capital element”). The effect is that, so far as it consists of the capital element, the annuity payment is exempt from income tax.

The way in which that exempt part is calculated varies according to the type of annuity involved, but the legislation is very jumbled and does not distinguish the different types very clearly.

By definition (see section 657(1) of ICTA) the term of a purchased life annuity is always dependent on the duration of a human life. The amount of the annuity payment might also be dependent on the duration of a human life. And the term or the amount (or both) might also be dependent on some other contingency (a “non-life contingency”).

There are two basic approaches to the calculation of how much of any annuity payment is exempt. Which approach applies is, in general, determined by whether or not the amount of the annuity payment depends on some non-life contingency. Where the amount does depend on a non-life contingency a constant sum is exempt (assuming the period covered by each payment is the same) - see section 656(2) of ICTA. But where the amount of the payment does not depend on a non-life contingency a constant proportion of each payment is exempt - see section 656(3)(a) to (c) of ICTA.

An example of an annuity where the amount depends on a non-life contingency is an index-linked annuity where the amount of the annuity fluctuates with movements in the Retail Prices Index. Initially the return under this type of annuity is low and the gross annuity may fall short of the amount of the constant exempt sum. With inflation the amount of the annuity payments is likely to rise and in due course to overtake the amount of the exempt sum.

ESC A46 deals with the situation where the amount of the annuity payment is less than the amount computed as exempt under the constant sum method in section 656(2) of ICTA. It allows any excess of the exempt amount over the gross annuity to be carried forward and increase the exempt part of the next payment. Section 719(5) of this Act gives statutory effect to the concession and Part 9 of Schedule 2 to this Act enables such excesses that were not absorbed by annuity payments made before tax year 2004-05 because they were too small, to be carried forward by increasing the exempt amount of the first payment made after 5 April 2005.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 120: Exempt income: purchased life annuity payments: determining the age of the person during whose life a purchased life annuity is payable: sections 720(4) and 721(4)

This change alters in certain circumstances the age to be taken for the person during whose life a purchased life annuity is payable for the purposes of calculating the amount of the annuity that is exempt.

Section 656(1) of ICTA provides for a part of an annuity payment made under a purchased life annuity to be treated as capital (the "capital element"). The effect is that, so far as it consists of the capital element, the annuity payment is exempt from income tax.

The way in which that exempt part is calculated varies according to the type of annuity involved, but the legislation is very jumbled and does not distinguish the different types very clearly.

By definition (see section 657(1) of ICTA) the term of a purchased life annuity is always dependent on the duration of a human life. The amount of the annuity payment might also be dependent on the duration of a human life. And the term or the amount (or both) might also be dependent on some other contingency (a "non-life contingency").

There are two basic approaches to the calculation of how much of any annuity payment is exempt. Which approach applies is, in general, determined by whether or not the amount of the annuity payment depends on some non-life contingency. Where the amount does depend on a non-life contingency, a constant sum is exempt (assuming the period covered by each payment is the same) - see section 656(2) of ICTA. This is determined by reference to the purchase price of the annuity and its expected term. Under section 656(2)(a)(ii) of ICTA the term is determined as at the date when the first annuity payment begins to accrue "by reference to prescribed tables of mortality".

But where the amount of the payment does not depend on a non-life contingency a constant proportion of each payment is exempt. (See section 656(3)(a) to (c) of ICTA.) Under section 656(4)(c) of ICTA the proportion used is the proportion that the total amount or value of the consideration for the grant of the annuity bears to the actuarial value of the annuity. That is determined as at the date on which the first payment begins to accrue "by reference to the prescribed tables of mortality".

Section 656(7) of ICTA provides that in using the prescribed tables of mortality to determine the expected term of an annuity or the actuarial value of the annuity payments:

“the age, as at the date when the first of the annuity payments begins to accrue, of a person during whose life the annuity is payable shall be taken to be the number of years of his age at his last birthday preceding that date.

So the age of the person during whose life the annuity is payable is determined by reference to his or her last birthday before the date of the calculation. Accordingly, where the calculation is to be made on the individual’s actual birthday, it is still his or her age on his or her *previous* birthday that is taken even though he or she is, in any ordinary sense, a full year older.

Actuarial practice recognises the annuitant’s age in years and fractions of years. For simplicity of calculation the purchased life annuity legislation only recognises full years, but it is not consistent with actuarial practice that it should attribute to an individual an age that he or she attained a year and a day previously. Inland Revenue practice follows actuarial practice in this respect, and so bases the calculation on the age attained on the date of the calculation if that date is the individual’s birthday. Under both approaches for calculating how much of any annuity payment is exempt, the constant sum approach and the constant proportion approach, this practice produces a higher figure for the exempt element than the legislation. Sections 720(4)(b) and 721(4)(c) of this Act rewrite this practice.

This change is in taxpayers’ favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 121: Exempt income: personal injury damages: omission of statutory references and inclusion of damages for death: sections 731 and 751 and paragraph 148 of Schedule 2

This change relates to the omission, from the provisions exempting interest on personal injury damages and damages paid as periodical payments from income tax, of references to the specific statutory provisions under which the damages are awarded, and the inclusion of damages for death.

Section 329(1) of ICTA exempts interest on damages for personal injury from income tax and section 329AA of ICTA exempts personal injury damages paid in the form of periodical payments.

Section 329AA(1) of ICTA (as amended by section 100(2) of the Courts Act 2003) exempts periodical payments (as defined in section 329AA(1A) of ICTA) from income tax. Under section 329AA(1A)(b) of ICTA “periodical payments” includes payments made under an agreement so far as it settles a claim or action for damages in respect of personal injury (including an agreement as varied).

Section 329AA(6) of ICTA provides that such a claim or action includes claims or actions brought under various statutory provisions. In fact, it was never intended to limit the scope of the exemption by referring to these specific provisions. So, in rewriting this exemption, section 731 of this Act omits these references. However, the omission of the specific references to the Fatal Accidents Act 1976 and the Fatal Accidents (Northern Ireland) Order 1977 has made it necessary to refer specifically to damages for death, because without the references to that Act and Order it would not be clear that such damages are included in damages for personal injuries.

Similarly, section 329(1) of ICTA exempts interest on damages in respect of personal injuries or in respect of a person’s death included in a sum for which judgment is given by virtue of the provisions referred to in section 329(2) of ICTA. In rewriting this exemption, section 751 of this Act omits these references and merely refers to interest on damages for personal injury or death included in a sum awarded by a court, without referring to the provisions under which the award may be made.

Since these references have been omitted, it is necessary specifically to exclude interest relating to the period between the making and satisfaction of an award, as such interest is awarded under the Judgments Act 1838, which is not listed in section 329(2) of ICTA.

This change has no implications for the amount of tax due, who pays it or when. It affects (in principle and in practice) only administrative matters.

Change 122: Exempt income: personal injury damages: exemption of persons receiving payments on behalf of injured persons: section 734

This change relates to the extension of the provisions exempting personal injury damages paid as periodical payments from income tax, to include payments to a person receiving payments on behalf of an individual entitled to the payments.

Section 329AA(4) of ICTA provides that certain payments paid by trustees to, or for the benefit of, an injured person who is entitled to damages are exempt from income tax. However, that section does not provide that the person receiving the payment on behalf of the person so entitled is exempt from income tax. But, in practice, the person receiving damages on behalf of another is not taxed.

In rewriting section 329AA(4) of ICTA, section 734(2)(b) of this Act extends the persons entitled to the exemption to a person who receives a payment on behalf of the injured person.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 123: Exempt income: health and employment insurance payments: extension to insurance against loss of office: sections 736(2) and 737(2)(b)

This change extends the risks against which insurance policies may provide if payments under them are to be exempt to loss of office.

Sections 580A and 580B of ICTA exempt payments under insurance policies providing cover against risks to health or employment from income tax where they meet specified conditions.

Under section 580A(3)(b) of ICTA the risk of loss of employment is described as "a risk that circumstances will arise as a result of which the insured will cease to be employed or will cease to carry on any trade, profession or vocation carried on by him". Under section 580A(4)(b) of ICTA the related period during which payments may continue is described as "any period during which the insured is, in circumstances insured against by the relevant part of the policy, either unemployed or not carrying on a trade, profession or vocation".

In practice, although section 580A(3)(b) of ICTA refers to loss of employment and not loss of office, the Inland Revenue does not distinguish between employees and office holders in deciding whether there is a qualifying risk relating to employment. So, taken together with the reference to trades, professions and vocations in section 580A(3)(b) of ICTA, the risk that a person will no longer be in receipt of income as a result of a loss of work of any sort is included. Accordingly, in rewriting that section in section 736(2), the risk that circumstances will arise as a result of which the insured will cease to hold an office has been included.

Similarly, in rewriting section 580A(4)(b) of ICTA in section 737(2)(b), a period during which the insured, in circumstances insured against by the relevant part of the policy, does not hold an office is expressly included.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 124: Exempt income: health and employment insurance payments: meaning of "the insured": section 742

This change extends the meaning of "the insured" in certain provisions relating to the exemption of payments made under insurance policies insuring against health or employment risks.

Sections 580A and 580B of ICTA exempt payments under insurance policies providing cover against risks to health or employment from income tax where they meet specified conditions. The legislation uses the expression “the insured” in several places, without any definition. In certain provisions, “the insured” is extended by section 580A(9) of ICTA to include the insured’s spouse, and any other person with whom they have joint, insured liabilities.

Section 742 extends the definition further so that a child of the insured is covered if the child is under 21. This means that payments from insurance policies taken out in respect of children’s health or employment are included in the exemption so long as the general conditions for the exemption are met. These include the condition under section 580A(6) of ICTA that the premiums must not have qualified for tax relief by being deductible in calculating the insured’s income from any source or be deductible from that income. So, following the extension of the meaning of “the insured” to include the insured’s children, if premiums were so deductible as respects the child’s income, the exemption would not be available for payments made under the policy. However, that is extremely unlikely to be the case.

This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 125: Exempt income: interest on damages for personal injury: awards by foreign courts: section 751(1)

This change gives statutory effect to ESC A30 (interest on damages for personal injuries (foreign court awards)).

Section 329(1) of ICTA exempts interest on damages for personal injury from income tax by reference to judgements given by virtue of the statutory provisions specified in section 329(2) of ICTA. These are provisions that have effect in the various parts of the United Kingdom.

However, ESC A30 provides that the exemption under section 329 of ICTA is extended to interest on damages awarded in corresponding circumstances by a foreign court if the interest is exempt from tax in the country in which the award is made.

Section 751(1)(c) gives effect to the concession.

This change is in taxpayers’ favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 126: Interest under employees’ share schemes: participants in the scheme: section 752

This change extends the exemption from tax to interest received from any participant in an employees’ share scheme (and not just from company employees and salaried directors).

The origin of section 688 of ICTA is paragraph 9 of Schedule 4 to FA 1970. In 1970 the exception from the prohibition on financial assistance for employees’ share schemes was in terms of the employees of the company (section 54(1) of the Companies Act 1948). It was specifically provided that “employees” included directors holding a salaried employment or office in the company.

The current exception (section 153(4)(b) of the Companies Act 1985) refers to “the provision by a company, in good faith in the interest of the company, of financial assistance for the purposes of an employees’ share scheme”. Section 743 of the Companies Act 1985 explains what is meant by an “employees’ share scheme”. Such a scheme may, among other things, encourage the holding of shares by former employees and the spouses and children of employees and former employees.

Consequently, although former employees and spouses and children can benefit from schemes that are set up to comply with section 153(4)(b) of the Companies Act 1985, any payments of interest by them do not benefit from the exemption in section 688 of ICTA.

Section 752 extends the exemption to interest received by trustees from any participant in the scheme.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 127: Interest under employees' share schemes: foreign source interest: section 752

This change extends the exemption from tax to foreign interest.

