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 4: Savings and investment income

Overview

1446. This Part contains the rules relating to savings and investment income. It consists of income that is charged under Schedule D Cases III, IV, V and VI; Schedule F and non-schedular charges in the source legislation.

1447. There is a separate Chapter for each category of income arranged as follows:

- interest (Chapter 2);
- dividends and other distributions from UK resident companies (Chapter 3);
- dividends from non-UK resident companies (Chapter 4);
- stock dividends from UK resident companies (Chapter 5);
- release of loan to participator in close company (Chapter 6);
- purchased life annuity payments (Chapter 7);
- profits from deeply discounted securities (Chapter 8);
- gains from contracts for life insurance etc. (Chapter 9);
- distributions from unauthorised unit trusts (Chapter 10);
- transactions in deposits (Chapter 11);
- disposals of futures and options involving guaranteed returns (Chapter 12); and
- sales of foreign dividend coupons (Chapter 13).

Structure of Chapters

1448. The basic structure of each Chapter is:

- charge to tax on income;
- the amount to be charged to tax;
- the person liable for the tax charged; and
- rules specific to that income.

1449. This Part does not contain exemption provisions. Signposts to the exemptions most likely to be relevant have been placed in the charge to tax provisions.

Chapter 1: Introduction

Section 365: Overview of Part 4

1450. This section sets out the income charged in this Part, the approach to exempt income and where to find the priority rules. It is new.

Section 366: Provisions which must be given priority over Part 4

1451. This section provides rules which determine which Part will take priority in the event of any overlap in the charging provisions. It is based on sections 18, 20 and 95 of ICTA, and section 9D of TMA.

1452. *Subsection (1)* ensures that, if any amount falls within a charge in Part 4 of this Act and the charge on trade profits, Chapter 2 of Part 2 of this Act will charge that amount as a trade receipt. This takes account of section 95 of ICTA which sets out the circumstances in which a distribution made by a UK resident company, or a payment which is representative of such a distribution is brought into account in calculating the profits of a trade.

1453. Section 95 of ICTA brings a distribution into account in calculating the trade profits if the recipient is a dealer in relation to that distribution. Subsection (1) instead focuses on the nature of the receipt. See *Change 79* in Annex 1.

1454. Subsection (1) also reflects the decision to give effect to the Crown Option. See *Change 66* in Annex 1.

1455. In the case of non schedular charges it is unlikely that there would be any overlap. But in theory it is possible that, for example, stock dividends (Chapter 5 of Part 4 of this Act) and gains from contracts for life assurance (Chapter 9 of Part 4 of this Act) may rank as trade receipts. Taxing such income under Chapter 2 of Part 2 of this Act accords with the policy and practice of taking trade receipts into account in calculating trade profits and not otherwise. See *Change 66* in Annex 1.

1456. *Subsection (2)* ensures that, if any amount falls within a charge in Part 4 of this Act and the charge on a UK property business, Chapter 3 of Part 3 of this Act will charge that amount as a receipt of a UK property business. This reflects the priority of Schedule A over Schedule D and is based on section 18(1)(b) of ICTA and Schedule D Cases III(a) and VI.

1457. Section 95 of ICTA can have no application to property income and there is no overlap between the Schedule A and Schedule F. The rule that Schedule F takes priority over Schedule A has not therefore been reproduced.

1458. Similarly as there is no overlap between Schedule A and the non schedular charges in section 249 of ICTA (stock dividends rewritten in Chapter 5 of Part 4 of this Act) and section 421 of ICTA (release of loan to participator in a close company rewritten in Chapter 6 of Part 4 of this Act) there is no need to exclude these charges from this priority rule.

1459. *Subsection (3)* ensures that ITEPA takes priority over Part 4 of this Act except for the charging provisions in Chapter 3 of Part 4 of this Act (dividends etc. from UK resident companies) and Chapter 6 of Part 4 of this Act (release of loan to participator in a close company). This reflects the priority that ITEPA has over Schedule D in the source legislation. It is based on section 18(1)(b) of ICTA and Schedule D Cases III(a) and VI of ICTA.

1460. A new provision, section 716A, has been added to ITEPA (see paragraph 615 of Schedule 1 to this Act) which gives priority to Chapter 3 of Part 4 of this Act over charges in ITEPA. This takes account of the fact that Schedule F has priority over ITEPA in the source legislation. It is based on section 20(1) and (2) of ICTA.

1461. In the source legislation there is a potential charge under section 421 of ICTA (which is rewritten in Chapter 6 of Part 4 of this Act (release of loan to a participator in a close company)) and section 188 of ITEPA. Section 189 of ITEPA gives priority to section 421 of ICTA. Section 189 of ITEPA will continue to assign priority to the charge in Chapter 6 of Part 4 of this Act.

1462. *Subsection (4)* provides that an amount can be used in calculating a chargeable event gain under Chapter 9 of Part 4 (gains from contracts for life insurance etc.) although it may also be used in calculating income under another provision in this Act. This is because the calculation of gains under Chapter 9 of this Part uses different principles from those used in other charges. However, section 527 of this Act ensures that the gain calculated under Chapter 9 is reduced by the amount charged elsewhere, to avoid a double charge on the same amount.

Section 367:Priority between Chapters within Part 4

1463. This section provides rules which determine which Chapter will take priority in the case of any overlaps in the charging provisions within Part 4 of this Act. It is based on sections 18 and 20 of ICTA and Schedule 15 of FA 1996.

1464. Usually, by their nature, the particular amounts charged in Part 4 of this Act can fall only within one Chapter so there is no need to make any special provision. This section covers a couple of exceptions.

1465. *Subsection (1)* provides the priority rule for two charging sections which are based on Schedule D Case III and Cases IV and V. Chapter 8 (profits from deeply discounted securities) has priority so that discounts continue to be taxed under the special rules for deeply discounted securities (previously relevant discounted securities) rather than under the general charge on interest which includes “all discounts”.

1466. *Subsection (2)* is concerned with the priority between Chapter 3 (dividends etc. from UK resident companies) and the other Chapters in Part 4 of this Act. Chapter 3 is based on section 20(2) of ICTA which provides specifically for Schedule F to take priority over the other Schedules. But *subsection (3)* provides for two exceptions to this basic rule. Dividends paid by building societies and by industrial and provident societies are treated as interest.

Section 368: Territorial scope of Part 4 charges

1467. This section provides that income within Part 4 of this Act is only charged to tax if it is from the United Kingdom or, if from outside the United Kingdom, it arises to a UK resident. It is based on section 18(1) of ICTA.

1468. Under section 18(1)(a) of ICTA income from any kind of property arising to a resident of the United Kingdom is chargeable to tax wherever that property is situated, while such income is chargeable on a non-resident only when it is from property within the United Kingdom.

1469. Section 18(1)(b) of ICTA, which charges tax in respect of “all interest of money, annuities and other annual profits or gains not charged under Schedule A or ITEPA and not specially exempted from tax”, does not mention the residence status of the person on whom the income or profits are chargeable.

1470. The exact scope of section 18(1)(b) of ICTA and its relation to the rules in section 18(1)(a) of ICTA is not entirely clear. Section 18(1) of ICTA appeared in broadly its present form in the Income Tax Act 1853, borrowing wording from the Income Tax Act 1842.

The 1842 Act is famously impenetrable but the provisions from which the words have been borrowed (sections 100 and 102) may be read as having territorial restrictions. It is difficult to believe that the 1853 provision that is now section 18(1)(b) of ICTA was not intended to share the same territorial restrictions as the provision that is now section 18(1)(a) of ICTA.

1471. Profits charged under Schedule D Case VI may fall within section 18(1)(a) of ICTA where they represent income from any kind of property. But the Income Tax Acts also charge certain specific profits or gains, which would not otherwise be chargeable to income tax, under Case VI and when they are not specified as income from property they fall more comfortably under section 18(1)(b) of ICTA as "annual profits or gains".

1472. In practice the same territorial restrictions are applied to Case VI profits falling within section 18(1)(b) of ICTA as within section 18(1)(a) of ICTA. This is both by analogy with the Case VI charge on income as well as under a general rule of law on territoriality mentioned below.

1473. Where non-schedular charges do not contain a territorial restriction, in practice the same territorial restrictions are applied as for section 18(1)(a) of ICTA. Again, this is both by analogy with the schedular charges and under a general rule of law on territoriality.

1474. Guidance is, however, available from case law. Since Colquhoun v Brooks (1889), 2 TC 490 HL the courts have followed Lord Herschell's judgement that (page 499):

"The Income Tax Acts, however, themselves impose a territorial limit, either that from which the taxable income is derived must be situate in the United Kingdom or the person whose income is to be taxed must be resident there.

1475. Whether Lord Herschell's words referred to the statutory rules of the time or to a general statement of the law, it is as the latter that they have been subsequently applied by the courts. For example in Perry v Astor (1935), 19 TC 255 HL Lord Russell of Killowen states (page 280):

"There must, of course, be the necessary limitation which is inherent in all our Income Tax legislation, namely, that what is taxed under or by virtue of this provision can only be either (1) income which is here, or (2) income of a person resident here.

1476. Additionally there is the general principle of United Kingdom law that, unless the contrary intention appears, an enactment is taken as not applying to matters outside the United Kingdom.

1477. The Schedule F charge on dividends and other distributions from UK companies contains its own territorial restriction, namely where the income arises from a company resident in the United Kingdom.

1478. *Subsections (1)* and *(2)* are drafted in terms of the "source" of the income. Although section 18 of ICTA refers to profits or gains from "property", the usual statutory term elsewhere in the Income Tax Acts and in case law for the same concept is "source" and this has been adopted as the more familiar and modern term.

1479. However, while the term "source" may apply to the majority of receipts chargeable to income tax it does not apply to all such receipts. "Source" is something from which income arises and not all sums charged to income tax are by nature income. "Source" may not be the appropriate term where the amount charged to tax represents a profit on a transaction which is not by nature income and would not be charged to income tax without a specific charge. Indeed, the chargeable profit may arise on the disposal of an income source. This restricted meaning of "source" is supported by Lord Hoffmann's judgement in Walker v Centaur Clothes Group Ltd (2000), 72 TC 379[1] HL and a more

1 STC [2000] 324

detailed discussion of this topic may be found in the commentary on Chapter 1 of Part 8 of this Act.

1480. It has therefore been necessary to consider how to express the territorial scope in cases where there is no natural source of income.

1481. *Subsection (3)* is broadly worded to catch such income. Where the connection such income has to the United Kingdom is comparable to the connection that income with a source in the United Kingdom has to the United Kingdom, then it is treated for the purposes of this section as income from a source in the United Kingdom.

