

# INCOME TAX (TRADING AND OTHER INCOME) ACT 2005

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## EXPLANATORY NOTES

### COMMENTARY ON SECTIONS

#### **Part 2: Trading income**

#### **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<sup>1</sup> (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

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<sup>1</sup> STC [1975] 127

- 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.
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:

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

- 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.