Section 688 of ICTA exempts trustees from income tax under Schedule D Case III. If a UK resident company advanced money to UK resident trustees for the purposes of an employees' share scheme, the trustees might receive interest from non-UK resident employees. In such circumstances the foreign interest would be charged under Schedule D Case V. Accordingly, the trustees would not benefit from the exemption in section 688 of ICTA.

Section 752 provides that no liability to income tax arises under Chapter 2 of Part 4 of this Act in respect of the interest. The income charged by that Chapter includes foreign income that was formerly charged under Schedule D Case V.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 128: Rent-a-room relief: income other than trading or property income: sections 785, 786, 794 and 798.

This change prevents the receipt of certain Schedule D Case VI income from disqualifying taxpayers from rent-a-room relief (as well as allowing the relief on that income).

Under paragraph 2(1) of Schedule 10 to F(No 2)A 1992 relief is available only if all "relevant sums" deriving from letting accommodation in the taxpayer's home would otherwise be chargeable under Schedule A or Schedule D Case I.

"Relevant sums" includes sums accruing in respect of meals, cleaning, laundry and goods and services of a similar nature provided in connection with the use of furnished accommodation (paragraphs 2(2) and 8 of Schedule 10 to F(No 2)A 1992). If a taxpayer lets a room and the income is charged under Schedule A, any incidental income for (say) occasional laundry services or meals would normally be chargeable under Schedule D Case VI. The receipt of that income would therefore disqualify the taxpayer from the relief.

This was not the case when F(No 2)A 1992 was enacted. Paragraph 2(1) of Schedule 10 to F(No 2)A 1992 originally referred to Schedule D Cases I and VI. At that time, income from letting furnished accommodation was charged under Schedule D Case VI unless the taxpayer elected for it to be charged under Schedule A (or unless the letting arrangements amounted to a trade as, for example, in the case of a bed and breakfast business).

In amending section 15 of ICTA, FA 1995 brought all lettings of furnished accommodation within the Schedule A charge. FA 1995 replaced the reference to Schedule D Case VI in paragraph 2(1) of Schedule 10 to F(No 2)A 1992 with a reference to Schedule A.

The definition of "rent-a-room receipts" in section 786(1) includes, by virtue of paragraph (d), receipts that would otherwise be chargeable under Chapter 8 of Part 5 of this Act (income not otherwise charged (the successor to Schedule D Case VI for this kind of receipt)). Consequently, those receipts no longer disqualify the taxpayer from the relief. Rent-a-room relief is also available on the receipts.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 129: Rent-a-room relief: making the United Kingdom location condition explicit and a potential disqualification from the relief: sections 785 and 786

This change makes it explicit that rent-a-room relief applies only to United Kingdom property and removes a bar to the relief that can arise in respect of a let United Kingdom residence if, exceptionally, an individual also lets an overseas residence.

Paragraph 2(1) of Schedule 10 to F(No 2)A 1992 provides that an individual qualifies for relief for a tax year if all sums which accrue to the individual for the year from letting a room in a qualifying residence, or from providing associated goods or services, would otherwise be chargeable under Schedule A or Schedule D Case I.

Paragraph 4 of Schedule 10 to F(No 2)A 1992 provides that a residence is an individual's "qualifying residence", in respect of a tax year, if at some time during the period specified in that paragraph it is the individual's only or main residence. In rewriting that provision, section 786(1)(a) makes it explicit that the residence must be in the United Kingdom.

For an individual who has only a single qualifying residence in respect of a tax year the requirement is implicit in paragraph 2(1) of Schedule 10 to F(No 2)A 1992. If the residence is overseas the individual could not qualify for rent-a-room relief because any income from letting a room in the residence would be chargeable to tax under Schedule D Case V (as profits of an overseas property business or, exceptionally, income of a foreign trade).

That contrasts with the case of an individual who in a tax year lets a room in a qualifying United Kingdom residence *and* in a qualifying overseas residence. This case arises only if the individual's only or main residence changes during the period specified in paragraph 4 of Schedule 10 to F(No 2)A 1992.

Under paragraph 2(1) of Schedule 10 to F(No 2)A 1992, any income from letting a room in the overseas residence which is chargeable under Schedule D Case V would disqualify the individual from any rent-a-room relief at all (and which would otherwise have been available on income from the United Kingdom residence).

Relief will continue not to be available on income from an overseas residence. But the income relating to the overseas residence will no longer disqualify the individual from obtaining rent-a-room relief on income from the United Kingdom residence at the time of the change of residence.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 130: Rent-a-room relief: removing anomaly from qualifications for relief: sections 788 and 795

This change counts any relevant balancing charge in the "total rent-a-room amount" for the purpose of establishing entitlement to the alternative method of calculation.

Under the source legislation a taxpayer with rent below the individual's limit but whose rent-a-room income and any relevant balancing charges together exceed the limit is not eligible for either form of rent-a-room relief.

Paragraph 9(4) of Schedule 10 to F(No 2)A 1992 prevents that taxpayer from qualifying for exemption. ("Relevant balancing charges" are balancing charges which would otherwise be made under CAA in respect of any plant or machinery used in any trade or Schedule A business from which the rent-a-room income is derived.)

But neither does the taxpayer qualify for the alternative method of calculation under paragraph 11 of Schedule 10 to F(No 2)A 1992 because the rent-a-room income alone does not exceed the limit (as required by sub-paragraph (1)(b)).

Section 795 provides that, if the other conditions are satisfied, the alternative method of calculating profits (the successor to paragraph 11 of Schedule 10 to F(No 2)A 1992) is available if the "total rent-a-room amount" exceeds the individual's limit. The "total rent-a-room amount" is defined in section 788 to include any relevant balancing charges.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

hange 131: Foreign income: special rules: meaning of "relevant foreign income": treatment of certain payments made by industrial and provident societies arising from a source outside the UK: section 830

This change allows foreign source loan interest, dividends and bonuses or other sums payable by a registered industrial and provident society to benefit from provisions available to income taxed under Schedule D Cases IV and V.

Under section 486(4) of ICTA any share or loan interest paid by a registered industrial and provident society is charged to tax under Schedule D Case III wherever it arises. Under section 66 of FA 1988 a society registered under the Industrial and Provident Societies Acts will be resident in the United Kingdom through incorporation. A society may, however, be non-resident where it also satisfies a residence test in the territory of a treaty partner of the United Kingdom and the treaty awards residence to that other territory. Section 249 of FA 1994 will then apply to treat the society as non-resident. Theoretically therefore share or loan interest paid by a registered society may arise outside the United Kingdom but be charged under Schedule D Case III. In consequence such income cannot, under the source legislation, benefit from treatment specific to Schedule D Cases IV and V.

It is unlikely that share or loan interest would arise to an industrial and provident society from a non-UK source. But it is believed that in principle it ought to benefit from the treatment available to interest within Schedule D Cases IV and V. Section 830 defines "relevant foreign income" as income arising from a source outside the United Kingdom which is charged under certain provisions which are listed. So, section 379 is not excluded from the list of provisions in section 830(2) under which a charge on relevant foreign income could arise. (See the reference to Chapter 2 of Part 4 of this Act in subsection (2)(e)).

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 132: Foreign income: special rules: relevant foreign income charged on remittance basis: conditions for claim: sections 831 and 857(1)

This change makes a minor alteration to the rules in section 65(4) of ICTA (remittance basis) to remove the citizenship condition so that any person who is not ordinarily resident in the United Kingdom is entitled to make a claim.

Section 18(3) of ICTA charges tax on income of a person resident in the United Kingdom which arises from securities (Schedule D Case IV) or possessions (Schedule D Case V) outside the United Kingdom. Section 65 of ICTA contains the rules for calculating the amount of income within Schedule D Cases IV and V that is chargeable to tax. Tax is charged on the amount of the income arising in the tax year unless the person chargeable under section 59 of ICTA meets one of the conditions set out in section 65(4) of ICTA and makes a claim. If one of those conditions is met and a claim is made, tax is charged on the amount of the income received in the United Kingdom. The first condition is that the person is domiciled outside the United Kingdom. The second condition is that the person is both not ordinarily resident and a citizen of the Commonwealth or the Republic of Ireland.

The restriction of the second condition to citizens of certain countries is thought to have little practical effect. Citizens of other countries who are resident, but not ordinarily resident, in the United Kingdom are very unlikely to have their domicile in the United Kingdom. And, if they are not domiciled in the United Kingdom, they will meet the first condition, regardless of where they are ordinarily resident. In addition, restricting the second condition to citizens of certain countries might be argued to involve discrimination.

Therefore, in order to simplify the second condition and to ensure equality of treatment for all citizens who are not ordinarily resident in the United Kingdom, section 831(4) rewrites the second condition without the reference to citizenship of certain countries.

This change affects not only section 831 but also those provisions that refer to meeting the conditions in that section. See, in particular, section 857 and the definition of when the remittance basis applies to a person in section 878(2). Section 857 (partners to whom the remittance basis applies) is based on section 112(1A) of ICTA which repeats the conditions found in section 65(4) of ICTA. The definition of when the remittance basis applies to a person is required for various sections in Part 3 of this Act relating to overseas property income. See in particular sections 269(3) and (4), 357 and 358.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 133: Foreign income: special rules: relevant foreign income charged on remittance basis: amalgamation of rules for Schedule D Cases IV and V: section 832

This change relates to the amalgamation of the rules which apply to income assessed under the remittance basis where income is taxed under either Schedule D Case IV or Case V.

Section 65(5) of ICTA contains the rules for calculating the quantum of income within Schedule D Cases IV and V that is chargeable to tax under the remittance basis. There are separate rules for Schedule D Case IV income (see section 65(5)(a) of ICTA) and Schedule D Case V income (see section 65(5)(b) of ICTA).

The rule for Case IV income is as follows:

> "Tax shall be computed in the case of tax chargeable under Case IV, on the full amount, so far as the same can be computed, of the sums received in the United Kingdom in the year of assessment, without any deduction or abatement

And for Case V income:

> "Tax shall be computed in the case of tax chargeable under Case V, on the full amount of the actual sums received in the United Kingdom in the year of assessment from remittances payable in the United Kingdom or from property imported, or from money or value arising from property not imported, or from money or value so received on credit or on account in respect of any such remittances, property, money or value brought or to be brought into the United Kingdom, without any deduction or abatement other than is allowed under the provisions of the Income Tax Acts in respect of profits charged under Case I of Schedule D.

These separate rules date from the Income Tax Act of 1803. Schedule D Case IV covers income from securities and Schedule D Case V income from possessions. The Case IV rule is more succinct, possibly because the rule did not need to cover so many eventualities as the rule applying to income from possessions, which covered income from more diverse sources.

The leading case of Thomson v Moyse (1960), 39 TC 291 HL established that the Case IV rule charging to tax "sums received in the United Kingdom" included all the examples of "sums received" listed under the Case V rule. There was some disagreement as to whether the Case V rule was narrower in its scope. This turned on whether or not the list of examples given in the rule was intended as a complete list of possibilities or merely examples of how sums might be received.

Although there was not a complete consensus of views, even those who did not think that the Case V rule was as wide in its scope as the Case IV rule agreed that the examples given for the Case V rule appeared to cover every conceivable way sums might be received in the UK.

In practice, the Inland Revenue treat the scope of the two rules as the same. There have been no cases since Thomson v Moyse where the point has been raised again.

Therefore no distinction between Schedule D Case IV and Case V type income is made in this Act and the two rules concerning the remittance basis have been merged to cover all Schedule Case IV and Case V income (in this Act "relevant foreign income" as defined in section 830). No list of how sums might be received has been included, because of the impracticality of producing a finite list, and the amount of detail required for a list of mere examples.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 134: Foreign income: special rules: relevant foreign income charged on remittance basis: allowable deductions under section 65(5)(b) of ICTA: section 832

This change extends the rule in section 65(5)(b) of ICTA allowing deductions from remittances in respect of trade profits to profits of professions or vocations exercised outside the United Kingdom.