Chapter 2: Interest

Overview

1482. This Chapter charges to tax interest and income that is treated as interest.

Section 369: Charge to tax on interest

1483. This section charges all interest to tax, whether from a source within or outside the United Kingdom. It is based on Schedule D Cases III(a), IV and V in section 18 of ICTA.

1484. *Subsection (1)* sets out the charge to tax.

1485. This section does not reproduce the separate charging provision in section 18(3)(c) of ICTA for "income from securities which is payable out of the public revenue of the United Kingdom or Northern Ireland". All the income which would fall into this category can be charged to tax under other provisions of this Act.

1486. Neither has the section reproduced the words "of money whether yearly or otherwise" in section 18(3) Case III (a) of ICTA.

1487. The cases of Re Euro Hotel (Belgravia) Ltd (1975), 51 TC 293[2] HC and Riches v Westminster Bank Ltd (1947), 28 TC 159 HL demonstrate that the reference to "of money" is to the debt upon which the interest itself is payable rather than the interest. Since the words "of money" add nothing to "interest" they have been dropped.

1488. The words "yearly or otherwise" follow the historical recognition by tax legislation of a distinction between yearly interest and short interest. Although the separate charging rules for these two types of interest were merged in 1918 the reference to "yearly or otherwise" was retained. The distinction between yearly and short interest is still relevant in some areas, for example the deduction of tax provisions in section 349(2) of ICTA, but as the words do not add anything to the charge to tax on "any interest…" in section 18(3)(a) of ICTA, they have not been reproduced in this section.

1489. The words in section 18(3) Case III (a) of ICTA "whether such payment is payable within or out of the United Kingdom" have not been reproduced. The place of payment is only one of a number of factors derived from case law which may be taken into account in determining the source of interest.

1490. The section charges interest to tax whether or not it arises within the United Kingdom. Whether interest arises from a source outside the United Kingdom will, as explained, depend on a number of factors. Some of these are considered in Westminster Bank Executor and Trustee Co (Channel Islands) Ltd v National Bank of Greece SA (1970), 46 TC 472 HL.

1491. For individuals, unless a particular charge specifies otherwise, interest arising from a source outside the United Kingdom is taxed under Schedule D Case IV if it arises from securities outside the United Kingdom but otherwise under Case V. This treatment is

2 STC [1975] 682.

confirmed by Lord Manton's Trustees v Steele (1927), 11 TC 549 CA and Westminster Bank Executor and Trustee Co (Channel Islands) Ltd v National Bank of Greece SA (1970), 46 TC 472 HL.

1492. Not all the income within this Chapter can have a foreign source and in some cases it would be most unusual for interest from a source outside the United Kingdom to arise. This is so with building society dividends and share interest from an industrial and provident society. In other cases it may be impossible for such income to have a foreign source. The following paragraphs look at foreign source income in relation to particular categories of income treated as interest under this Chapter.

Building Societies

1493. Under section 66 of FA 1988 a society incorporated under the Building Societies Act 1986 will be resident in the United Kingdom through incorporation. As long as dividends are paid by a UK resident company they have a UK source under the principle in Bradbury v The English Sewing Cotton Company Ltd (1923), 8 TC 481 HL.

1494. But a society may be non-resident where it satisfies a residence test in the territory of a treaty partner and the treaty awards residence to that other territory. Section 249 of FA 1994 will then apply to treat the society as non-resident. Theoretically dividends paid by a building society may therefore arise from a source outside the United Kingdom. This would be most unlikely, however, since a building society may only be incorporated under the Building Societies Act 1986 if its principal office is in the United Kingdom. With the place of incorporation and the principal office in the United Kingdom a residence test is unlikely to be satisfied in another territory.

Open-ended Investment Companies

1495. The definition of an open-ended investment company in section 468(10) of ICTA carries a limitation that the company should be incorporated in the United Kingdom under the OEIC regulations of 1996. Section 468(10) of ICTA is inserted in section 468 of ICTA by Regulation 10(4) (Open-ended Investment Companies (Tax) Regulations 1997 SI 1997/1154). All open-ended investment companies within the definition in section 468(10) of ICTA are therefore subject to the company residence rule in section 66 of FA 1988 ("regarded for the purposes of the Taxes Acts as resident"). Open-ended investment company interest distributions treated as made by a UK resident company will be UK source income. Although, as explained in connection with industrial and provident societies, it may be theoretically possible for section 249 of FA 1994 to make such companies non-resident, this is most unlikely in practice.

Authorised Unit Trusts

1496. It is possible for the FSA to recognise a non UK unit trust scheme for marketing into the UK. However, only those UK tax resident unit trusts that are "authorised" by the FSA come within section 468 of ICTA. Section 468(1) of ICTA provides that the Tax Acts apply to UK authorised unit trusts and shall have effect as if the trustees of the authorised unit trust were a company resident in the United Kingdom. Although the application of section 468(1) of ICTA is by reference to the trustees' income (and relief for capital expenditure), the treatment of the trustees as a UK resident company carries through for the purposes of taxing interest distributions treated as made to unit holders. That is because section 468L(2) of ICTA provides that the Tax Acts shall have effect as if such interest distributions were made "by the company referred to in section 468(1)". As these distributions are treated as made by such a company, that is a UK resident company, they can only be UK source income.

Industrial and Provident Societies

1497. Under section 66 of FA 1988 a society registered under the Industrial and Provident Societies Acts will be resident in the United Kingdom through incorporation. A society may, however, be non-resident where it also satisfies a residence test in the territory of a treaty partner of the United Kingdom and the treaty awards residence to that other territory. Section 249 of FA 1994 will then apply to treat the society as non-resident.

1498. Section 486(4) of ICTA provides that share or loan interest is chargeable under Schedule D Case III. Theoretically therefore payments by a registered society may arise outside the United Kingdom but be charged under Schedule D Case III and not able to benefit from treatment specific to Schedule D Cases IV and V. For the sake of consistency this section treats such income arising outside the United Kingdom as relevant foreign income and therefore able to benefit from the special rules in Part 8 of this Act. See *Change 131* in Annex 1.

1499. Section 18(3)(b) of ICTA charges "all discounts" to tax under Case III. Although these words could be read as embracing discounts that arise outside the United Kingdom, it has long been the practice to charge discounts with a foreign source under Schedule D Cases IV or V. There is however little direct authority in case law for this approach, although it is fully accepted by the commentaries.

Section 370: Income charged

1500. This section sets out the amount of interest charged to tax on sources both within and outside the United Kingdom. It is based on sections 64, 65 and 68 of ICTA.

1501. *Subsection (1)* sets out the amount of interest charged to tax. This is the full amount of interest arising in the tax year.

1502. Section 64 of ICTA sets out the basis of assessment for income chargeable under Schedule D Case III. It requires that income tax should be computed "…on the full amount of the income…without any deduction". There are no specific provisions allowing deductions from the amount charged to tax under Schedule D Case III and it is not clear what such deductions would represent. There are no rules allowing expenditure in earning Schedule D Case III income. The words "full amount of the income" carry some weight in suggesting that the amounts chargeable are without deduction.

1503. In relation to certain sources of income falling within Schedule D Case III, for example interest on savings bank deposits or private loans, the phrase "without any deduction" will not usually have any significance, as interest in such cases necessarily represents net income. There may, however, be such items as costs of collection but these cannot be deducted. Likewise in the case of discounts no set off can be made for losses incurred where the assessment is made under Schedule D Case III.

1504. The charging provision for Schedule F in section 20(1) of ICTA, which charges "all dividends and other distributions…of a company resident in the United Kingdom" does not state that the dividends are without any deduction. The words would be superfluous since no provision exists to give deductions from dividends from UK companies.

1505. For these reasons it is thought that the words are superfluous in the context of Schedule D Case III and they have therefore been omitted.

1506. The omission of these words also affects the following 'income charged' sections in this Act which are based on Schedule D Case III, section 424 (Chapter 7 of Part 4 of this Act, purchased life annuities) and 684 (Chapter 7 of Part 5 of this Act, annual payments not otherwise charged). In each case the income charged is expressed as: "Tax is charged under this Chapter on the full amount of the [annuity payments] [annual payments] arising in the tax year".

1507. The word "arising" has been the subject of a number of tax cases. "Arising" includes received and also credited to a bank account (Parkside Leasing v Smith (1984), 58 TC 282[3] HC). However, "arising" has a wider meaning than this. For example, it was

3 STC [1985] 63.

held in Dunmore v McGowan (1978), 52 TC 307[4] CA, to include the "swelling of a person's assets", even where the person had no immediate right of access to the income. In view of the wide meaning given to "arising", and the fact that it is a term with which practitioners are familiar, the word has been retained.

1508. *Subsection (2)* makes subsection (1) subject to the rules in Part 8 of this Act. This enables income that is non-UK source and which would have been charged under Schedule D Cases IV or V to obtain the benefit of the special rules for such income.

Section 371: Person liable

1509. This section states who is liable for any tax charged. It is based on section 59(1) of ICTA.

1510. Section 59 of ICTA gives the person chargeable as the person "receiving or entitled to" the income.

1511. The phrase "receiving or entitled to" has been considered at length by the courts, although no clear definition of it has emerged. In early cases the courts placed greater emphasis on the concept of receipt than on entitlement - see, for example, Dewar v Commissioners of Inland Revenue (1935), 19 TC 561 CA. Later, equal importance was attached to each part of the phrase - see, for example, Aplin v White (1973), 49 TC 93[5] HC. The most recent cases, such as MacPherson v Bond (1985), 58 TC 579[6] HC, and Peracha v Miley (1990), 63 TC 444[7] CA, have hinged on whether or not any benefit has accrued to the taxpayer.

1512. As the phrase is well established in case law, it is retained in the rewritten legislation. It is not, however, considered appropriate to include any further explanation of the phrase because of its wide interpretation by the courts.

Section 372: Building society dividends

1513. This section treats building society dividends as interest. It is based on section 477A of ICTA.

1514. *Subsection (1)* provides that any building society dividend is to be treated as paid by way of interest for the purposes of this Act. See *Change 80* in Annex 1. The wording "for the purposes of this Act" is necessary here since building society dividends are not treated as interest for all income tax purposes. They are treated as dividends for the purposes of deducting tax, by virtue of regulations made under section 477A(1) of ICTA (regulation 3(1) of the Income Tax (Building Societies) (Dividends and Interest) Regulations 1990 SI 1990/2231) or by virtue of section 349(3A) of ICTA.

Section 373: Open-ended investment company interest distributions

1515. This section and the two sections that follow provide investors, who are liable to income tax, with the information required to determine their taxable income from the open-ended investment company (OEIC). The tax provisions relevant to the OEIC, which is liable to corporation tax, are not in this Act.

