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

COMMENTARY ON SECTIONS

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).

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.

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1 STC [1975] 578

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.

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.

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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.

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.

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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.

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.

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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.