Section 65(5) of ICTA contains the rules for calculating the quantum of income within Schedule D Case IV and V that is chargeable to tax under the remittance basis. There are separate rules for Schedule D Case IV (section 65(5)(a) of ICTA) and Schedule D Case V (section 65(5)(b) of ICTA) income.

The rules for Schedule D Case V income are as follows:

> "Tax shall be computed in the case of tax chargeable under Case V, on the full amount of the actual sums received in the United Kingdom in the year of assessment from remittances payable in the United Kingdom or from property imported, or from money or value arising from property not imported, or from money or value so received on credit or on account in respect of any such remittances, property, money or value brought or to be brought into the United Kingdom, *without any deduction or abatement other than is allowed under the provisions of the Income Tax Acts in respect of profits charged under Case I of Schedule D.*

The italicised words at the end are interpreted as meaning that where the income remitted is the equivalent of income within Schedule D Case I (i.e. profits arising from a trade), then the same deductions are available. The deductions are not available to all types of income remitted. But section 832(3) and (4) extend this rule so that the same deductions may be made from remittances of income in respect of professions or vocations exercised outside the United Kingdom as are made from income in respect of professions or vocations exercised in the United Kingdom.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 135: Foreign income: special rules: relief for unremittable income and delayed remittances: conditions for granting relief: sections 835 and 841

This change broadens one condition and removes another condition for claims for relief in respect of unremittable income under section 584 or 585 of ICTA.

Section 584 of ICTA provides for relief for taxpayers taxed on income arising outside the United Kingdom, where the income cannot be remitted to the United Kingdom and certain conditions are met. Section 584(1)(a) and (2)(b) of ICTA refer to income which cannot be remitted to the United Kingdom because of the laws of the overseas territory, any executive action of its government or the impossibility of the person obtaining foreign currency in the overseas territory "notwithstanding any reasonable endeavours on his part".

Section 585 of ICTA applies to taxpayers on the remittance basis (see section 65(4) of ICTA). It provides that relief from tax on income taxed under Schedule D Case IV or V may be claimed if the conditions set out in subsection (1)(a) to (c) are met.

- Subsection (1)(a) requires the taxpayer to have been unable to transfer the income to the United Kingdom.

- Subsection (1)(b) requires the inability to transfer to have been due to one of three reasons:
  - the laws of the territory where the income arose;
  - executive action of its government; or
  - the impossibility of obtaining foreign currency in that territory.

Subsection (1)(c) requires the inability to transfer to have been not due to any want of "reasonable endeavours" on the part of the taxpayer.

(1) This concerns the condition contained in sections 584(1)(a) and 585(1)(b) of ICTA requiring an inability to transfer "due to….the impossibility of obtaining foreign currency" in the territory where the income arose. It could be argued that there cannot be an inability to transfer due to the impossibility of obtaining foreign currency in that territory if foreign currency is in fact obtainable there (regardless of whether it may be transferred to the United Kingdom).

Sections 835(3)(c) and 841(3)(c) remove the possibility of that narrow interpretation being taken. They require an inability to transfer because of the impossibility of obtaining in the territory currency "that could be transferred to the United Kingdom". The reference to that currency being foreign has been dropped as misleading: if local currency can be obtained that cannot be transferred to the United Kingdom, the case is likely to fall within section 835(3)(a) or (b) or 841(3)(a) or (b), but there is no point in excluding it from paragraph (c).

(2) The condition contained in section 585(1)(c) of ICTA and the similar words about "reasonable endeavours" in section 584(2) of ICTA are not rewritten in this Act. They are regarded as adding little to the requirements of sections 584(1)(a) and 585(1)(a) and (b) of ICTA. If, by reasonable endeavours, the taxpayer could transfer the income to the United Kingdom, the test in section 584(1)(a) of ICTA of his being prevented from transferring it and the similar tests in section 585(1)(a) of ICTA about being unable to transfer the income or remit the proceeds of transfer must not be met, and there would then be no inability to transfer *because of* local law, government action or the impossibility of obtaining foreign currency as required under section 585(1)(b) of ICTA.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 136: Foreign income: special rules: delayed remittances: remittances in respect of which a claim may be made: section 835

This change enables a claim for relief to be made in respect of some (as opposed to all) of a taxpayer's delayed remittances where the taxpayer is taxed on the remittance basis.

Relief is available under section 585 of ICTA to taxpayers who are taxed on the remittance basis for income which cannot be remitted to the United Kingdom, if the conditions in section 585(1) of ICTA are met.

Section 585 of ICTA does not expressly refer to the possibility that a claim for relief may be made in respect of some (as opposed to all) of the income from a source which meets those conditions. But in practice the Inland Revenue would allow such a partial claim.

Section 835(1) gives effect to this practice by providing that a claim may be made "in respect of any of the income which meets [the relevant conditions]" without requiring that the claim must be made in respect of all the income.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 137: Foreign income: special rules: deductions: omission of requirement for income not to be received in the United Kingdom: section 838

This change involves rewriting the part of section 65(1) of ICTA that permits deductions for expenses incurred outside the United Kingdom to be allowed in calculating the amount of foreign income chargeable to tax with the omission of the condition that the income in question must not be received in the United Kingdom.

Under section 65(1)(a) of ICTA certain deductions may be made from income within Schedule D Case IV and V that is taxed on the arising basis (with the exception of income arising from a trade carried on wholly abroad). The deductions are only permitted to be made where the income concerned is not received in the United Kingdom. (See the words preceding paragraph (a) of section 65(1) of ICTA.)

It is thought that this rather curious condition was included as an attempt to put taxpayers who found themselves within the arising basis rather than the remittance basis (following the restrictions placed on the remittance basis in FA 1914) on a similar footing to those who could still take advantage of the remittance basis. In fact, no deductions are available to those taxed on the remittance basis (except in the case of trading income). Moreover, in practice, for taxpayers within the arising basis, the Inland Revenue make no distinction between income received and not received in the United Kingdom: deductions available under section 65(1)(a) of ICTA are given whether or not the income in question is received in the United Kingdom. (See Change 138 for further details about the nature of these deductions.)

In rewriting the circumstances in which these deductions are allowed, this restriction has been omitted. (It is necessary, however, and has been retained for the deduction allowed for annuities under section 65(1)(b) of ICTA which is rewritten in section 839: see subsection (5)(a) of that section.)

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 138: Foreign income: special rules: specifying deductions available: section 838

This change concerns specifying the type of deductions available under section 65(1)(a) of ICTA for income within Schedule D Cases IV and V and extending the availability of these deductions to profits of foreign trades.

Section 65(1)(a) of ICTA allows certain deductions in computing the charge to income tax under Schedule D Cases IV and V where the income is taxed under the arising basis. Section 65(1)(a) of ICTA is drafted in very vague terms, referring to “the same deductions and allowances as if it [the income] had been so received [in the United Kingdom]”. In this context, the word “received” is thought to be a reference to income taxed on the remittance basis.

In practice, the Inland Revenue treat these words as referring to expenses incurred in the “management and collection” of the income and the expenses allowed are confined to expenses incurred outside the United Kingdom. (See paragraph 1669 of the Inland Revenue’s Inspector’s Manual (IM 1669).) This interpretation is in accordance with the decision in Atkin v McDonald’s Trustees (1894), 3 TC 306 (Court of Exchequer, Scotland, First Division) which involved income assessed on the remittance basis. In that case it was held that expenses incurred in the United Kingdom could not be deducted from the remitted income. So it follows that if deductions under section 65(1)(a) of ICTA are to mirror the position a taxpayer might find himself or herself in under the remittance basis, the section 65(1)(a) of ICTA expenses are confined to expenses incurred outside the United Kingdom.

Section 838 uses the words “collection or payment” rather than “management and collection” because the use of the word “management” might imply that the costs of managing a portfolio of investments should be allowed, but that is not so. The deductions that are allowed are those solely concerned with the costs of handling the income. There is nothing in the legislation that confines those costs to costs involved in sending the money to the United Kingdom, so no such restriction has been imposed.

Section 65(3) of ICTA provides that section 65(1)(a) of ICTA does not apply to income arising from a trade, profession or vocation carried on wholly outside the United Kingdom ("a foreign trade"). But, in practice, the Inland Revenue treat section 65(1)(a) of ICTA as conferring a deduction for certain extra expenses of a foreign trade that result from the income arising outside the United Kingdom, although in fact it is unlikely that there are any expenses within section 65(1)(a) of ICTA that would not be allowable in arriving at the profits of a foreign trade. Such trades are thus treated in the same way as overseas property businesses, since section 65A(5) of ICTA does not disapply section 65(1)(a) of ICTA.

In rewriting section 65(1)(a) of ICTA, section 838 does not exclude income from a foreign trade. So the costs attributable to the collection or payment of income from a foreign trade are deductible.

This change is adverse to some taxpayers and favourable to others in principle but in practice is expected to have only favourable effects and those small, and in few cases, because the incidence of these costs is rare.

Change 139: Pensions charged on the arising basis (sections 575, 613 and 635 of ITEPA): relief for arrears of foreign pensions: section 840 and paragraph 152 of Schedule 2

This change gives statutory effect to ESC A55 (arrears of foreign pensions). In doing this the Act makes a number of changes to the approach in the concession.

Sections 575, 613 and 635 of ITEPA determine the amount of taxable pension income for foreign pensions, foreign annuities and foreign voluntary annual payments respectively. The amount is found by applying the rules of Schedule D Case V. Section 65(1) of ICTA computes income under Schedule D Case V on the full amount of the income arising in the year of assessment (unless the remittance basis applies – see section 65(4) of ICTA). Section 68 of ICTA has provisions equivalent to section 65(1) of ICTA (but not to section 65(4) of ICTA), in respect of such income from the Republic of Ireland.

When a pension, annuity or voluntary annual payment (or an increase in such a pension etc) is granted retrospectively, arrears paid in respect of an earlier year or years arise for the purposes of sections 65(1) and 68 of ICTA in the year they become due rather than in an earlier year or years. The person receiving the arrears may be liable at a higher rate of tax in the year the income arises than the rate that would have applied had the arrears arisen in the earlier year.

Under ESC A55 the Inland Revenue recalculates the tax for the year in which the arrears arise for the purposes of section 65(1) of ICTA as if the arrears had arisen in the earlier year or years. If the recalculation is advantageous to the taxpayer, the tax charged is abated. The recalculation takes into account the 10% deduction under sections 65(2) or 68(5) of ICTA where appropriate. The abatement is applied without a claim.

Section 840 gives effect to the concession, but with some adaptations, taking the parallel relief for income charged under the remittance basis in section 836 (relief for delayed remittances: back dated pensions) as its model. So, rather than the tax for the year in which the arrears arise being abated, the arrears are treated as income of each relevant earlier year. The tax charge for each earlier year will increase, but the reduction of the charge in the year in which the arrears otherwise arise will compensate (and normally exceed the aggregate of the increases). Section 840(2) also requires a claim by the person liable for tax on the arrears, instead of action being initiated by the Inland Revenue. The administrative provisions of section 837 (claims for relief on delayed remittances) are applied so as to cater for these factors in the change of approach. It provides a time limit for claims, machinery for adjusting tax for earlier years and administration of the relief when a claimant dies.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is broadly in line with current practice.

Change 140: Foreign income: special rules: unremittable income: time limit for claims for relief: section 842(5)

This change alters the time limit for claims to relief in respect of unremittable income arising outside the United Kingdom so that the limit is tied to the tax year for which the income would otherwise be chargeable, rather than to the tax year in which the income arises.

Under section 584(6)(a) of ICTA a claim must be made "on or before the first anniversary of the 31 January next following the year of assessment in which the income arises". The year in which the income arises, however, might not be the year for which the income is chargeable, and the normal time limit for claims is by reference to the year for which the income is chargeable. So in such a case the limit under section 584(6)(a) of ICTA would differ from the normal time limit for claims.