1516. This section is based on section 468L of ICTA and the Open-ended Investment Companies (Tax) Regulations 1997 SI 1997/1154. These regulations provide that the tax treatment of investors (shareholders) in an OEIC generally follows the tax treatment of investors (unit holders) of an authorised unit trust (AUT). For an outline of the treatment of investors in an AUT see the commentary on section 376.

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4 STC [1978] 217.
5 STC [1973] 322.
6 STC [1985] 678.
7 STC [1990] 512.

1517. The section provides for amounts that are not interest and would otherwise be something else to be treated as interest received by the investors. The amounts so treated are charged to tax by section 369 and are subject to the deduction of tax rules in section 349 of ICTA as amended by section 468L(4) of ICTA.

Section 374: Date when interest payments under section 373 made

1518. This section is based on sections 468H and 468L of ICTA and the Open-ended Investment Companies (Tax) Regulations 1997 SI 1997/1154. It applies to the amounts treated as interest.

Section 375: Interpretation of sections 373 and 374

1519. This section is based on sections 468H and 832 of ICTA and the Open-ended Investment Companies (Tax) Regulations 1997 SI 1997/1154.

1520. The regulations contained in SI 1997/1154, in so far as they apply to invoke the AUT rules for the tax charge on OEIC investors liable to income tax, are rewritten in the preceding sections. The regulations remain in place in respect of investors liable to corporation tax and all other aspects concerning OEICs. A saving has been made in Part 5 of Schedule 2 to this Act to preserve the power in section 152 of FA 1995 so that regulations may continue to be made for achieving any purpose that could be achieved by such regulations before enactment of these sections.

Section 376: Authorised unit trust interest distributions

1521. This section and the two sections that follow provide investors, who are liable to income tax, with the information required to determine their taxable income from the authorised unit trust (AUT). The tax provisions relevant to the AUT are not in this Act. This is because the AUT trustees are treated as a company liable to corporation tax under section 468(1)(a) of ICTA.

1522. This section is based on section 468L of ICTA which is part of the special tax rules for AUTs. These rules provide that AUTs are *treated for tax purposes* as though *all* of the money shown in their distribution accounts, as available for distribution or in the case of investors holding accumulation units, for adding to the capital value of their share of the fund, is *actually paid out* to unit holders. This means that the investors are taxed when they receive the benefit of the distribution made by the AUT rather than when they sell their units.

1523. The investors are treated as receiving a payment of interest or a dividend depending on how the AUT has allocated the money in its accounts. There are various rules which determine how and when this allocation can be made by the AUT.

1524. The amounts treated as interest are charged to tax by section 369 and are subject to the deduction of tax rules in section 349 of ICTA as amended by section 468L(4) of ICTA. The amounts treated as dividends are dealt with in section 389.

Section 377: Date when interest payments under section 376 made

1525. This section is based on sections 468H and 468L of ICTA. It applies to the amounts treated as interest.

Section 378: Interpretation of sections 376 and 377

1526. This section is based on sections 468H and 832 of ICTA.

Section 379: Industrial and provident society payments

1527. This section provides that share interest from industrial and provident societies is treated as interest. It is based on section 486 of ICTA.

1528. Section 486(4) of ICTA provides that share or loan interest is chargeable under Schedule D Case III. The definition of "share interest" in section 486 of ICTA is "any interest, dividend, bonus or other sum….". This section treats the dividend, bonus and other sums as interest. See *Change 81* in Annex 1.

1529. *Subsections (2) to (5)* are definition subsections. The reference to "the Department of Agriculture for Northern Ireland" in section 486(12) of ICTA is rewritten in subsection (5) as the "the Department of Agriculture and Rural Development", its current title.

1530. The closing words of section 486(12) of ICTA ("and references to the payment of share interest or loan interest include references to the crediting of such interest") are not rewritten. They are relevant to the rules within that section on the deduction of tax rather than the charge.

Section 380: Funding bonds

1531. This section provides for an issue of funding bonds in respect of a liability to pay interest to be treated as a payment of interest. It is based on section 582 of ICTA.

1532. There is one specific situation where a funding bond is chargeable to tax under Schedule D Case VI rather than Schedule D Case III. Section 582(2)(a) of ICTA provides that where funding bonds are issued some bonds have to be retained on account of income tax. However, section 582(2)(b) of ICTA provides that where it is "impracticable" to do this the recipient is chargeable to tax under Schedule D Case VI on the amount of interest treated as having been paid by the issue of the bonds. This section charges this income also as interest for income tax purposes. One consequence is that all funding bond interest will be included in what was Schedule D Case III income in section 1A of ICTA as consequentially amended. See *Change 82* in Annex 1.

1533. Relief for losses under the former Schedule D Case VI provisions will still be available under section 392 of ICTA.

1534. Section 582(1) of ICTA treats the issue of funding bonds as a payment of interest and they are taxed accordingly. The deemed interest is equal to the value of the bond at the time of issue. This section clarifies that the value which applies is the market value of the bond and not its nominal value. If the value were the nominal value a change in value could only occur in the unlikely circumstance of a change in the face value of the bond after issue. Moreover, tax could be easily avoided by issuing bonds with a low face value but repaying at a premium.

Section 381: Discounts

1535. This section treats discounts taxed under Schedule D Case III(b) as interest. It is based on section 18 of ICTA.

1536. Although section 18 of ICTA includes discounts as a separate category of charge without treating them as interest, this section provides for them to be charged as if they were interest. See *Change 83* in Annex 1.

Chapter 3: Dividends etc. from UK resident companies etc.

Introduction

Section 382: Contents of Chapter

1537. This section explains the scope of the Chapter. The Chapter contains the charge to tax on dividends and other distributions (and amounts treated as dividends) from companies resident in the United Kingdom. It also contains special provisions about dividends paid in respect of shares awarded under approved share incentive plans ("SIPs"). And, it contains provisions about tax credits and deduction of tax.

1538. Exemptions from the charge to tax under this Chapter are signposted in *subsection (3)*.

1539. The exemptions include section 498 of ITEPA which is part of the SIP code (see further the commentary on section 392 of this Act and the overview to the SIP provisions). The SIP code provides various exemptions from tax for persons participating in an approved SIP. The code also imposes tax charges in certain circumstances, for example, if shares are not held within the plan for the prescribed period of time. Section 498 of ITEPA provides an exemption from the charge to income tax that arises if dividend shares cease to be subject to the plan, if the participant is a "good leaver". In the source legislation, section 498 of ITEPA is expressed as a proviso to section 251C of ICTA (see section 251C(6) of ICTA). But as the charge to tax in respect of all dividends and other distributions of a UK resident company falls under Chapter 3 of Part 4 of this Act, section 498 of ITEPA is signposted as an exemption from the tax charge under this Chapter.

1540. S*ubsection (4)* replicates the position under the source legislation by ensuring that stock dividends that are taxed under Chapter 5 of Part 4 of this Act are not dividends for the purposes of this Chapter. (Despite their name, they do not count as dividends for the purposes of Schedule F. See further the commentary on Chapter 5 of Part 4 of this Act.)

1541. See the commentary on paragraph 10 of Schedule 1 to this Act for an explanation of the repeal of Schedule F.

Section 383: Charge to tax on dividends and other distributions

1542. This section charges to tax dividends and other distributions from UK resident companies. It is based on Schedule F in section 20 of ICTA.

1543. The section charges to tax "dividends and other distributions". The expression "distribution" is not defined in this Act except by reference to section 832(1) of ICTA (see the index of defined expressions in Part 2 of Schedule 4 to this Act).

1544. The main reason for not rewriting "distribution" in this Act is the importance of the expression in a corporation tax context (because, for example, distributions of companies resident in the United Kingdom are not taken into account in computing profits for corporation tax purposes - see section 208 of ICTA - and do not give rise to a tax deductible expense for the distributing company - see section 337A of ICTA). The expression therefore needs to be retained in a corporation tax context. Rewriting it in an income tax context would mean maintaining similar but not identical provisions for different purposes (some of the provisions - for example, section 209(5) to (7) of ICTA - are not relevant for income tax purposes). This is not thought to be straightforward or convenient for users of the legislation.

1545. Section 20(1) paragraph 1 of ICTA charges to tax all dividends and other distributions. But this is subject to section 95(1A)(a) of ICTA (taxation of dealers in respect of distributions). Section 95(1A)(a) of ICTA provides that tax is not charged under Schedule F where a dealer receives a "relevant distribution". Instead, tax is charged under Schedule D Case I or II. Section 383 does not explicitly rewrite the proviso in section 20(1) of ICTA but the effect of the proviso is replicated by section 366(1) of this Act (which gives charging priority to Chapter 2 of Part 2 of this Act for income which is a receipt of a trade). So a distribution made by a UK resident company which is a receipt of a trade is charged to tax under Part 2 of this Act and not under this Chapter.

1546. The charge to tax under Schedule F in the source legislation is also subject to section 171(2) of FA 1993 (Lloyd's underwriters: taxation of profits and allowance of losses) (see section 20(2) of ICTA). As with dealers, the tax charge in the source legislation is Schedule D Case I and not Schedule F. But section 171(2) of FA 1993 additionally provides that the amount of the profits arising from assets in an ancillary trust fund is calculated under the relevant Schedule or Case. Again, section 383 does not explicitly rewrite the proviso in section 20(2) of ICTA but the effect of that section is replicated by section 366(1) of this Act (which gives charging priority to Chapter 2 of Part 2 of this Act). And section 2(4) of this Act ensures that the calculation can be made under this Chapter.

1547. *Subsections (2)* and *(3)* confirm that the distribution is regarded as income for all income tax purposes even if it would otherwise be treated as capital (a capital dividend is a distribution – see section 209(2)(a) of ICTA).

Section 384: Income charged

1548. This section sets out the amount charged to tax and is based on section 20(1) paragraphs 1 and 2 of ICTA. The amount charged is the amount or value of the dividends paid and distributions made in the tax year. But if the recipient of the distribution is entitled to a tax credit, the amount charged is the amount or value of the distribution plus the tax credit (see *subsection (3)*).

1549. Dividends are treated as paid for the purposes of the Corporation Tax Acts "on the date when they become due and payable, except in so far as Chapter III of Part XII makes other provision for dividends treated as paid by virtue of that Chapter" (see section 834(3) of ICTA).

1550. The "Corporation Tax Acts" means the enactments relating to the taxation of the income and chargeable gains of companies and company distributions (including provisions relating to income tax) (see section 831(1) of ICTA). Chapter 3 of Part 12 of ICTA (referred to in the previous paragraph) specifies the date on which dividends which an authorised unit trust is treated as paying, are paid. So in all other cases the date on which a dividend is paid is the date on which the dividend becomes due and payable.

1551. The date when a final dividend becomes due and payable is usually established by a resolution of the company. The dividend becomes due when the date on which it is expressed to be payable arrives. Only then is payment enforceable. In the case of a final dividend where a date for payment is not specified, an immediately enforceable debt is created so that the date of declaration of the dividend is the due and payable date.

1552. An interim dividend can be varied and rescinded at any time before payment and can therefore only be regarded as "due and payable" when the date for payment arrives.

1553. The main case law authority for the above propositions is Potel v CIR (1970), 46 TC 658 HC (which particularly indicates that the declaration of a dividend by a company and its payment are two separate matters). Paragraph 2007b of the Inland Revenue's Company Taxation Manual (CT2007b) provides the Inland Revenue's interpretation of section 834(3) of ICTA and the meaning of "paid".

Section 385: Person liable

1554. This section states who is liable for any tax charged.

1555. Under the source legislation there is no provision expressly stating who is liable for the tax charged. Although section 20(1) paragraph 1 of ICTA makes it clear that the charge to tax encompasses all distributions of a UK resident company made in a tax year, and includes a reference to the recipient, it does not actually specify the person liable.

1556. The person liable can however be deduced from the legislation as a whole (and this has been reflected in *subsection (1)*).

1557. Section 20(1) of ICTA refers to recipients of distributions and persons entitled to tax credits. Paragraph 1 of section 20(1) of ICTA provides that distributions are regarded as income "…however they fall to be dealt with in the hands of the recipient"; paragraph 2 of that section provides that where "…a person is entitled to a tax credit" in respect of a distribution it is the aggregate of the distribution and the tax credit which is taxed.

1558. Section 231(1) of ICTA (tax credits for certain recipients of qualifying distributions) provides that a UK resident "receiving" a qualifying distribution is entitled to a tax credit. And section 232 of ICTA (tax credits for non-UK residents) refers to distributions "received" by certain individuals. Section 231(4) of ICTA deals with the case where a distribution "is, or falls to be treated as, or under any provision of the Tax Acts is deemed to be, the income of a person other than the recipient", so that other person is treated as receiving the distribution for the purposes of section 231 of ICTA. So, section 231(4) of ICTA suggests that where the distribution actually belongs to someone other than the recipient, or under any provision of the Tax Acts is treated as belonging to someone other than the recipient, that other person is liable for the tax charged.

1559. Section 209 of ICTA is the main provision which defines the term "distribution". Section 209(1) of ICTA provides that "The following provisions of this Chapter, together with section 418 of ICTA, shall, subject to any express exceptions, have effect with respect to the meaning of "distribution" and for determining the persons to whom certain distributions are to be treated as made ...".

1560. Where an asset or liability is transferred by a company to a member, section 209(4) of ICTA requires an amount to be treated as a distribution made to the member.

1561. Distributions are made, in most circumstances, to shareholders. For the purposes of Part 6 of ICTA (company distributions, tax credits etc) section 254(12) of that Act regards something done "in respect of a share" as being done to the shareholder, or to someone who has at a particular time been the shareholder. This suggests that someone to whom a distribution is treated as made for the purposes of Part 6 of ICTA is liable.

1562. The definition of distribution is extended by section 418(1) of ICTA to include any amount which is required to be treated as a distribution by section 418(2) of ICTA. Under section 418(2) of ICTA, where a close company incurs expense in providing a benefit or facility for a participator "the company shall be treated as making a distribution to him of an amount equal to so much of that expense as is not made good to the company". While it does not explicitly identify the person liable in respect of the distribution, in practice the participator is regarded as the person liable.

1563. So, while there is no express person liable provision (as there is for Schedule D for example), there are provisions covering:

- the person to whom a distribution is made or to whom it is treated as made for the purposes of Part 6 of ICTA – sections 209(1) and (4), 254(12) and 418(2) of ICTA;
- the person receiving a distribution – sections 20(1)1, 231(1) and (4) and 209(4) of ICTA;
- the person entitled to the distribution – sections 20(1)2 and 231(4); and
- the person to whom the distribution, under any provision of the Tax Acts, is treated as belonging (where that person is not the recipient) – section 231(4) of ICTA.

1564. A provision stating who is liable for any tax charged on distributions from UK resident companies needs to cover all these possibilities save the last one. If a distribution is treated under any provision of the Tax Acts as the income of a person other than the recipient, that legislation will provide who is liable for the tax.

Section 386: Open-ended investment company dividend distributions

1565. This section and the two sections that follow provide investors, who are liable to income tax, with the information required to determine their taxable income from the open ended investment company (OEIC). The tax provisions relevant to the OEIC, which is liable to corporation tax, are not in this Act.

1566. This section is based on section 468J of ICTA and the Open-ended Investment Companies (Tax) Regulations 1997 SI 1997/1154. These regulations provide that the tax treatment of investors (shareholders) in an OEIC generally follows the tax treatment of investors (unit holders) of an authorised unit trust (AUT). For an outline of the treatment of investors in an AUT see the commentary on section 376.

1567. The section provides for amounts that are not dividends and would otherwise be something else to be treated as dividends received by the investors. The amounts so treated are charged by section 383 and the provisions about tax credits or tax being treated as paid at sections 397 to 399 will apply as appropriate.

Section 387: Date when dividends paid under section 386

1568. This section is based on sections 468, 468H and 468J of ICTA and the Open-ended Investment Companies (Tax) Regulations 1997 SI 1997/1154. It applies to the amounts treated as dividends.

Section 388: Interpretation of sections 386 and 387

1569. This section is based on sections 468H and 832 of ICTA and the Open-ended Investment Companies (Tax) Regulations 1997 (SI 1997/1154).

1570. The regulations contained in SI 1997/1154, in so far as they apply to invoke the AUT rules for the tax charge on OEIC investors liable to income tax, are rewritten in the preceding sections. The regulations remain in place in respect of investors liable to corporation tax and all other aspects concerning OEICs. A saving has been made in paragraph 78 of Schedule 2 to this Act to preserve the power in section 152 of FA 1995 so that regulations may continue to be made for achieving any purpose that could be achieved by such regulations before enactment of these sections.

Section 389: Authorised unit trust dividend distributions

1571. This section and the two sections that follow provide investors, who are liable to income tax, with the information required to determine their taxable income from the authorised unit trust (AUT). The tax provisions relevant to the AUT are not in this Act. This is because the AUT trustees are treated as a company liable to corporation tax under section 468(1)(a) of ICTA.

1572. This section is based on section 468J of ICTA which is part of the special tax rules for AUTs. For an outline of the treatment of investors in an AUT see the commentary on section 376.

1573. The amounts treated as dividends received by the investors are charged by section 383 and the provisions about tax credits or tax being treated as paid at sections 397 to 399 will apply as appropriate.

Section 390: Date when dividends paid under section 389

1574. This section is based on sections 468H and 468J of ICTA. It applies to the amounts treated as dividends.

Section 391: Interpretation of sections 389 and 390

1575. This section is based on sections 468H and 832 of ICTA.

Shares in approved share incentive plans ("SIPs")

Overview

1576. Section 392 and the following four sections are based on sections 251A to 251C of ICTA which are part of the legislation relating to SIPs. The SIPs legislation was originally contained in Schedule 8 to the FA 2000 (introduced by section 47 of FA

2000) and was rewritten in ITEPA. The majority of the SIP code is contained in Chapter 6 of Part 7 of and Schedule 2 to ITEPA.

1577. The SIP code is designed to encourage employee share ownership. The core of the SIP code is that a company establishes a share incentive plan. Under the plan various types of share can be acquired or awarded - free shares, partnership shares and matching shares. In addition, scheme participators may, with the dividends paid on their shares, acquire "dividend shares".

1578. The shares awarded or acquired under the plan are held on behalf of the scheme participant by the trustees of the scheme. Therefore, any dividend paid by the company on those shares is paid to the trustees.

1579. The participant may choose (or the company may require) that all cash dividends paid on the shares be reinvested in further shares. If so, the cash dividend is used by the trustees of the scheme to acquire further shares. Those shares are called dividend shares.

1580. Section 493 of ITEPA (which is rewritten as section 770(2)(a) of this Act) provides that a scheme participant is not liable to income tax on the amount applied by the trustees in acquiring dividend shares on the participant's behalf.

1581. But a tax charge may arise if the dividend shares subsequently cease to be subject to the approved SIP. The special rules applying when dividend shares cease to be subject to the plan are rewritten in section 394.

1582. If the trustees cannot reinvest the cash dividend either because the amount of the cash dividend is not sufficient to acquire a share or because there is an amount remaining after acquiring shares, the trustees may keep the cash dividend and carry it forward with a view to reinvestment at a later date (see paragraph 68(2) of Schedule 2 to ITEPA). In that case, section 496 of ITEPA (rewritten as section 770(1)(b) of this Act) provides that the participant is not liable to income tax in respect of the amount of the cash dividend held by the trustees.

1583. But if the trustees subsequently pay over the cash dividend to the participant, the tax charge may revive. The special rules applying when the cash dividend held by the trustees is paid over to the participant is rewritten in section 393.

Section 392: SIP shares: introduction

1584. This section introduces the special rules about SIPs. It is based on section 251A of ICTA.

1585. *Subsections (2)* to *(7)* ensure that sections 393 to 396 apply only if the participant has benefited from the tax advantages of an approved SIP. Those tax advantages apply to an individual who is chargeable to tax under Part 2 of ITEPA in respect of eligible employment (as defined in *subsection (4)*) or, if the shares were awarded before ITEPA came into force, under Schedule E.

Section 393: Later charge where cash dividends retained in SIPs are paid over

1586. This section is based on section 251B of ICTA.

1587. The trustees of the scheme may only hold on to a cash dividend and carry it forward for three years from the date the dividend is paid by the company. Additionally, any amount not reinvested must be paid to the participant if the participant ceases to be in "relevant employment" or if a termination notice is issued in respect of the plan (see paragraph 68(4) of Schedule 2 to ITEPA).

1588. *Subsection (2)* ensures that in any of these circumstances, the participant is charged to income tax for the tax year in which the dividend is paid over.

1589. Tax is charged on the amount of the cash dividend paid over and not on the amount of the cash dividend originally paid by the company (*subsection (3)*).

1590. Whether the participant is entitled to a tax credit and, if so, the amount of it, is determined by reference to the tax year in which the cash dividend is paid over by the trustees and not by reference to the tax year the company actually paid the dividend (see *subsection (5)*).