In rewriting section 584(6)(a) of ICTA in section 842(5), the time limit for claims has been expressed by reference to the tax year for which the income would be chargeable if no claim were made, so aligning the limit for this kind of claim with the normal time limits for claims.

This change has no implications for the amount of tax due, who pays it or when. It affects (in principle and in practice) only administrative matters.

Change 141: Foreign income: special rules: unremittable income: withdrawal of relief: ECGD payments received: section 843

This involves the withdrawal of relief in respect of unremittable income on the making of an Export Credit Guarantee Scheme payment in respect of the income.

Section 584 of ICTA provides a relief from income tax where a person's income arising outside the United Kingdom is charged on the basis of the income arising in the tax year, but cannot be transferred to the United Kingdom because of circumstances outside the person's control ("unremittable income"). Section 584(2) of ICTA provides that if such a person makes a claim in respect of overseas income which:

- is unremittable; and
- he or she will continue to be prevented from transferring to the United Kingdom, notwithstanding any reasonable endeavours on his or her part,

the amount of the income is to be left out of account in charging income from that source.

However, under section 584(2A) of ICTA if on any date "paragraph (a) or (b) of subsection (2) above ceases to apply" the income is treated as arising on the date of the change and is charged to tax for the tax year in which that date falls.

Section 584(5) of ICTA modifies the operation of the relief where a payment is made under the Export Credit Guarantee Scheme in respect of the unremittable income. Section 584(5) of ICTA provides that "…to the extent of the payment, the income shall be treated as income to which paragraphs (a) and (b) of subsection (2) above do not apply (and accordingly cannot cease to apply)". This makes it clear that no claim can be made, but not whether relief already given may be withdrawn or, if it may, whether the charge to withdraw the relief is to be made for the tax year in which the income first arose, or the year in which the ECGD payment is made.

This lack of clarity appears to be an unintentional result of amendments made by paragraph 33 of Schedule 20 to FA 1996, which substituted the present subsections (2) and (2A) of section 584 of ICTA for the original subsection (2) and amended subsection (5) in consequence. Those amendments, which were part of the changes made to facilitate Self Assessment for income tax, built on the changes already made by F(No 2)A 1987 for the introduction of "Pay and File" for corporation tax. Before the FA 1996 changes section 584(2) of ICTA was much longer and provided not only that account would not be taken of the income to the extent that the claimant showed "to the satisfaction of the Board that conditions [corresponding to those in paragraphs (a) and (b) in the present subsection (2)]" were satisfied with respect to it, but also that "on the Board ceasing to be satisfied that those conditions are satisfied" such assessments etc were to be made as were necessary to take account of the income and of any tax payable in the overseas territory in respect of it "according to their value at the date when in the opinion of the Board those conditions cease to be satisfied with respect to it".

The original section 584(5) of ICTA provided that to the extent of the Export Credit Guarantee Scheme payment the income should be treated as income "with respect to which the conditions mentioned in subsection (2) above are not satisfied (and accordingly cannot cease to be satisfied)". So it plainly had the effect that not only could no claim be made, but the Board would be bound to be satisfied that the income had ceased to be unremittable – or perhaps had never been unremittable – and so it could be assessed. It was never very clear what date was to be used for the value of the income and the foreign tax. But presumably the only date that could be used was the date when the Board had to cease to be satisfied, that is the date of the payment.

There is no good reason for the treatment of income which is no longer unremittable to vary according to whether circumstances have changed or an ECGD payment has been made. So this apparent change in the effect of section 584(5) of ICTA appears to have been completely unintentional. In practice, the income is taxed in the tax year in which the ECGD payment is made. Therefore section 843(4) and (5), which rewrite section 584(5) of ICTA, provide for the income to be taxed in that tax year, and accordingly for the income and any tax payable in respect of it in the place where it arises to be taken into account for income tax purposes at that date.

This change is adverse to some taxpayers in principle. But it is in line with the original legislation before amendment and with the intention of the amended legislation. And it is expected to have no practical effect as it is in line with current practice.

Change 142: Relevant foreign income: unremittable income: appeals to the Special Commissioners: Chapter 4 of Part 8 and paragraph 153 of Schedule 2

This change involves the omission from this Act of any provision rewriting the requirement under section 584(9) of ICTA that appeals concerning questions about relief for unremittable income should be heard by the Special Commissioners.

Section 584(9) of ICTA provides that appeals involving any question as to the operation of that section (relief for unremittable overseas income) must be made to the Special Commissioners and not to the General Commissioners. This is a departure from the normal rules in sections 31B to 31D of TMA under which in most cases a taxpayer may have an appeal heard by the General Commissioners or make an election under section 31D of TMA for the appeal to be heard by the Special Commissioners.

This Act does not include any requirement about appeals involving any question as to the operation of Chapter 4 of Part 8 of the Act, which rewrites section 584 of ICTA. So the normal rules in sections 31B to 31D of TMA will apply to such appeals without restriction.

This change has no implications for the amount of tax due, who pays it or when. It affects (in principle and in practice) only administrative matters.

Change 143: Partnerships: allocation of firm's profits between partners: section 850

This change legislates the practice in paragraph 72245 of the Inland Revenue's Business Income Manual.

Section 111(3) of ICTA provides that a partner's share of the profits or losses of a trade carried on in partnership is to be determined "according to the interests of the partners". It offers no guidance on how this is to be done.

Some partnership agreements provide for an initial allocation of profits (often in the form of a salary or interest on capital) to some partners before the balance is allocated on the basis of a percentage share in the profits.

For instance, three partners may agree to allocate profits of 250,000 as follows:

Partner	***A***	***B***	***C***	***Total***
Salary	50,000	50,000		100,000
Balance (30/30/40)	45,000	45,000	60,000	150,000
Total	95,000	95,000	60,000	250,000

But, if the profits were only 90,000, the position would be:

Partner	***A***	***B***	***C***	***Total***
Salary	50,000	50,000		100,000
Balance (30/30/40)	(3,000)	(3,000)	(4,000)	(10,000)
Total	47,000	47,000	(4,000)	90,000

Section 111(3) of ICTA deals in this case with an allocation of the trade *profits*. So the answer for partner C cannot be a loss. The Inland Revenue practice, supported by decisions by the Special Commissioners, is to re-allocate C's "loss" to the other partners, so that in the example both A and B are allocated 45,000 of the trade profits. C's share is nil.

A similar position can arise if the result for the firm is a loss. A share of that loss under section 111(3) of ICTA cannot be a profit.

Section 850(2) and (3) of this Act set out how a profit is to be allocated between partners, so that no partner's share is a loss. Subsections (4) and (5) set out the corresponding rule for the case where the overall result is a loss.

This change is in principle adverse to some taxpayers and favourable to others but it is expected to have no practical effect as it is in line with current practice.

Change 144: Partnerships: carrying on by partner of notional business: section 854

This change makes clear how the basis period rules apply to a non-trade business carried on in partnership.

If a person carries on a business (but not a trade) in partnership, section 111(10) of ICTA provides that subsections (1) to (3) of that section apply as they apply to a trade carried on in partnership. But those subsections do not import the special basis period rules in sections 60 to 63A of ICTA. So the income of the firm is assessed on the basis of the income arising or profits accruing in the tax year.

The position changes if the firm also carries on a trade. Then each partner's share of the trading profits is assessed, in accordance with the rules in sections 60 to 63A of ICTA, on the profits of basis periods which may differ from tax years. A consequence of that treatment is that section 111(7) and (8) of ICTA apply to the non-trading income of the firm. So the non-trading income may also be assessed on the income of basis periods which differ from tax years.

There is a potential problem if a non-trading firm starts to trade. Section 111(8)(b) of ICTA seems to require the basis periods for the non-trading income to be re-determined for all years since the partner joined the firm. That would pose considerable practical difficulties in the absence of rules about how to make the adjustments to assessments for earlier years.

Section 854(2)(b) of this Act makes it clear that the partner's "notional business" (comprising a share of the non-trading income) does not start until the firm starts to trade: there is no question of looking back to the time when the partner joined the firm.

This change is in principle adverse to some taxpayers and favourable to others but it is expected to have no practical effect as it is in line with current practice.

Change 145: Partnerships: resident partners and double taxation agreements: section 858

This change enacts the Inland Revenue practice of giving a narrow interpretation to the word "affect" in section 112(4) of ICTA.

The business profits article of the United Kingdom/Jersey double taxation agreement exempts the profits of a Jersey firm from United Kingdom tax. In the case of Padmore v CIR (1989), 62 TC 352 CA[21], the Court of Appeal decided that the exemption covered the share of the profits arising to a United Kingdom resident partner. The rules in section 112(4) and (5) of ICTA were enacted in 1987 to remove the exemption.

It was intended, in the case of income tax, that the 1987 legislation should do no more than remove the exemption claimed in the Padmore case. The words used in section 112(4) of ICTA are "shall not affect any liability to tax". On the face of it, these words could deny the partner any relief, including tax credit relief, under a double taxation treaty.

Section 858(2) of this Act makes it clear that it is only the partner's chargeability to tax that is preserved, overriding any provision to the contrary in a double taxation treaty. No other effect of the treaty is overridden.

This change is in principle in taxpayers' favour but is expected to have no practical effect as it is in line with current practice.

Change 146: Exception of certain business gifts from the disallowance of expenditure on business entertainment and gifts in calculating the profits of non-trade and non-property businesses: section 867

This change extends an exception made in calculating profits, in the case of a business which is a trade or property business, to non-trade and non-property businesses.

Section 577 of ICTA (business entertaining expenses) prohibits the deduction of business entertaining expenditure in calculating profits chargeable to tax under Schedule D (section 18 of ICTA). Profits chargeable to tax under Schedule D include not only profits of a trade, profession or vocation, whether chargeable under Case I or II or Case V of that Schedule, but profits chargeable under other Cases of that Schedule. Section 21A(2) of ICTA applies section 577 of ICTA to the computation of income under Schedule A (section 15 of ICTA).

Section 577(8) of ICTA extends the restriction of deductible expenses under that section to the provision of gifts.

There are a number of exceptions from the restriction under section 577(1) or (8) to ICTA. Subsection (9) makes an exception for gifts to "expenditure incurred in making a gift to a body of persons or trust established for charitable purposes only" and two named bodies are treated as such a body of persons for this purpose. This exception was inserted by section 54 of FA 1980 in the predecessor of section 577 of ICTA, to give statutory form to an extra-statutory concession for donations by businesses to local charities. The scope of the former concession was broadened by the inserted exception, but the exception was restricted to "computing profits under Case I and II of Schedule D".

The exception provided by section 577(9) of ICTA does not therefore apply to business other than trades, professions and vocations or property businesses.

Section 577 of ICTA is rewritten, in respect of such trades and property businesses, in sections 45 to 47 in Part 2 of this Act. This section borrows from those sections to provide the extension of the rules, including exceptions, to non-trade businesses and non-property businesses.

It was not Inland Revenue policy, despite the drafting used in section 577(9) of ICTA, to make a distinction in the application of the exception between trades and property businesses and

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other businesses. Section 867 extends the benefit of the exception in principle to those other businesses.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 147: General calculation rules: apportionment of profits: section 871

This modifies the application of section 72 of ICTA so that it applies to certain income within Schedule D Cases IV and V as well as Case VI.

Section 72(1) of ICTA permits the apportionment of profits or losses for the purposes of Schedule D Cases I, II or VI where accounts have been made up for a period which is not coterminous with the tax year (for income tax) or an accounting period (for corporation tax). Section 72 of ICTA is applied by section 21A of ICTA for the purpose of calculating the profits of a Schedule A business.

Although section 72 of ICTA is expressed to apply in the case of profits or gains chargeable under Schedule D Cases I, II and VI only, it applies also to income chargeable to tax under Schedule D Cases IV and V which is derived by a person (whether solely or in partnership) from a trade profession or vocation. Section 65(3) of ICTA applies the rules applicable to Schedule D Cases I and II in computing such Schedule D Case IV or V income. Section 203 (apportionment etc. of profits to basis periods) applies the income tax rule in section 72 of ICTA to all trades, professions and vocations, whether within Schedule D Cases I or II or Cases IV or V.

Section 871 applies the income tax rule in section 72 of ICTA for the purpose of calculating income charged under provisions listed in section 836B of ICTA (inserted by paragraph 340 of Schedule 1 to this Act). Subsection (2) disapplies section 836B(4)(a) of ICTA, which excludes relevant foreign income from income within the tables in that section. This ensures that section 871 extends to income within Schedule D Case IV or V as well as income within Case VI.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 148: Definition of "caravan" given by section 875 relevant to sections 20, 266, 308, 787 and 809

This change provides a single definition of "caravan" relevant to a number of sections and based on section 29(1) of the Caravan Sites and Control of Development Act 1960 and section 13(1) of the Caravan Sites Act 1968.

The change is relevant to sections 20, 266, 308, 787 and 809.

For the purposes of paragraph 3 of Schedule A (see section 15(1) of ICTA) "caravan" has the meaning given by section 29(1) of the 1960 Act. Paragraph 3 is re-written in section 266. The same definition is attracted by paragraph 4 of Schedule A (re-written in section 308).

Subsection (1) of section 875 reproduces the effect of section 29(1) of the 1960 Act; and subsection (2) reproduces the effect of section 13(1) of the 1968 Act. The section does not, however, reproduce the effect of section 13(2) of the 1968 Act (which provides that a structure mentioned in section 13(1) (a twin-unit caravan) is not a caravan if its dimensions exceed specified limits). Neither the 1960 Act nor the 1968 Act extend to Northern Ireland. However, the Caravans Act (Northern Ireland) 1963 contains the same definition for Northern Ireland as is contained in section 29(1) of the 1960 Act.

It is not clear whether the 1968 Act modifications apply for the purposes of paragraphs 3 and 4 of Schedule A. First, it is likely that Parliament intended that only one definition of "caravan" was to apply throughout the United Kingdom. But the 1968 Act does not extend to Northern Ireland. As the substance of the definitions in the 1960 Act (which applies to Great Britain) and in the Northern Ireland Act of 1963 are the same, a reference to the definition in the 1960 Act would be enough to secure a uniform definition.

Second, paragraph 3(2) of Schedule A provides that "caravan" has the meaning "given by" section 29(1) of the 1960 Act. Section 13 of the 1968 Act modifies the operation of Part 1 of the 1960 Act (rather than the section 29(1) definition). Because the definitions in section 29(1) apply "in" Part 1 of the 1960 Act it is therefore not certain whether the modifications made by the 1968 Act have been attracted.

Section 875 resolves these doubts by reproducing only section 13(1) of the 1968 Act. Consequently it does not matter whether a twin-unit caravan can be lawfully moved on a highway when assembled. For the purposes of Schedule A (as re-written in this Act) it is also immaterial if the twin-unit caravan exceeds the dimensions specified in section 13(2) of the 1968 Act. Schedule A treatment seems more appropriate the bigger the structure.

The definition of "caravan" in section 875 is also relevant to sections 787 and 809. "Caravan" is not defined in the definition of "residence" in paragraph 7 of Schedule 10 to F(No 2)A 1992 (rent-a-room relief) or in paragraph 7(3) of Schedule 36 to FA 2003 (foster-care relief). Accordingly, "caravan" has its ordinary meaning in those provisions. The definition of "caravan" in section 875 is wider than the ordinary meaning: for example, it includes structures that can be moved only by being put on trailers.

In relation to section 787 (which re-writes paragraph 7 of Schedule 10 to F(No 2)A 1992), a structure covered by the extended definition of "caravan" may be covered by the reference to a building or part of a building. But if not, the effect of moving from the ordinary meaning of "caravan" to the definition in section 875 is to widen the range of residences in relation to which rent-a-room relief is available.

In relation to section 809 (which re-writes paragraph 7(3) of Schedule 36 to FA 2003) the definition of "residence" used in section 787 applies. Consequently, the point made in relation to section 787 is also relevant. In referring to "the" residence, paragraph 7(3) of Schedule 36 to FA 2003 assumes that the accommodation which is actually provided by the foster carer for the child is caught. That would include accommodation comprising a structure covered by the extended definition of "caravan". Therefore the application of the extended meaning of "caravan" has no effect in relation to foster-care relief.

The changes are in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 149: References to "the Inland Revenue": section 878

This change converts references in the source legislation to an inspector or to the Board of Inland Revenue into references to any officer of the Board.

(1) *References to an inspector* The legislation rewritten in this Act contains a substantial number of references to an "inspector" (which means an inspector of taxes: see section 832(1) of ICTA). Except in the cases where that legislation refers to the making of claims and elections to the inspector, this Act replaces such references with references to "the Inland Revenue". This expression is defined by section 878(1) to mean any officer of the Board of Inland Revenue. For the purposes of this Act "the Board of Inland Revenue" means the Commissioners of Inland Revenue appointed under section 1 of the Inland Revenue Regulation Act 1890: see section 878(1).

As a result, the provisions affected will expressly authorise or require things to be done by or in relation to an officer of the Board instead of by or in relation to an inspector. This is consistent with the internal reorganisation of the Inland Revenue which took place in the mid-1990s and resulted in the merger of the previously separate networks of collection and tax offices and less rigid specialisation in relation to particular functions.

This represents only a minor change in the law because a similar result could in many cases be achieved by a different means under section 1(2B) of TMA, which was inserted by FA 1990. Under that provision a person who is not an inspector may for particular purposes exercise functions conferred on inspectors if, in accordance with the Board's administrative practices, he or she has been authorised to act as an inspector for those purposes.

In the cases where the legislation rewritten in this Act refers to the making of a claim or election to the inspector, the Act does not expressly provide for such a claim or election to be made to an officer of the Board. It does not specify to whom the claim or election must be made.

If the claim or election could be made by being included in a return to an officer of the Board, section 42(2) of TMA will apply to require it to be made in such a return. Otherwise paragraph 2(1) of Schedule 1A to TMA will apply to require the claim or election to be made to an officer of the Board.

This does not represent a change to the position before the passing of this Act. Section 42(2) of TMA and paragraph 2(1) of Schedule 1A to that Act also apply where the source legislation refers to the making of a claim or election to the inspector. They operate to require the claim or election to be made to an officer of the Board.

(2) *References to the Board of Inland Revenue* The source legislation also contains a number of references to "the Board" (which means the Commissioners of Inland Revenue: see section 832(1) of ICTA). Except where it is dealing with claims and elections, or where in practice the Board has not devolved the function concerned, this Act replaces such references with references to "the Inland Revenue". As mentioned above, this expression is in turn defined by section 878(1) to mean any officer of the Board of Inland Revenue.

Where the source legislation provides for a claim or election to be made to the Board, this Act does not expressly state to whom such a claim or election is to be made. Section 42(2) of TMA, or paragraph 2(1) of Schedule 1A to that Act, will apply to require the claim or election to be made to an officer of the Board. In such cases the requirement to make the claim or election to the Board is still replaced by a requirement to make the claim or election to an officer of the Board, as a result of the application of the TMA.

This last change has a further consequence. If a claim to the Board is made in a return, section 46C of TMA provides that an appeal concerning the claim will be heard by the Special Commissioners. If such a claim is made otherwise than in a return, paragraph 10 of Schedule 1A to that Act has the same effect.

Neither section 46C of TMA nor paragraph 10 of Schedule 1A to that Act will apply to the equivalent claim under this Act, which will be made to an officer of the Board. An appeal concerning such a claim will be heard by the General Commissioners instead, by virtue of section 31B of TMA (claims in returns) or paragraph 11(1) of Schedule 1A to that Act (other claims).

The claimant will still have the right under section 31D(1) of TMA (claims in returns) or paragraph 11(2) of Schedule 1A to that Act (other claims) to elect for the appeal to be heard by the Special Commissioners, although the General Commissioners may in certain circumstances disregard that election.

The result of the changes mentioned in this section is that the provisions affected will authorise or require things to be done by or in relation to an officer of the Board instead of by or in relation to the Board itself. However, as with the conversion of references to an inspector, this reflects the current organisation of the Inland Revenue.

Under section 4A of the Inland Revenue Regulation Act 1890 (which was introduced by FA 1969) any function conferred on the Board by or under any enactment, including any future enactment, may be exercised by any officer of the Board acting on their authority. All of the functions under the provisions affected by the conversion of references to the Board, which are in the main concerned with administrative processes, have in fact been devolved to officers of the Board, and the Board itself is no longer directly involved in their exercise.

Each of the provisions affected by the conversion of references to the inspector or to the Board is identified in the Table of Origins by a cross-reference to this change.

This change has no implications for the amount of tax paid, who pays it or when. It affects administrative matters only (and does so in principle and occasionally in practice).

Change 150: Definition of "houseboat" given by section 878 relevant to sections 787 and 809

This change provides a single definition of "houseboat", relevant to sections 787 and 809.

For the purposes of paragraph 3 of Schedule A (see section 15(1) of ICTA) "houseboat" is defined as a boat or similar structure designed or adapted for use as a place of human habitation. Paragraph 3 is re-written in section 266. The same definition is attracted by paragraph 4 of Schedule A (re-written in section 308).

But "houseboat" is not defined in the definition of "residence" in paragraph 7 of Schedule 10 to F(No 2)A 1992 (rent-a-room relief) or in paragraph 7(3) of Schedule 36 to FA 2003 (foster-care relief). Accordingly, "houseboat" has its ordinary meaning in those provisions. The definition of "houseboat" in section 878 is wider than the ordinary meaning: for example, it includes structures which are similar to boats (but are not boats).

In relation to section 787 (which re-writes paragraph 7 of Schedule 10 to F(No 2)A 1992), a structure covered by the extended definition of "houseboat" may be covered by the reference to a building or part of a building. But if not, the effect of moving from the ordinary meaning of "houseboat" to the definition in section 878 is to widen the range of residences in relation to which rent-a-room relief is available.

In relation to section 809 (which re-writes paragraph 7(3) of Schedule 36 to FA 2003) the definition of "residence" used in section 787 applies. Consequently, the point made in relation to section 787 is also relevant. In referring to "the" residence, paragraph 7(3) of Schedule 36 to FA 2003 assumes that the accommodation which is actually provided by the foster carer for the child is caught. That would include accommodation comprising a structure covered by the extended definition of "houseboat". Therefore the application of the extended meaning of "houseboat" has no effect in relation to foster-care relief.

The change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 151: Definition of "personal representatives" and replacement of the expression "executors or administrators" with "personal representatives": section 878

This change involves replacing the expressions "personal representatives" and "executors and administrators", where they are used in the source legislation without definition, with a defined term, "personal representatives". It also involves applying that new definition in relation to provisions in the source legislation which use the expression "personal representatives" as defined in section 701(4) of ICTA.

The term "personal representatives" is used without definition in the following provisions of the legislation on which this Act is based:

- section 103(3)(b) and (bb) of ICTA (which disapply the charge to tax on receipts after the discontinuance of a trade, profession or vocation in relation to consideration paid to the personal representatives of an author for the assignment of copyright, and consideration paid to the personal representatives of a designer for the assignment of a design right) (see section 253);

- section 108 of ICTA (which allows personal representatives to elect for tax chargeable on sums received after discontinuance to be charged as if they were received on the date of discontinuance) (see section 257);
- section 113(7) of ICTA (by which a change in the personal representatives of a person is not to be treated for the purposes of that section as a change in the persons carrying on a trade, profession or vocation carried on by the personal representatives as such) (see sections 258 and 361);
- section 525(2) of ICTA (which allows the personal representatives of a person on whom a charge to tax falls or would fall to be made by reason of the person's sale of patent rights to require the tax payable to be reduced) (see sections 593 and 862);
- paragraphs 4(2), 6(7) and (8) of Schedule 13 to FA 1996 (by which the vesting of a relevant discounted security in personal representatives on a person's death, and the transfer of such a security by personal representatives to a legatee, is to be treated as a transfer of the security for its market value) (see sections 437 and 440); and
- paragraph 14 of Schedule 22 to FA 2002 (which makes provision about the liability of personal representatives to an adjustment charge arising from a change of basis in computing the profits of a trade, profession or vocation) (see section 240).