1591. Section 251B of ICTA is rewritten so that the original tax charge is postponed (contrast section 394 which deems a further distribution to be made). This approach has rendered the phrase "except to the extent that it represents a foreign cash dividend" redundant. In effect, the cash dividend paid over by the trustees does not lose its original character as either a cash dividend paid by a UK resident company (in which case it is dealt with under this Chapter) or a cash dividend paid by a non-UK resident company (in which case it is dealt with under Chapter 4 of Part 4 of this Act).

1592. But the definition of "foreign cash dividend" in section 251D of ICTA does suggest that it is the date that the company originally paid the dividend that determines, under the source legislation, whether the tax charge falls under Schedule F (if UK resident company) or Schedule D Case V (if non-UK resident company). This is rewritten in *subsection (6)*.

Section 394: Distribution when dividend shares cease to be subject to SIP

1593. This section is based on section 251C of ICTA and applies if the dividend shares acquired with the cash dividend cease to be subject to the approved SIP within three years of acquisition.

1594. *Subsection (2)* deems a distribution to have been made to the participant in the tax year in which the dividend shares cease to be subject to the plan.

1595. *Subsection (3)* confirms that tax is charged on the amount of the cash dividend applied to acquire the shares (which have ceased to be subject to the plan) rather than, for example, the amount or value of the dividend shares.

Section 395: Reduction in tax due in cases within section 394

1596. This section is based on section 251C of ICTA and applies if tax has been paid in respect of any capital receipts received in connection with the holding of the dividend shares which cease to be subject to the approved SIP.

1597. *Subsection (2)* operates to reduce the amount of tax due under section 394.

Section 396: Interpretation of sections 392 to 395

1598. This section is based on section 251D of ICTA.

Section 397: Tax credits for qualifying distributions: UK residents and eligible non-UK residents

1599. This section and the following four sections deal with:

- a person's entitlement to a tax credit attaching to qualifying distributions;
- the tax treatment of qualifying distributions where the person is not entitled to a tax credit; and
- the tax treatment of non-qualifying distributions.

1600. The sections are based on sections 231, 232 and 233 of ICTA.

1601. By virtue of sections 231(1) and 232 of ICTA tax credits are available to certain recipients in respect of certain qualifying distributions from companies resident in the United Kingdom.

1602. Tax credits attach to qualifying distributions which are made either to residents of the United Kingdom or to certain non-UK resident persons. The source legislation has been rearranged so that there is a single provision dealing with both categories of recipients (UK resident and non-UK resident) who are entitled to tax credits.

1603. Most distributions of companies resident in the United Kingdom are "qualifying distributions" (see section 14(2) of ICTA). Only the issue of redeemable share capital (unless that share capital is taxed under the stock dividends legislation) or the issue of securities in respect of shares or securities of a company otherwise than wholly for new consideration, are non-qualifying distributions.

1604. In line with the decision not to define the expression "distribution" in this Act, the expression "qualifying distribution" is likewise not defined (other than by reference to section 832(1) of ICTA).

1605. *Subsection (1)* sets out who is entitled to the tax credit, in what circumstances and what the value of that tax credit is. Those entitled to the tax credit include "eligible non-UK residents".

1606. *Subsection (2)* deals with how the tax credit may be used and rewrites section 231(3) of ICTA. Section 231(3) in the source legislation is subject to section 231(3AA) of ICTA. This is rewritten in a slightly different way. *Subsection (3)* treats the tax credits attaching to qualifying distributions as reduced if those distributions are not brought into charge to tax. So, for example, if an individual's total income is reduced by deductions (for example, personal allowances) such that the qualifying distributions are not, or are not wholly, brought into charge to tax, the value of the tax credits attaching to those distributions are correspondingly reduced. So a person may be entitled to a tax credit whose value is nil.

1607. Although companies resident in the United Kingdom are expressly excluded in section 231(3) of ICTA, (because section 231(3) of ICTA applies to a person "not being a company resident in the United Kingdom") this exclusion has not been adopted. See *Change 84* in Annex 1.

1608. *Subsection (4)* defines eligible non-UK resident. Section 232 of ICTA extends the entitlement to tax credits to certain non-UK resident individuals. These are referred to as individuals who:

"having made a claim in that behalf, [are] entitled to relief under Chapter I of Part VII by virtue of section 278(2) …

1609. The words about making the claim in section 232 of ICTA are unnecessary because the individual will have to make a claim for personal allowances under section 278(8) of ICTA before the tax credit can be taken into account.

1610. Also, section 278 of ICTA does not specify whether the individual concerned has to come within one of the given categories (eg Commonwealth citizen or EEA national) throughout the tax year in question or merely at any time during the tax year in question. However, given personal allowances are available to these individuals simply for falling within a particular category, subsection (4) has followed this approach and has used the words "at any time".

1611. *Subsection (5)* rewrites section 231(4) of ICTA. The words "(and accordingly the question whether he is entitled to a tax credit in respect of it shall be determined by reference to where he, and not the actual recipient, is resident)" have been omitted. The revised wording of the section makes the words unnecessary.

Section 398: Increase in amount or value of dividends where tax credit available

1612. This section is based on section 20(1) of ICTA (including the proviso "other than section 95(1)"). It applies for all income tax purposes including the case where the recipient of the distribution is a member of Lloyd's. But the section does not apply if the recipient of the distribution is a dealer (in which case only the net amount of the distribution is taken into account in calculating the profits of the dealer).

Section 399: Qualifying distributions received by persons not entitled to tax credits

1613. This section deals with the tax treatment of qualifying distributions received by persons not entitled to a tax credit (for example, because they are non-resident and do not fall within the definition of "eligible non-UK resident"). As mentioned in the commentary on section 397(3), a person may be entitled to a tax credit whose value is nil. The person is nevertheless entitled to a tax credit and therefore this provision does not apply to such a person. It is based on section 233(1) and (1A) of ICTA.

1614. *Subsection (2)* provides that the non-UK resident is treated as having paid income tax at the dividend ordinary rate (Schedule F ordinary rate in the source legislation) on the amount or value of the distribution.

1615. The amount or value of the distribution will either be the actual amount of the distribution (if the person is a non-UK resident company receiving the qualifying distribution in a beneficial capacity) or that amount is "grossed up" by reference to the dividend ordinary rate. *Subsections (3)* and *(4)* explain when the grossed up amount (as defined in *subsection (5)*) is substituted for the actual amount.

1616. The words "not being a company resident in the United Kingdom" in section 233(1) of ICTA and "any person who is not a company" in section 233(1A) of ICTA create the same difficulties as those in section 231(3) of ICTA. So this section follows a similar approach to that taken in section 397(2) by rewriting sections 233(1) and 233(1A) of ICTA without any exclusion for companies. See *Change 84* in Annex 1.

1617. Section 233(1)(c) of ICTA treats the amount or value of the distribution as not brought into charge to tax for the purposes of sections 348 and 349 of ICTA. Section 233(1)(c) of ICTA is not rewritten in this Act. But rather than leaving the provision "stranded" in section 233 of ICTA, it has been incorporated in section 348 of ICTA as paragraph (a) of a new subsection (4) (see paragraph 147(3) of Schedule 1 to this Act).

Section 400: Non-qualifying distributions

1618. This section is based on section 233(1) of ICTA and applies when a person receives a non-qualifying distribution.

1619. A non-qualifying distribution is defined as any distribution which is not a qualifying distribution (see *subsection (6)*). A qualifying distribution is defined in section 14(2) of ICTA. Broadly, a non-qualifying distribution is an issue of redeemable share capital (unless the share capital is taxed as a stock dividend) or of securities in respect of shares or securities of the issuing company otherwise than wholly for new consideration. A non-qualifying distribution does not carry a tax credit.

1620. *Subsection (2)* treats the recipient of the non-qualifying distribution as having paid income tax at the dividend ordinary rate (Schedule F ordinary rate in the source legislation) on the actual amount of the non-qualifying distribution (that is, there is no grossing up).

1621. The words "not being a company resident in the United Kingdom" in section 233(1) of ICTA create similar difficulties to those in sections 231(3) and 233(1A) of ICTA. See *Change 84* in Annex 1.

1622. *Subsections (4)* and *(5)* are based on section 233(1B) of ICTA. In the case of trustees of accumulation or discretionary trusts, the trustees are taxed on the amount or value of the distribution at the dividend trust rate (Schedule F trust rate in the source legislation). However, the trustees' tax liability is reduced by an amount of income tax equivalent to the dividend ordinary rate (Schedule F ordinary rate in the source legislation).

Section 401: Relief: qualifying distribution after linked non-qualifying distribution

1623. This section is based on section 233(2) of ICTA.

1624. A non-qualifying distribution is generally the first part of an event that will eventually be a qualifying distribution. So the issue of redeemable share capital (unless a stock dividend) is a non-qualifying distribution (see section 14(2)(a) of ICTA) but the repayment of that share capital is a qualifying distribution. So section 233(2) of ICTA provides relief to avoid double taxation for higher rate taxpayers.

1625. The section applies where a taxpayer pays income tax at the dividend upper rate (Schedule F upper rate in the source legislation) on the receipt of a non-qualifying distribution and is liable to income tax at the dividend upper rate (Schedule F upper rate in the source legislation) on the receipt of the linked qualifying distribution. *Subsection (1)* enables a taxpayer to set his or her extra tax liability (ie, the higher rate element) arising on the non-qualifying distribution against the extra liability arising on the qualifying distribution so that the taxpayer is only liable to pay the balance.

1626. *Subsections (5)* and *(6)* explain how the extra liability is calculated in earlier tax years (because the rates at which higher rate taxpayers have paid tax have changed over the years).

Chapter 4: Dividends from non-UK resident companies

Overview

1627. This Chapter introduces a separate charge to income tax on dividends from companies not resident in the United Kingdom.

1628. Under section 18(3) of ICTA, there are no individual charges according to types of income within the Schedule D Case IV or V charge. But the system of identifying and classifying income by Schedule and Case has been replaced in this Act by individual charges on types of income.

1629. Income which, under the source legislation, is charged to tax under Schedule D Cases IV or V, has, where appropriate, been fully integrated with the equivalent income arising from a UK source. In the case of dividends from non-UK resident companies there is no exact equivalent in terms of UK source income. The closest equivalent is the charge to tax on dividends and other distributions from UK resident companies (section 20 of ICTA, Schedule F in the source legislation). But there is no precise overlap. The UK charge, by the adoption of the definition of "distribution" from Part 6 of ICTA (see the commentary on Chapter 3 of Part 4 of this Act) can include dividends or distributions of a capital nature and can also operate to convert payments that would otherwise be treated as interest into distributions. Any charge on distributions from non-UK resident companies must be confined to income only. For this reason (and also because the basis of assessment is different – see the commentary on section 403 elow), it is not thought appropriate to integrate the charges. So a separate charge is needed to cover dividends from non-UK resident companies.

Section 402: Charge to tax on dividends from non-UK resident companies

1630. This section charges to tax dividends of companies not resident in the United Kingdom. It is based on section 18(1) and (3) of ICTA.

1631. For the reasons explained in the overview, the expression “distribution” has not been adopted. It is possible that a non-UK resident company may make a distribution of income which would not fall within Chapter 4 of Part 4 of this Act because it is not a “dividend”. But if the distribution comprises income it will fall to be dealt with either under alternative specific charges (eg interest) or within “income not otherwise charged”, the charge on which appears in Chapter 8 of Part 5 of this Act.

1632. The term “dividend” is not defined in this Act. “Dividend” is a widely used and understood term and is defined only in very specific circumstances not applicable in this context (see, for example, section 49 of ICTA – dividends held in the name of Treasury). It is not thought appropriate to attempt to define “dividend” here. It will usually be a matter of referring to the relevant company law to determine whether or not a payment made by a company is a dividend.

1633. *Subsection (2)* highlights an exemption from income tax for dividends paid under approved share incentive plans (“SIPs”) and *subsection (3)* signposts section 498 of ITEPA. See further the commentary on the SIPs legislation in Chapter 3 of Part 4 of this Act and Chapter 9 of Part 6 of this Act (particularly the commentary on section 770 of this Act).

1634. *Subsection (4)* ensures that dividends of a capital nature do not fall within the charge to tax under this Chapter. In determining whether a payment is income in nature, it is necessary (as it is under the source legislation) to analyse the payment under local law (see CIR v Trustees of Joseph Reid (dec’d) (1949), 30 TC 431 HL and Rae v Lazard Investment Co Ltd (1963), 41 TC 1 HL). Whiteman on Income Tax, Third Edition, on page 1107, comments in this context “the proper test in such circumstances is, applying the local law, whether or not the corpus of the asset is left intact after the distribution. If it is not, the receipt will be a capital receipt; if it is, the payment will be chargeable”.

Section 403: Income charged

1635. This section sets out the amount charged to tax and is based on section 65(1) of ICTA.

1636. *Subsection (1)* charges tax on the full amount of the dividends arising in the tax year. The term “arising” has been retained (see the commentary on income charged in Chapter 2 of Part 4 of this Act). The arising basis is different from the paid basis which applies to the charge to tax on dividends and other distributions from UK resident companies (for a discussion of the paid basis see the commentary on Chapter 3 of Part 4 of this Act) and, given they do not mean exactly the same, “paid” has not been used in this context.

1637. *Subsection (2)* makes the basis of assessment in subsection (1) subject to the SIPs rules and Part 8 of this Act. Part 8 contains the special rules which apply to foreign income (see further the commentary on Part 8 of this Act).

Section 404: Person liable

1638. This section states who is liable for any tax and is based on section 59(1) of ICTA.

Section 405: SIP shares: introduction

1639. This section and the following three sections are based on sections 68A to 68B of ICTA which were inserted into ICTA by ITEPA. They are part of the SIPs code. See also the commentary on the SIPs legislation in Chapter 3 of Part 4 of this Act.

1640. This section introduces the special rules about charges to tax on SIP dividends.

1641. *Subsection (2)* provides that sections 406 to 408 apply only if the participant has benefited from the tax advantages of an approved SIP. Those tax advantages will only apply to an individual who is chargeable to tax under Part 2 of ITEPA in respect of eligible employment, or, in the case of shares awarded before ITEPA came into force, under Schedule E.

Section 406: Later charge where cash dividends retained in SIPs are paid over

1642. This section is based on section 68B of ICTA.

1643. SIP trustees may only retain a cash dividend and carry it forward for three years from the date the dividend is paid by the company. Any amount not reinvested must be paid to the participant if the participant ceases to be in "relevant employment" or if a termination notice is issued in respect of the plan (see paragraph 68(4) of Schedule 2 to ITEPA).

1644. This section makes provision about amounts so paid over.

1645. The definition of "foreign cash dividend" in section 68C of ICTA suggests that it is the date that the company originally paid the dividend that determines whether the tax charge falls under Schedule F or Schedule D Case V in the source legislation. This is rewritten in *subsection (5)*.

Section 407: Dividend payment when dividend shares cease to be subject to SIP

1646. This section is based on section 68B(2) of ICTA and applies if the dividend shares acquired with the cash dividend cease to be subject to the approved SIP within three years of acquisition.

Section 408: Reduction in tax due in cases within 407

1647. This section is based on section 68B(3) of ICTA. *Subsection (1)* provides that the section applies if the participant has paid tax in respect of any capital receipts received in connection with the holding of the dividend shares which cease to be subject to the approved SIP.

1648. *Subsection (2)* operates to reduce the amount of tax otherwise due under Chapter 4 of Part 4 of this Act by an amount equal to the tax paid on the capital receipts.

Chapter 5: Stock dividends from UK resident companies

Overview

1649. This Chapter deals with the charge to income tax on stock dividend income.

1650. "Stock dividend" is a term often given to particular form of dividend made by a UK resident company which is subject to a particular charge to income tax.

1651. A bonus issue of non-redeemable shares by a company is not a distribution (see, for example, CIR v Blott (1921), 8 TC 101 HL, CIR v Fisher's Executors (1926), 10 TC 302 HL, and CIR v Wright (1926), 11 TC 181 CA). Without any special provision it would not have any income tax consequences for the shareholder.

1652. A bonus issue of redeemable shares, however, is a distribution (see section 209(2)(c) of ICTA). Without any special provision it would be charged to tax under the source legislation under Schedule F. However, there is a special provision – the charge to tax on stock dividends under section 249 of ICTA. And, under section 230 of ICTA, anything that is a stock dividend:

- is not a distribution for Schedule F purposes;
- is not treated as a distribution for the purposes of section 210 of ICTA (repayment of share capital followed by bonus issue); and
- does not count as a bonus issue for the purposes of section 211 of ICTA (bonus issue followed by repayment).

1653. In this Chapter, the term "stock dividend income" is defined by reference to the issue of the share capital by a UK resident company in two circumstances. These circumstances are set out in section 249(1) and (2) of ICTA. These subsections are not rewritten in this Act because of their relevance to corporation tax.

1654. The first circumstance is where share capital is issued as a result of the shareholder exercising an option to choose whether to receive an ordinary cash dividend or additional share capital (section 249(1)(a) of ICTA).

1655. The second circumstance is where the company issues "bonus share capital" in respect of shares which, under their terms (whether original or otherwise), carry the right to bonus share capital (section 249(1)(b) and (2) of ICTA). (This is distinct from a bonus issue which arises from a specific resolution and not from the terms of the shares themselves.)

1656. Section 249(7) of ICTA is spent and is therefore repealed by this Act. Subsections (8) and (9) of section 249 of ICTA are open-ended and so have been retained in ICTA (but are amended by paragraph 119(4) and (5) of Schedule 1 to this Act).

Section 409: Charge to tax on stock dividend income

1657. This section charges stock dividend income to tax. It is based on section 249 of ICTA.

Section 410: When stock dividend income arises

1658. This section explains when and to whom stock dividend income is treated as arising. It is based on section 249(4) to (6) of ICTA.

1659. If stock dividends are issued to personal representatives during the administration period, stock dividend income is treated as arising (see *subsection (4)*) but that income is not taxed under Chapter 5 of this Part. Instead, that income forms part of the aggregate income of the estate for the purposes of Chapter 6 of Part 5 of this Act or section 701(8) of ICTA. "Personal representatives" is defined in section 878 of this Act.

Section 411: Income charged

1660. This section sets out the amount charged to tax and is based on section 249(4) and (6) of ICTA.

1661. *Subsection (2)* defines the amount charged to tax. It is the cash equivalent of the stock dividends issued (see section 412) grossed up at the dividend ordinary rate (the Schedule F ordinary rate in the source legislation). For the meaning of "grossing up" see section 877 and the commentary on that section.

Section 412: Cash equivalent of share capital

1662. This section explains how to calculate the cash equivalent of the stock dividend (in other words the net amount of the stock dividend income to be grossed up). It is based on section 251 of ICTA. This section also rewrites part of Statement of Practice A8.

1663. The source legislation is complex, particularly where the stock dividend is bonus share capital. Section 412 simplifies the rules for both types of stock dividend (ie, stock dividends in lieu of cash dividends and bonus share capital). See *Change 85* in Annex 1.

1664. *Subsection (1)* deals with stock dividends within section 249(1)(a) of ICTA – an issue of share capital in lieu of a cash dividend. The cash equivalent of such share capital is the amount of the cash dividend alternative unless subsection (2) applies.

1665. *Subsection (2)* applies if the difference between the cash dividend alternative and the share capital's market value equals or exceeds 15% of that market value. In that case, the cash equivalent is not the amount of the cash dividend alternative but rather the market value of the share capital.

1666. *Subsection (3)* deals with stock dividends within section 249(1)(b) of ICTA - bonus share capital. The cash equivalent of such share capital is its market value.

1667. Section 251(2)(a)(ii) and (4) of ICTA have been omitted, making the rule relating to bonus share capital more straightforward. See *Change 85* in Annex 1.

1668. *Subsection (4)* specifies the date on which the “market value” is to be taken for the purposes of these provisions. It is based on section 251(2) and (3) of ICTA.

1669. *Subsection (5)* gives definitions for “listed” and “market value”. Section 251(3) of ICTA includes more complicated references to the relevant provisions in TCGA. Subsection (5) instead simply imports the definition of “market value” in sections 272 to 273 of TCGA save for subsection (2) of section 272 of TCGA.

Section 413: Person liable

1670. This section states who is liable for any tax charged and is based on section 249(4) to (6) of ICTA.

1671. *Subsection (2)* deals with individuals who are beneficially entitled to the stock dividend income. Such individuals could include outright owners, a beneficiary of a bare trust or one with an interest in possession, or the beneficial owner under a nominee arrangement.

1672. *Subsection (3)* indicates that the trustees of an accumulation and discretionary trust are the persons liable if:

- stock dividends are issued to them; and
- had the trustees been paid a cash dividend in respect of the shares, any of that cash dividend would be income to which section 686 of ICTA applies (accumulation and discretionary trusts: special rates of tax).

1673. *Subsection (4)* deals with stock dividend income arising to personal representatives during the administration of a deceased person’s estate. As personal representatives are not charged to tax under Chapter 5 of this Part they are not “persons liable”. This means that they are not treated as having paid income tax under section 414 but see further the commentary on section 680.