The expression "executors or administrators" is used, also without definition, in the following provisions of the legislation on which this Act is based (using "personal representatives" in place of that expression):

- section 584(7) of ICTA (relief for unremittable overseas income) (see section 843); and
- section 585(8) of ICTA (relief on delayed remittances) (see section 837).

The definition of "personal representatives" in section 701(4) of ICTA applies to the following provisions of the legislation on which this Act is based:

- section 249(5) of ICTA (by which stock dividend income is deemed in certain circumstances to be part of the aggregate income of the estate of a deceased person) (see sections 410 and 664);
- section 421(2) of ICTA (by which the amount charged to tax in respect of the release of a loan made to a participator in a close company falls in certain circumstances to be treated as part of the aggregate income of the estate of a deceased person) (see sections 419 and 664);
- section 347A(3) of ICTA (which makes provision about annual payments made by personal representatives) (see sections 727 and 730);
- section 547(1) of ICTA (by which the amount of a gain treated as arising on the happening of a chargeable event in relation to a contract for life insurance etc is deemed in certain circumstances to be part of the aggregate income of the estate of a deceased person) (see sections 466 and 664);
- sections 547(7A) and 547A(3) of ICTA (which make provision for and in connection with the liability of personal representatives to tax on a gain treated as arising on the happening of a chargeable event in relation to a contract for life insurance etc) (see sections 466 and 470);
- section 697(1) of ICTA (which makes provision for the determination of the amount of the residuary income of an estate for a year) (see section 666);
- section 698(1) and (3) of ICTA (which make provision for the personal representatives of a deceased person to be deemed to have an absolute or limited interest in relation to the estate of another deceased person) (see section 650);
- section 701(8), (9) and (12) of ICTA (which define various concepts for the purposes of Part 16 of that Act) (see sections 651, 664 and 681); and

- paragraph 7(3) of Schedule 5AA to ICTA (which makes provision about the application in relation to personal representatives of provisions about the taxation of profits and gains from disposals of futures and options involving guaranteed returns) (see section 568).

The definition of "personal representatives" in section 701(4) of ICTA provides that:

> ""personal representatives" means, in relation to the estate of a deceased person, his personal representatives as defined in relation to England and Wales by section 55 of the Administration of Estates Act 1925 and persons having in relation to the deceased under the law of another country any functions corresponding to the functions for administration purposes under the law of England and Wales of personal representatives as so defined; and references to "personal representatives as such" shall be construed as references to personal representatives in their capacity as having such functions.

The new definition in section 878 of this Act provides that:

> ""personal representatives", in relation to a person who has died, means—
>
> (a) in the United Kingdom, persons responsible for administering the estate of the deceased, and
>
> (b) in a country or territory outside the United Kingdom, those persons having functions under its law equivalent to those of administering the estate of the deceased.

This follows section 721(1) of ITEPA. It is also similar to the definition of "personal representatives" in section 229(1) of ICTA. This definition (which does not apply to any of the provisions listed above) provides that:

> ""personal representatives" means persons responsible for administering the estate of a deceased person.

So the main difference between the definition in section 701(4) of ICTA and the definition in section 878 is that the former applies the definition in section 55 of the Administration of Estates Act 1925. Subsection (1)(xi) of that section provides that:

> ""personal representative" means the executor, original or by representation, or administrator for the time being of a deceased person, and as regards any liability for the payment of death duties includes any person who takes possession of or intermeddles with the property of a deceased person without the authority of the personal representatives or the court, and "executor" includes a person deemed to be appointed executor as respects settled land.

It is also worth noting the definition of "personal representatives" in section 111(3) of FA 1989. This definition (which does not apply to any of the provisions listed above) provides that:

> "(3) In this section "personal representatives" means—
>
> (a) in relation to England and Wales, the deceased person's personal representatives as defined by section 55 of the Administration of Estates Act 1925;
>
> (b) in relation to Scotland, his executor or the judicial factor on his estate;
>
> (c) in relation to Northern Ireland, his personal representatives as defined by section 45(1) of the Administration of Estates Act (Northern Ireland) 1955; and
>
> (d) in relation to another country or territory, the persons having in relation to him under its law any functions corresponding to the functions for administration purposes of personal representatives under the law of England and Wales.

Section 45(1) of the Administration of Estates Act (Northern Ireland) 1955 provides that:

> ""personal representatives" means the executors or executor, original or by representation, or the administrators or administrator for the time being of a deceased person.

The first question is whether there is any difference in coverage between the definition in section 701(4) of ICTA on the one hand, and the first limb of the section 878 definition on the other.

The definition in section 55 of the Administration of Estates Act 1925 (and that in section 45(1) of the Administration of Estates Act (Northern Ireland) 1955 mentioned in the definition in section 111(3) of FA 1989) refer to executors as well as administrators.

Under English law, executors are generally appointed by the will. Administrators are appointed by the court where no one is appointed as executor by the will or where the deceased dies without leaving a valid will.

English law recognises three other categories of executor. The first is “executor according to the tenor” who on the terms of the will is appointed to perform the essential duties of an executor where the deceased person has failed to nominate a person to be his executor. Secondly there is the “executor de son tort”, who is a person who takes upon himself the position of executor or intermeddles with the goods of the deceased person without having been appointed executor or administrator. Thirdly there is the “special executor”, the term given to a person who is a trustee of settled land at the time of the death. The position is similar for Northern Ireland.

For the purposes of Scottish law, an executor is appointed either expressly or impliedly by the deceased, in which case he is known as an executor nominate, or by the court, in which case he is known as an executor dative. So the term “executor” under Scottish law is broadly equivalent to an “executor or administrator” under English law. Scottish law also recognises judicial factors and executor-creditors who may be appointed by the court to administer the deceased's estate or part of it. Although a judicial factor could not be described as an executor, he might be regarded as an “administrator”.

So, in relation to any part of the United Kingdom, a deceased person’s personal representatives within the meaning of section 701(4) of ICTA (or section 111(3) of FA 1989) are the persons responsible for administering the person’s estate. The first limb of the section 878 definition therefore seems to catch the same persons as does section 701(4) of ICTA (and section 111(3) of FA 1989) in relation to each part of the United Kingdom, but does so more directly and succinctly.

Then there are the provisions in the source legislation which use the expression “personal representatives” or the expression “executors and administrators” without definition. It follows from what is said above that the application of the first limb of the section 878 definition in relation to these provisions as rewritten in this Act reflects the ordinary common sense meaning of those terms in each part of the United Kingdom.

So far as the second limb of the section 878 definition is concerned, if the first limb covers the same ground as section 701(4) of ICTA, it follows that the application of that first limb to countries and territories outside the United Kingdom must have the same effect as the application of section 701(4) to such countries and territories.

That leaves the question of whether there is any change involved in applying the section 878 definition to provisions in the source legislation which use the expressions “personal representatives” and “executors and administrators” without definition, as those provisions apply to countries and territories outside the United Kingdom.

The terms “executor” and “administrator” are not terms of art in relation to countries and territories outside the United Kingdom. But it seems likely that a court would hold that references to “personal representatives” or “executors or administrators” in tax legislation would, in the absence of a definition, cover the people that most closely resemble executors or administrators in the United Kingdom. In view of what is said above, that means the people who have functions corresponding to those of personal representatives in the United Kingdom ie functions equivalent to those of administering the estate of the deceased.

References to “personal representatives” or “executors or administrators” in the provisions on which this Act is based can be read as references to anyone with responsibility for administering a deceased person's estate, including those with equivalent responsibilities in other jurisdictions. These provisions can be divided into two categories.

In the first category are provisions like section 108 of ICTA. These confirm that, on a person's death, the rights and liabilities which are or would otherwise have been conferred on him are conferred on his personal representatives or his executors and administrators. Sections 584(7) and 585(8) of ICTA and paragraph 14 of Schedule 22 to FA 2002 also fall into this category.

In this context it is clear that the references to "personal representatives" (or "executors or administrators") are to whoever in fact has the role of administering the property of the deceased person. These provisions are intended to confirm that such persons have the same ability to deal with the deceased's tax affairs as he or she would have if he or she were still alive, and are subject to the same tax liabilities.

The second category covers those provisions which only apply because a person has died, so that his or her property is being administered by his or her personal representatives. See, for example, section 103(3)(b) and (bb) of ICTA. This says that the fact that someone who was previously carrying on a trade has died does not mean that certain sums received by his or her personal representatives are to be treated as post-cessation receipts of the trade. Sections 113(7) and 525(2) of ICTA and paragraphs 4(2) and 6(7) and (8) of Schedule 13 to FA 1996 also fall into this category.

In these cases the fact that someone has died creates a gap in the law (or at least a doubt as to what the law is) or requires some special arrangement to be made. The provisions in question fill that gap. So it is consistent with the aim of these provisions for them to be interpreted as applying in all cases in which a person has died and his property is being administered by others.

This change has no implications for the amount of tax paid, who pays it or when.

Change 152: Intellectual property receipts which are earned income for the purposes of the Income Tax Acts: paragraph 338 of Schedule 1 (section 833 of ICTA)

This change concerns certain capital receipts from intellectual property which fall within the definition of "earned income" for the purposes of the Income Tax Acts.

Section 529(1) of ICTA provides that "income from patent rights" arising to an individual is in certain circumstances to be treated as earned income. The circumstances are where the patent was granted for an invention devised by the individual, whether alone or jointly. If any part of the patent rights has previously belonged to someone else, only the part of the income which is not attributable to the rights owned by the other person counts as earned income (section 529(2) of ICTA).

There is no definition of "income from patent rights" in Chapter 1 of Part 13 of ICTA. Section 533(1) of ICTA defines "patent rights" as the right to do or authorise the doing of anything which would, but for that right, be an infringement of a patent. The section also contains a definition of "income from patents" covering:

- any royalty or other sum paid in respect of the user of a patent;
- any amount on which tax is payable under section 524 (taxation of receipts from sale of patent rights) or 525 (taxation of such receipts on death, winding up or partnership change) of ICTA; and
- any amount on which tax is payable under section 472(5) of or paragraph 100 to Schedule 3 to CAA 2001 (balancing charges).

In practice, all the kinds of income mentioned in this definition of "income from patents" are treated as if they were "income from patent rights" for the purposes of section 529(1) of ICTA. It is not thought that there is any other kind of income which is covered by the reference in that section to "income from patent rights".

It benefits taxpayers for the amounts mentioned in the definition of "income from patents" to be treated as earned income for the purposes of the Income Tax Acts.

Earned income is excluded from the rule in section 282A of ICTA that, in a case where the property from which income arises is jointly owned by a husband and wife, it is to be treated as income to which they are entitled in equal shares.

Income treated as earned income by virtue of section 529 of ICTA also falls within the definitions of "relevant earnings" which apply for the purposes of Chapters 3 (retirement annuities) and 4 (personal pension schemes) of Part 14 of that Act (see sections 623 and 644 of ICTA respectively).

The amendment to section 833 of ICTA in paragraph 338 of Schedule 1 to this Act rewrites section 529 of ICTA as subsections (5B) to (5E) of section 833 of that Act. These subsections form part of the main definition of "earned income" for the purposes of the Income Tax Acts.