1674. *Subsections (5)* and *(6)* deal with joint ownership of share capital and are based on section 249(3) of ICTA.

Section 414: Income tax treated as paid

1675. This section explains how a person’s income tax liability is satisfied (in whole or in part). It is based on section 249(4) and (6) of ICTA.

1676. Under *subsection (1)*, the taxpayer is treated as having paid income tax at the dividend ordinary rate (Schedule F ordinary rate in the source legislation) on the amount charged to tax. The words “and where trustees are so liable … the income is treated as if it were chargeable to tax at that rate” are based on section 249(6)(b) of ICTA and have been retained because they were considered significant in Howell and another v Trippier 2004[8] EWCA Civ 885.

1677. *Subsection (2)* provides that the tax treated as paid is not repayable. This applies even if the person liable is a non-taxpayer.

1678. *Subsections (3)* to *(5)* ensure that individual taxpayers cannot be given credit for income tax on more than the amount charged to income tax. So, for example, if the individual’s total income is reduced by deductions (for example, personal allowances) such that the

8 STC [2004] 1245

stock dividend income is only partially brought into charge to tax, credit will only be given for so much of the stock dividend income as is so taxed.

1679. Section 249(4)(c) of ICTA deals with tax rates and treats the stock dividend income as not brought into charge to tax for the purposes of sections 348 and 349 of ICTA. Section 249(4)(c) of ICTA is not rewritten in this Chapter. But rather than leaving it "stranded" in section 249 of ICTA, it is rewritten in amendments to sections 1A and 348 and 349 of ICTA (see paragraphs 3 and 147(3) of Schedule 1 to this Act respectively).

Chapter 6: Release of loan to participator in close company

Section 415: Charge to tax under Chapter 6

1680. This section is based on sections 421(1) and 422(5) and (6) of ICTA. It imposes a charge to tax if a close company lends money to a participator and subsequently releases or writes off all or part of the debt.

1681. "Close company" and "participator" are defined in the interpretative provisions of Part 6 of ICTA (see sections 414 and 417 of that Act). Broadly, a close company is a UK resident company controlled by five or fewer participators (or any number of participators who are also directors of the company). A UK resident company may also be close if on the winding-up of the company more than half of the assets of the company would be distributed to five or fewer participators (or any number of participators who are also directors of the company). "Participator" is given a very wide meaning and includes any person having a share or interest in the capital or income of the company.

1682. *Subsection (1)* sets out the circumstances giving rise to the charge to tax. The expressions "releases", "writes off", "debt", "loan" and "advance" have been preserved from the source legislation. There is no compelling reason to change any of these words and they need to be preserved to maintain the link with section 419 of ICTA.

1683. The tax charge under subsection (1) is subject to section 418 (see*subsection (2)*). This prevents double taxation under this Chapter and Chapter 5 of Part 5 of this Act.

1684. *Subsections (3)* and *(4)* rewrite section 422(5) and (6) of ICTA. If a loan is made by a company ("B") which is controlled by a close company ("A"), in circumstances where section 419 of ICTA would not otherwise apply, section 422(1) of ICTA treats the loan as made by A (so section 419 of ICTA applies). If B releases or writes off the loan, section 422(5) of ICTA effectively treats A as having released or written off the loan (so section 421 of ICTA applies). Further, section 419(2) of ICTA gives "loan" an extended meaning. So, if a person incurs a debt to a close company or a debt due from a person to a third party is assigned to a close company, the close company is treated as having made a loan. This extended meaning of loan is applied to B by section 422(6) of ICTA.

Section 416: Income charged

1685. This section sets out the amount charged to tax and is based on section 421(1) of ICTA.

Section 417: Person liable

1686. This section states who is liable for any tax charged.

1687. *Subsection (1)* explains that it is the person to whom the loan or advance was made unless that person has died or the loan or advance was made to trustees of a trust which has come to an end (*subsection (2)*).

1688. There is no reference, here or in the source legislation, to the position where the burden of the debt has been passed to a third party. This is because it is not possible in law for a debtor to assign a debt. Any transfer of debt must be made by way of novation, which would involve the existing debtor being released from the debt and the new debtor taking on a new debt. In such a case, therefore, a charge to tax under section 421 of

ICTA would arise on the release of the existing debtor. The interpretation is based on the cases of Collins v Addies and Greenfield v Bains (1992), 65 TC 190 CA[9].

Section 418: Relief where borrowers liable as settlors

1689. This section is based on sections 421(3) and 677(3) of ICTA. Together these provisions prevent double taxation on the release or writing off of a loan where a sum in respect of the loan is treated as the borrower's income in his or her capacity as settlor of a settlement.

1690. Section 677 of ICTA charges a settlor to income tax where the trustees of the settlement directly or indirectly make a capital payment to the settlor. A charge to income tax is only made if, and to the extent that, the payment can be matched against income retained within the settlement.

1691. So, it is possible that in respect of a particular tax year the borrower is liable to income tax in his or her capacity as settlor on a sum in respect of a loan and is also liable to tax under section 421 of ICTA in respect of amounts released or written off. Likewise, it is possible that the borrower has been liable to income tax in an earlier tax year in his or her capacity as settlor on a sum in respect of a loan or under section 421 of ICTA in respect of amounts released or written off.

1692. Section 421(3) of ICTA provides relief for sums which fall to be included as income under section 677 of ICTA. It suggests that section 677 of ICTA takes precedence:

"This section shall not have effect in relation to a loan or advance made to a person if any sum falls in respect of the loan or advance to be included in his income by virtue of section 677, except so far as the amount released or written off exceeds the sums previously falling to be so included (without the addition for income tax provided for by subsection (6) of that section).

1693. But section 677(3) of ICTA provides:

"Where any amount is included in a person's income by virtue of section 421 in respect of any loan or advance, there shall be a corresponding reduction in the amount (if any) afterwards falling to be so included in respect of it by virtue of this section.

1694. This suggests that section 421 of ICTA takes precedence.

1695. The purpose of these provisions (which were introduced in the same Finance Act) is to prevent the same sum being taxed both under section 421 of ICTA and section 677 of ICTA. It is believed that "afterwards falling to be so included" in section 677(3) of ICTA is a reference to later tax years. So, for the purposes of section 677 of ICTA amounts charged in earlier tax years under section 421 of ICTA will be taken into account, but within the same tax year section 677 of ICTA will take precedence. This would mean that "previously falling to be so included" in section 421(3) of ICTA would include amounts charged to tax under section 677 of ICTA in the same and earlier tax years.

1696. So section 418:

- makes it clear that section 677 of ICTA (rewritten as section 633 of this Act) takes precedence over section 421 of ICTA; and
- ensures that the same sum is not taxed twice.

1697. *Subsections (2)* to *(6)* set out the steps to be taken to determine whether tax is charged under section 415. In particular, subsections (2) and (3) require the "total amount previously charged" (that is, sums taxed under section 633 of this Act either in previous tax years or in the same tax year and amounts taxed under this Chapter) to be compared

9 STC [1991] 445; STC [1992] 746

with the "total amount released". Only if the total amount released exceeds the total amount previously charged, is tax charged under this Chapter.

1698. Any amount that is charged to tax under section 415 is grossed up at the dividend ordinary rate (Schedule F ordinary rate in the source legislation) in the usual way (see subsection (3)).

1699. Subsection (5) provides that, when calculating the amount that has already been charged under section 633of this Act, only the net amount is taken into account, not the amount produced by the grossing up required under section 640(1) of this Act.

Section 419: Loans and advances to persons who die

1700. This section deals with who is liable for any tax charged where the original debtor has died and the loan is released or written off during the administration of the estate, or at some later point. It is based on section 421(2) of ICTA.

1701. If the conditions in *subsection (1)* are met, s*ubsection (2)* confirms that there is no charge under section 415. Instead, the amount that would have been charged under that section is treated as forming part of the aggregate income of the estate and may be charged under Chapter 6 of Part 5 of this Act or section 701(8) of ICTA.

1702. If subsection (2) does not apply,*subsection (3)* will (so that tax is charged under this Chapter).

Section 420: Loans and advances to trustees of trusts that have ended

1703. This section is based on section 421(2) of ICTA and applies where a loan has been made to trustees of a trust and the loan is released or written off after the trust has come to an end.

Section 421: Income tax treated as paid

1704. This section explains how a person's income tax liability is satisfied (in whole or in part). It is based on section 421(1)(b) of ICTA.

1705. Under *subsection (1)*, the person liable is treated as having paid income tax at the dividend ordinary rate (Schedule F ordinary rate in the source legislation) on the gross amount released or written off.

1706. If the debt is released or written off during the administration of a deceased person's estate, the personal representatives are not charged to tax under this Chapter but the amount of income that would otherwise be so charged forms part of the aggregate income of the estate for the purposes of Chapter 6 of Part 5 of this Act or section 701(8) of ICTA. As personal representatives are not charged to tax under this Chapter they are not "persons liable". This means that they are not treated as having paid income tax under this section (but see the commentary on section 680). "Personal representatives" is defined in section 878 of this Act.

1707. *Subsection (2)* provides that the tax treated as paid is not repayable. This applies even if the person is a non-taxpayer.

1708. *Subsections (3)*, *(4)* and *(5)* ensure that an individual cannot be given credit for income tax on more than the amount of the loan released or written off which is charged to tax.

1709. Section 421(1)(c) of ICTA deals with tax rates and treats the amount charged to tax as not brought into charge to tax for the purposes of sections 348 and 349 of ICTA. Section 421(1)(c) of ICTA is not rewritten in this Chapter. But rather than leaving it "stranded" in section 421 of ICTA it is rewritten in amendments to sections 1A of ICTA and 348 and 349 of ICTA (see paragraphs 3 and 147(3) of Schedule 1 to this Act respectively).

Chapter 7: Purchased Life Annuity Payments

Overview

1710. Annuity payments made under a purchased life annuity are annual payments and taxable under the source legislation by section 18 of ICTA under Schedule D Case III or Case V. However, because of the special exemption that applies to payments made under a purchased life annuity (see the commentary on Chapter 7 of Part 6 of this Act) and because such payments are generally regarded as investment income, a specific charge has been carved out of the residual annual payments charge (which is in Chapter 7 of Part 5 of this Act).

1711. In line with the approach of bringing together all exemptions in one Part, the exemption for part of the purchased life annuity payment is in Chapter 7 of Part 6 of this Act.

Section 422: Charge to tax on purchased life annuity payments

1712. This section is based on section 18(1) and Schedule D Case III and Case V in section 18(3) of ICTA. It charges to tax annuity payments made under a purchased life annuity.