Section 833(5B) of ICTA provides for "patent income" to be earned income in certain circumstances, mirroring the circumstances specified in section 529(1) of ICTA. The definition of "patent income" in section 833(5D) of ICTA follows the definition of "income from patents" in section 533(1) of ICTA (except that it is drafted by reference to the intellectual property provisions in this Act rather than in ICTA).

So section 833 of ICTA, as amended, confirms that the kinds of income referred to in the definition of "income from patents" in section 533(1) of ICTA are all to be treated as "earned income" for the purposes of the Income Tax Acts.

This change is in taxpayers' favour in principle, but it is expected to have no practical effect as it is in line with current practice.

Change 153: Deduction for employers' national insurance contributions paid by an employee: paragraph 594 of Schedule 1

This change gives a deduction as part of an employee's travel expenses for national insurance contributions paid in respect of a person employed by the employee.

Section 617(3) of ICTA contains a general prohibition on the deduction for tax purposes of any social security contribution. But subsection (4) sets out certain exceptions to the general prohibition. One of the exceptions concerns a deduction from taxable earnings for employers' national insurance contributions paid by an employee.

Before section 617 of ICTA was amended by ITEPA the exception was expressed in terms of a deduction available under section 198 of ICTA. That section covered most of the expenses for which an employee could have a deduction. In ITEPA the rules for expenses were split between the "general rule" in section 336 and the rule for "travel expenses" in sections 337 to 342.

The consequential amendment of section 617 of ICTA by paragraph 87(3) of Schedule 6 to ITEPA allows a deduction for employers' national insurance contributions only if they are within the general rule in section 336 of ITEPA. It is possible for an employee to incur travel expenses in the form of an employee's wages (for instance, those of a chauffeur). In that case, a deduction should be available for employers' national insurance contributions under sections 337 to 342 of ITEPA.

This Act moves the employment income part of the rule in section 617 of ICTA into ITEPA, where it becomes section 360A. Subsection (2) of the new section makes it clear that a deduction may be made for employers' national insurance contributions in accordance with the general rule in section 336 of ITEPA or in accordance with the rules for travel expenses in sections 337 to 342 of ITEPA. This restores the law to what it was before the ITEPA amendment to section 617 of ICTA.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 154: Certain pension income from the Republic of Ireland: basis of calculation: paragraphs 606 to 609 of Schedule 1(sections 575, 613, 631 and 635 of ITEPA)

This gives a 10% deduction in calculating the amount of certain pension income arising in the Republic of Ireland regardless of whether it is the income of a person who could make a claim for the remittance basis.

Section 68 of ICTA provides the basis for calculating the amount of income chargeable under Schedule D Cases IV and V where that income arises in the Republic of Ireland. It provides rules which are in part equivalent to those provided by section 65 of ICTA where such income arises in any other country outside the United Kingdom. The basis provided by section 68 of ICTA (disregarding some obsolete material on averaging) is the amount of income arising in the tax year. Section 68 of ICTA does not include an equivalent of the remittance basis, which is made available by section 65 of ICTA to those who fall within the terms of section 65(4) of ICTA.

Sections 65 and 68 of ICTA are applied by sections 575, 613, 631 and 635 of ITEPA to the pension income charged as a result of those sections. Section 68(5) of ICTA provides that, in calculating the amount of any income which arises in the Republic of Ireland from a pension, a deduction of 10% of the amount of the pension income may be allowed. This is equivalent to the deduction provided by section 65(2) of ICTA for other foreign pension income charged on the arising basis. However, section 68(5) of ICTA adds a condition which denies the deduction where the pension income is “the income of a person falling within section 65(4)”, that is a person who has claimed the remittance basis for his non-Irish income.

In practice, the Inland Revenue do not apply that condition. Accordingly, in the amendments made by paragraphs 606 to 609 of Schedule 1 to this Act to the provisions in sections 575, 613, 631 and 635 of ITEPA that contain the basis for the calculation of the pension income charged under that Act as a result of those sections, no distinction is drawn between income charged on the basis of the amount arising in the Republic of Ireland and income charged on the basis of the amount arising in any other country outside the United Kingdom. The 10% deduction is made a part of the basis of calculation for all the income.

This change is in taxpayers’ favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 155: Employment-related annuities: taxable pension income: annuities arising in the Republic of Ireland: paragraph 607 of Schedule 1 (section 613 of ITEPA 2003)

This ensures that 10% can be deducted when calculating the taxable amount of certain annuities arising in the Republic of Ireland.

Section 613(2) of ITEPA applies the rules applicable to income within Schedule D Case V to calculate the amount chargeable as taxable pension income in respect of foreign annuities within Chapter 10 of Part 9 of that Act. Section 613(3) of ITEPA lists relevant rules, and includes both sections 65 and 68 of ICTA.

The 10% deduction for pensions provided by section 65(2) of ICTA was extended by section 613(4) of ITEPA to annuities within Chapter 10 of Part 9 of ITEPA. (The text of the note explaining that change in the law is given below for ease of reference.)

The deduction provided by section 65(2) of ICTA does not extend to pensions arising in the Republic of Ireland. Section 68 of ICTA disapplies section 65 of ICTA for all income arising in the Republic of Ireland which is chargeable under Schedule D Case IV or V. Section 68 of ICTA provides calculation rules for the taxable amount of such income, although the differences from those in section 65 of ICTA are in practice limited to the non-availability of the remittance basis set out in section 65(4) to (9) of ICTA. Section 68(5) of ICTA provides a deduction from *pensions* which is equivalent to that provided by section 65(2) of ICTA. But this does not extend to annuities, even where they are in the nature of pensions. The need to extend the benefit of section 68(5) of ICTA to annuities arising in the Republic of Ireland was overlooked in drafting section 613(4) of ITEPA.

The amendments of section 613 of ITEPA in paragraph 607 of Schedule 1 to this Act replace the references to Schedule D Case V and to provisions in ICTA, all of which are repealed by Schedule 3 to this Act (for income tax purposes only, where appropriate). In doing so, the amendments extend the benefit of the 10% deduction provided by section 68(5) of ICTA to annuities arising in the Republic of Ireland which are within Chapter 10 of Part 9 of ITEPA.

This change is in principle in taxpayers' favour but is expected to have no practical effect as it is in line with current practice.

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Change 138: Other employment-related annuities: income chargeable: foreign annuities: section 613

This ensures that 10% can be deducted when calculating what amount of certain foreign annuities is to be taxed and also that retrospective payments of these annuities can be spread out over previous tax years when calculating tax liability.

Sections 65(2) and 585(2) of ICTA both concern pensions taxable under Schedule D, Case V. Schedule D, Case V taxes foreign income and so most pensions arising outside the United Kingdom are taxed under it.

Under section 65(2) of ICTA, the amount of the pension which is taxed under Schedule D, Case V is reduced by 10%.

Section 585(2) of ICTA concerns any pension (or increase in a pension) taxed under Schedule D, Case V which is granted retrospectively (i.e. granted for a period before the time of the grant). The pension (or increase) is treated as arising in the period for which it is granted, not at the time when it is actually granted. This may allow the pensioner’s liability to tax on the retrospective payment to be spread out over more than one tax year.

Section 65(2) and section 585(2) both refer only to pensions, not to annuities. However, certain kinds of annuities taxed under Schedule D are in the nature of pensions. In cases where annuities like these arise outside the United Kingdom (and so are also taxed under Case V), the practice of the Inland Revenue is to allow sections 65(2) and 585(2) to be applied.

The following provisions of Part 9 of the Act (pension income) provide for tax to be charged on those Schedule D annuities which are in the nature of pensions–

- section 609: annuities for the benefit of dependants;
- section 610: annuities under sponsored superannuation schemes; and
- section 611: annuities in recognition of another person’s services.

In cases where these annuities arise outside the United Kingdom, the amount which is taxed is determined in accordance with section 613 of the Act. This section applies certain provisions of ICTA, including sections 65 and 585 (see section 613(1)(a) and (c)). Section 613(4) makes clear that when sections 65 and 585 apply for these purposes, the references in sections 65(2) and 585(2) to pensions are to be read as references to these kinds of annuity.

This change is in principle in taxpayers' favour but is expected to have no practical effect as it is in line with current practice.

Change 156: Post-cessation receipts: paragraph 61 of Schedule 2

This change removes the charge on some receipts of individuals born before 6 April 1917 following the cessation of a trade etc before 6 April 2000 or a change of accounting basis before 6 April 1999.

As a result, section 109 of ICTA (which applies in the case of a charge under section 104, but not section 103, of ICTA) need not be rewritten.

Section 104 of ICTA applies where profits have been calculated on a conventional basis (that is, otherwise than by reference to earnings). The section charges tax in two circumstances. First, if there are post-cessation receipts ("sums arising from the carrying on of the trade … before the discontinuance … not brought to account … before the discontinuance" – section 104(2) of ICTA). Second, if there are sums received after a change of accounting basis (section 104(4) of ICTA), being "sums arising from the carrying on of the trade … before the change … not brought to account … for any period" – section 104(5) of ICTA.

Post-cessation receipts

The charge on post-cessation receipts is restricted to sums that are not "otherwise chargeable to tax" (section 104(2) of ICTA). So, if they are chargeable under section 103 of ICTA they are not charged under section 104 of ICTA. The effect of this restriction is that the only post-cessation receipts charged by section 104 of ICTA (under subsection (2)) are those excluded from section 103 of ICTA by section 103(2)(b). This is where the profits are calculated on a "conventional" basis and the receipt would have been included in profits if those profits had been calculated by reference to earnings.

Change of basis

The second charge under section 104 of ICTA, under subsection (4) on a change of accounting basis, was replaced by section 44(3) of FA 1998 but only for changes of accounting basis on or after 6 April 1999. The replacement charge was under Schedule 6 to FA 1998, later replaced by Schedule 22 to FA 2002. The two sets of rules tackled a change of basis in different ways: the charge under section 104(4) of ICTA was triggered by the receipt of a sum (which may be some time after the change of accounting basis); the replacement charges arise on the change of accounting basis.

So section 104(4) of ICTA may theoretically apply, despite its repeal, to a sum which arose before a change of accounting basis before 6 April 1999 but which is received in 2005-06 or later.

Section 109 of ICTA was introduced at the same time as the charges under section 104 to give a measure of relief for cash basis people who were (at the time – in 1968) within ten years of retirement.

Who is chargeable?

There are three possibilities of a charge under section 104 of ICTA:

(a) The recipient ceased trading (calculating profits on a conventional basis) on or before 5 April 2000 (the last date possible, unless the recipient is a barrister) and receives a sum in 2005-06 or later.

(b) The recipient ceased trading (calculating profits on a conventional basis) after 5 April 2000 and receives a sum in 2005-06 or later. Such a person must be a barrister in the early years of practice (section 43 of FA 1998) because that is the only person for whom the earnings basis is not obligatory under section 42 of FA 1998.

(c) The recipient had a change of accounting basis before 6 April 1999 and receives a sum in 2005-06 or later.

The approach of the Act

This transitional provision changes the spreading relief in section 109 of ICTA into an exemption. But the exemption, like the relief in section 109 of ICTA, applies only to individuals born before 6 April 1917. For those individuals the effect is as follows:

The charge for individuals within paragraph (a) is removed.

An individual within paragraph (b) cannot both have been carrying on the profession on 18 March 1968 (as required by section 109(1)(a) of ICTA) and be in the early years of practice on cessation after 5 April 2000. So the relief in section 109 of ICTA does not apply.

Section 104 of ICTA no longer applies to pre-1999 changes of accounting basis for individuals born before 6 April 1917. So the charge for individuals within paragraph (c) is removed.

This change is in taxpayers' favour in principle and may benefit some in practice. But the numbers affected and the amounts involved are likely to be small.

Change 157: Gains from contracts for life insurance etc: time limit for policy holders previously not resident in the United Kingdom to vary policy or contract so it is not a personal portfolio bond: paragraph 125 of Schedule 2

This change gives statutory effect to Part 3 of ESC B53.

Regulation 3 of the Personal Portfolio Bonds (Tax) Regulations 1999 SI 1999/1029 contains exceptions from the definition of "personal portfolio bond" for certain pre-17 March 1998 policies or contracts. One exception applies to a policy or contract which is varied before the end of the first insurance year which begins on or after 6 April 1999 to restrict the kinds of property or index which may be selected under its terms.

A further refinement applies if the policy holder was not resident in the United Kingdom on 17 March 1998, but later becomes UK resident. To prevent the policy or contract from being a personal portfolio bond, the policy holder may vary it before the later of the end of the first insurance year which begins on or after 6 April 1999, and the end of the first insurance year which begins after the time when the policy holder first becomes resident in the United Kingdom after 17 March 1998.

An individual who becomes UK resident during a tax year is treated as being resident for the whole of that tax year. So where the insurance year in relation to a policy or contract begins shortly after the beginning of a tax year, and the policy holder arrives in the United Kingdom close to the end of the tax year, the period for variation of the policy or contract may end shortly after the policy holder's arrival in the United Kingdom.

Part 3 of the concession moderates the effect of this rule in a case where a policy holder arrives in the United Kingdom after 17 March 1998 to take up permanent residence, or to stay for at least two years. In that case the insurance year within which the policy or contract may be varied is the first insurance year to begin on or after the date the policy holder first arrives in the United Kingdom to take up permanent residence or to stay for at least two years.

Paragraph 125 of Schedule 2 to this Act ("policy holders becoming permanently UK resident after 17th March 1998") gives statutory effect to this part of the concession.

It applies where a policy holder was not UK resident on 17 March 1998, but becomes UK resident after that time. The policy holder must, on the date of his or her arrival by virtue of which he or she becomes UK resident, have the intention to take up permanent residence, or to stay for at least two years.

Where those conditions are met the policy or contract may be varied to take it outside the definition of "personal portfolio bond" before the later of the end of the first insurance year beginning on or after 6 April 1999, and the end of the first insurance year beginning on or after the date of his arrival by virtue of which he became UK resident.

Part 3 of ESC B53 does not say in terms that no gain arises under the Personal Portfolio Bonds (Tax) Regulations 1999 in relation to any insurance year ending after the date on which the policy holder became UK resident, but before the insurance year in which the variation is made. This is how the ESC is operated in practice, and the paragraph mentioned above spells this out.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 158: Redundant material – Table 1

This change concerns the omission of redundant material.

The omission of provisions that are redundant in whole or in part is an integral part of the rewrite process and, strictly speaking, does not involve any change in the substantive law.

But for ease of reference those omissions worthy of specific explanation are listed in the table below. The table sets out where those explanations can be found.

This change has no implications for the amount of tax due, who pays it or when.

Redundant provision	***Topic***	***See commentary on section etc***
Industry Act 1972 etc	Industrial development grants	105
Industrial Devpt. Act 1982	Regional development grants	105
ICTA s.18(3) Case III(a) (part)	Interest – “payable out of UK”	369
ICTA s.18(3) Case III(a) (part)	Annual payments – “payable out of UK”	683
ICTA s.18(3) Case III(a) (part)	Interest – “of money, yearly, etc”	369
ICTA s.18(3) Case III(a) (part)	Annual payments – omission of examples of annual payments	683
ICTA s.18(3) Case III(a) (part)	Annual payments – omission of “any annuity”	683
ICTA s.18(3) Case III(c)	Interest – government securities	369
ICTA s.18(6)	Interest and royalties exemption	758
ICTA s.24(6)(a)	Definition of “lease”	317
ICTA s.40(1),(2),(3),(4),(4A)	Apportionment of sale proceeds	320
ICTA s.53(2)	Farming – body of persons	9
ICTA s.56(2) (part)	Transactions in deposits – person liable	554
ICTA s.56(3)(a)	Transactions in deposits	Chapter 11 of Part 4
ICTA s.56A(3)(a)	Transactions in deposits – person liable	554
ICTA s.59(2)	Person liable – “concerns”	8
ICTA s.60(4)	Death of taxpayer	paragraph 36 of Schedule 1
ICTA s.64 (part)	Annual payments – “without any deduction”	684
ICTA s.64 (part)	Interest, etc – “without any deduction”	370
ICTA s.64 (part)	Purchased life annuities – “without any deduction”	424
ICTA s.65(1)	Foreign income – whether income received in United Kingdom	Part 8 (overview)

Redundant provision	***Topic***	***See commentary on section etc***
ICTA s.68(3) (part)	Foreign income – Irish trades and pensions	7
ICTA s.71	Computation of income tax where no profits in year of assessment	paragraph 43 of Schedule 1
ICTA s.74(1)(b)	Private expenses	paragraph 45 of Schedule 1
ICTA s.74(1)(c)	Private expenses – rent	34
ICTA s.74(1)(d)	Trade tools	68
ICTA s.74(1)(g)	Improvements	33
ICTA s.74(1)(h)	Notional interest	paragraph 45 of Schedule 1
ICTA s.74(1)(k)	Average losses	paragraph 45 of Schedule 1
ICTA s.74(1)(m)	Annuities	paragraph 45 of Schedule 1
ICTA s.74(1)(o)	Miras	paragraph 45 of Schedule 1
ICTA s.82	Interest to non-residents	paragraph 53 of Schedule 1
ICTA s.86(5)(d)	Seconded employees	paragraph 60 of Schedule 1
ICTA s.92	Regional development grants	paragraph 45 of Schedule 1
ICTA s.96(7)(c)	Averaging – stock relief	221
ICTA s.105(1) (part), (3)	Post-cessation receipts – capital allowances	255
ICTA s.113(6)	Successions	paragraph 94 of Schedule 1
ICTA s.119(2)	Mineral rents paid in kind	335
ICTA s.122(4)	Income tax deducted from mineral rents	paragraph 106 of Schedule 1
ICTA s.232(1) (part)	Tax credits – non-residents – “having made a claim in that behalf”	397
ICTA s.251B(2)	Share incentive plans – drop “(except to the extent that it represents a foreign cash dividend)”	393
ICTA s.325 (part)	NSB ordinary account interest	691
ICTA s.326(1) (part)	SAYE schemes – “other sum”	702
ICTA s.347A(2)(d) – cross reference to section 125(1)	Annual payments – payments to which 347A applies	729

Redundant provision	***Topic***	***See commentary on section etc***
ICTA s.347A(5) (part)	Annual payments – deductions – reference to section 355 of ITEPA	paragraph 146 of Schedule 1
ICTA s.349(7) (part)	Interest and royalties exemption	757
ICTA s.443	Insurance policies paid in kind	Schedule 1
ICTA s.491(9),(11)	Mutual concerns – examples dropped	104
ICTA s.524(10)	Patent rights – election by non-residents	591
ICTA s.526(2) (part)	Relief for expenses: patent income	600
ICTA s.531(8) (part)	Disposals of know-how	583
ICTA s.533(4) (part)	Patent rights – sums paid for Crown use etc.	599
ICTA s.540(1)(b) (part)	Gains on contracts for life insurance policies etc	485
ICTA s.553A(3) (part)	Gains on contracts for life insurance policies etc	531
ICTA s.554	Borrowing on life policies	paragraph 229 of Schedule 1
ICTA s.580B(4)	Health and employment insurance – terms of a policy	740
ICTA s.585(3) (part), (4), (5)	Delayed remittances – application of relief	835
ICTA s.586	Disallowance war risk premiums	paragraph 247 of Schedule 1
ICTA s.587	Disallowance war injury payments	paragraph 248 of Schedule 1
ICTA s.656(2)(a)	Purchased life annuities	718
ICTA s.660C(1A)(c), (d) and (e)	Settlements	619
ICTA s.698(1) (part)	Income from estates	664
ICTA s.699(6)(b)	Income from estates	669
ICTA s.699A(1)(b)	Income from estates	680
ICTA s.701(6) and (7)	Income from estates	666
ICTA s.817	Deductions not allowed	paragraph 327 of Schedule 1
ICTA s.832(1)	Definition of farming	876
ICTA Sch. 5 para. 3(4)(b)	Herd basis – replacement of animals	116
ICTA Sch. 5 paras. 7 and 9(5)	Herd basis – working animal rule	112

Redundant provision	***Topic***	***See commentary on section etc***
ICTA Sch 5AA par. 4(1)	Guaranteed returns on futures and options – disposal, etc to include more than one	562
ICTA Sch. 15B para. 7(3)(a)	Venture capital trusts "(including a capital dividend)"	709
ICTA Sch.30 para. 5	Schedule A transitional	paragraph 352 of Schedule 1
ICTA Sch.30 para. 18	Stock relief transitional	paragraph 352 of Schedule 1
FA 1996 Sch.13 para. 3(2) (part)	Deep gain securities "disregarding"	435
FA 1996 Sch. 13 para. 4(4)	Deep gain securities "Whether by the exercise"	438
FA 1996 Sch. 13 para 9A(2)(b)	"connected with the company"	456
FA 1996 Sch. 13 para 14D(6) (part)	"otherwise giving effect"	447
FA 2000 Sch. 23 para. 4	Telecommunication rights – group accounts	147
FA 2002 Sch.22 para. 13(3) and (4)	Adjustment income: partnerships	238
FA 2004 s. 97(4)	Interest and royalties exemption. Effect of Treasury order	767
SI 1997/1029 para. 5(2B)(c)	Personal portfolio bonds – calculation of gain	524

Change 159: Case law - Table 2

This change concerns giving statutory effect to principles derived from case law.

If a principle derived from case law is clear and well established it has been given statutory effect. The table below lists the sections and subject matter concerned.

This change has no implications for the amount of tax due, who pays it or when.

Topic	***Case Law***	***Section***
Apportionment of expenses	Lochgelly Iron Co v Crawford (1913)[22]	34
Capital receipts	Attorney General v LCC (1900)[23]	96
Territorial scope – Part 4	Colquhoun v Brooks (1892)[24]	368
Territorial scope – Part 5		577
Purchased life annuities – tax deducted	Allchin v Corporation of South Shields (1943)[25]	426
Patent income – tax deducted		602

22 6 TC 267
23 4 TC 265
24 2 TC 490
25 25 TC 445

Topic	***Case Law***	***Section***
Annual payments – tax deducted	Stokes v Bennett (1953)[26] Grosvenor Place Estates Ltd v Roberts (1960)[27]	686
Telecommunications – tax deducted		618
Intellectual property: certain income	Curtis Brown Ltd v Jarvis (1929)[28]	582
Films and sound recordings: non-trade businesses		612
Telecommunication rights: certain income		617

26 34 TC 337
27 39 TC 433
28 14 TC 744
22 6 TC 267
23 4 TC 265
24 2 TC 490
25 25 TC 445
26 34 TC 337
27 39 TC 433
28 14 TC 744

ANNEX 2: DESTINATION OF REWRITTEN EXTRA-STATUTORY CONCESSIONS:

ESC Number	Description	See Annex 1
A29	Farming and market gardening: relief for fluctuating profits	Change 59
A30	Interest on damages for personal injuries (foreign court awards)	Change 125
A34	Ulster savings certificates: certificates encashed after death of registered holder	Change 113
A46	Variable purchased life annuities: carry forward of excess of capital element	Changes 118 and 119
A55	Arrears of foreign pensions	Change 139
A96 (part)	Old life insurance policies: insurer stopping collection of premiums	Change 89
B29	Treatment of income from caravan sites where there is both trading and associated letting income	Change 3
B38	Tax concessions on overseas debts	Change 50
B42 (part)	“Free gifts” and insurance contracts	Change 91
B53 (part)	Non residents and gains on life insurance policies	Changes 88 and 157
B54	Tax relief for expenditure on films, tapes and discs confirmed	Change 38