Section 423: Meaning of "purchased life annuity"

1713. This section rewrites the definition of "purchased life annuity" in section 657(1) of ICTA.

Section 424: Income charged

1714. Section 424 sets out the amount charged to tax on annuity payments and is based on section 64 and section 65(1) of ICTA. The amount charged may be reduced if the exemption in section 717 (exemption for part of purchased life annuity payments) applies.

1715. The words "without any deduction" in section 64 of ICTA have not been reproduced. They are considered unnecessary. There are no provisions in the source legislation allowing deductions from Schedule D Case III income and one of the defining characteristics of an annual payment is that it represents pure income profit in the hands of the recipient. See further the commentary on section 370. In the case of annuity payments arising from a source outside the United Kingdom, *subsection (2)* makes *subsection (1)* subject to the special rules for foreign income in Part 8 of this Act (see further the commentary on Part 8).

Section 425: Person liable

1716. This section is based on section 59(1) of ICTA and states who is liable for any tax charged. The phrase "receiving or entitled to" has been retained because it is generally understood and has been widely interpreted by the courts. See further the commentary on section 371.

Section 426: Annuity payments received after deduction of tax

1717. This section provides that if income tax has been deducted by the payer of the annuity, the recipient is treated as having paid that income tax. It is based on section 348(1)(d) of ICTA and case law.

1718. The policy has been adopted that only those tax deduction rules which both relate to the recipient and to amounts of tax treated as paid, will be rewritten in this Act. So, section 348(1)(c) of ICTA, for example, is not rewritten.

1719. Under section 348(1)(d) of ICTA, tax deducted from annual payments under section 348(1)(b) of ICTA is treated as paid by the recipient. Case law extends this proposition to tax deducted under sections 348(2) and 349 of ICTA. This section fills the legislative gap otherwise filled by case law.

1720. Section 348(1) of ICTA deals with annual payments within Schedule D Case III (other than interest) which are payable wholly out of profits or gains brought into charge to income tax. Under section 348(1)(b) of ICTA the payer is entitled, but not obliged, to deduct and retain out of the annual payment a sum representing income tax. Under section 348(1)(c) of ICTA the recipient has to allow the tax to be deducted by the payer. The recipient is charged to tax on the full amount of the payment (that is, the actual payment received plus the tax deducted) but is treated as having paid income tax equal to the amount of the sum deducted (see section 348(1)(d) of ICTA).

1721. Sections 348(2) and 349 of ICTA provide for certain other payments also to be made after deduction of tax, but there is no equivalent provision to say that the tax deducted should be treated as tax paid by the recipient. Various tax cases, however, extend the effect of section 348(1)(d) of ICTA to these provisions.

1722. In Allchin v Corporation of South Shields (1943), 25 TC 445 HL, Viscount Simon LC said (on page 461):

"If and in so far as the annual payment is not payable and paid out of profits or gains brought into charge, the person making the payment is bound to deduct from it Income Tax at the current rate and to account to the Crown for the amount deducted. In effect, the payer in such a case acts as collector for the Crown of the tax due from the recipient. The requirement that the recipient must allow the deduction and treat the payer as acquitted of liability in respect of this amount is not repeated in Rule 21, but must be implied.

1723. The final sentence quoted clearly follows the text of section 348(1)(c) of ICTA and effectively extends it to section 349 cases. The words of section 348(1)(d) of ICTA are not mentioned but the obiter words, "In effect, the payer in such a case acts as collector for the Crown of the tax due from the recipient", amount to the same thing because it follows from them that once deduction has occurred, the recipient has paid his or her tax.

1724. In Stokes v Bennett (1953), 34 TC 337 HC, a divorced wife received maintenance payments, "free of tax", under a UK court order from her former husband who was not resident in the United Kingdom. There was no evidence that tax was deducted from the payments and no such tax was accounted for to the Inland Revenue. Also, there was no evidence that the husband received income which was subject to UK income tax. The wife was taxed under Schedule D Case III on the amounts received.

1725. It was held in the High Court, however, that the wife should be treated as having received sums from which tax had been deducted and no further assessments could therefore be made. As the order was for an amount to be paid "free of tax", and because the husband had paid the same amounts as the free of tax amounts (rather than the grossed up amounts), the court thought that the correct inference was that he had deducted tax.

1726. As there was no evidence that the payments were out of taxed income, it was a case within what is now section 349 of ICTA, rather than section 348 of ICTA. Deduction of tax was presumed to have occurred and Lord Simon's dicta from Allchin v Corporation of South Shields were applied so that the requirement that the recipient must allow the deduction and treat the payer as acquitted of his liability had to be implied. It followed that the wife could not sue her husband for the tax because she would be met with the defence that he was acquitted of his liability. Therefore the wife fell to be treated as the recipient of an amount that had borne tax. Collection of the tax was a matter between the payer and the Crown. The husband had become in effect an agent for the Crown, as the collector for the Crown of the tax due from (and in effect paid by) the wife. This is tantamount to the provision in section 348(1)(d) of ICTA.

1727. Section 349 of ICTA is regarded as applying to annual payments made under United Kingdom court orders etc not wholly out of profits or gains bought into charge to income tax even where the payer is not UK resident.

1728. In Grosvenor Place Estates Ltd v Roberts (1960), 39 TC 433 CA, the National Coal Board failed to deduct tax from certain payments which were not made out of profits or gains brought into charge to tax. The recipient company was taxed on the full amount of the payments. On appeal the company contended that as the National Coal Board was obliged to deduct tax no assessment could be made on the recipient. It was held, however, that the recipient could be assessed to tax where the payer failed to deduct tax, notwithstanding the express rights of the Inland Revenue to assess the payer. Donovan LJ said (on page 453):

"The power and duty of the General Commissioners to make assessments upon annual payments charged with tax under Schedule D where such payments are made out of profits or gains not brought into charge to tax still remains. This does not involve liability to double taxation, once by deduction at source and again by assessment upon the same income. It is true there is nothing in the Act expressly prohibiting such an injustice, but the prohibition is implicit in its provisions, as the Courts have frequently said.

1729. In effect this means that section 349 of ICTA impliedly contains the provision in section 348(1)(d) of ICTA, that the deduction is treated as tax paid by the payee.

Chapter 8: Profits from deeply discounted securities

Overview

1730. This Chapter rewrites the provisions in Schedule 13 to FA 1996 that deal with "relevant discounted securities". FA 2003 introduced various changes to Schedule 13, principally repealing reliefs for losses and allowances for expenditure, but with transitional rules for securities held since before 27 March 2003. Since these losses and allowances continue to apply for securities held since that date it was considered more helpful to set out the law relating to them in this Chapter rather than relegate them to Schedule 2 to this Act.

Section 427: Charge to tax on profits from deeply discounted securities

1731. This section charges to tax profits on deeply discounted securities which arise when the security is disposed of (for whatever reason) or, in certain circumstances, is treated as being disposed of. It also ensures that gains which would not otherwise be income are treated as such. The section is based on paragraph 1 of Schedule 13 to FA 1996.

1732. Although Schedule 13 to FA 1996 refers to a "relevant discounted security", this Act uses the term "deeply discounted security". This seems a more appropriate term to reflect both the nature of the security and the nature of the tax charge while distinguishing this regime from the "deep gain securities" regime of Schedule 11 to FA 1989.

Section 428: Income charged

1733. This section sets out the amount charged to tax on profits that arise on a disposal of securities that are within or outside the United Kingdom. It is based on sections 64, 65 and 68 of ICTA and on paragraph 1 of Schedule 13 to FA 1996.

1734. Paragraph 1(1) of Schedule 13 to FA 1996 provides that profits arising from a security out of the United Kingdom are chargeable under Schedule D Case IV. This allows the assessment rules for Case IV income in section 65 of ICTA to apply.

1735. *Subsection (3)(a)* treats such profits as arising from a source outside the United Kingdom. This links to the definition of "relevant foreign income" in section 830, thus attracting the special rules for such income in Part 8 of this Act.

1736. *Subsection (3)(b)* then makes the rule in *subsection (1)* subject to the rules in Part 8 of this Act for such profits.

Section 429: Person liable

1737. This section states who is liable for any tax charged. It is based on paragraph 1 of Schedule 13 to FA 1996.

Section 430: Meaning of "deeply discounted security"

1738. This section provides a general definition of "deeply discounted security" for the purposes of Chapter 8. It is based on paragraph 3 of Schedule 13 to FA 1996.

1739. The main test to identify relevant discounted securities is spread over paragraph 3(1), (3) and (4) of Schedule 13 to FA 1996. The test compares the amount payable on redemption with the issue price of the security to see whether, under its terms of issue, it is capable of yielding a "deep discount" on redemption.

1740. A security is capable of yielding a "deep discount" if the amount payable on redemption could exceed the issue price by more than a specified percentage of the amount payable on redemption. In the rare case where the security has an expected life of 30 years or more, the percentage specified is 15%. In all other cases the percentage specified is equal to half the number of years between the date of issue and the date of redemption.

1741. This means that a deep discount occurs where the amount payable on redemption could exceed the issue price and the potential difference amounts to more than 0.5% of the amount payable on redemption for each year of the security's life. For example, a five year bond issued for £90 and redeemable for £100 is a deeply discounted security because the discount is more than the specified 2.5% (that is, 0.5% for each year of the bond's life). This is expressed in s*ubsection (1)* by means of a formula.

Section 431: Excluded occasions of redemption

1742. This section exempts from the charge under this Chapter certain securities which were not issued to gain a tax advantage and where redemption is not within the power of the holder. It is based on paragraph 3 of Schedule 13 to FA 1996.

1743. Under section 430(1) the test for a deep discount can be applied on maturity or any possible occasion of redemption. Those occasions of redemption are ignored if the conditions in subsection (2) or (3) of this section are met.

1744. In *subsection (2)* the conditions in paragraphs 3(1A) and 3(1C) of Schedule 13 to FA 1996 have been amalgamated and renamed "the third-party option conditions". These apply where the achieving of a tax advantage (defined in section 460(2)) is not a main benefit and the security is issued to a person who is not connected with the issuer (see *subsection (7)* and section 878(5) of this Act) and is not redeemable by the holder.

1745. *Subsection (3)* provides the second conditions which have been renamed "the commercial protection conditions". These exempt from charge securities which can only be redeemed as the result of an event which in practice is likely to be outside the power of the holder and which could not have been anticipated when the securities were issued.

1746. Under *subsection (4)* neither of these two sets of conditions is considered as met simply because an occasion of redemption happens to takes place coincidentally at the same time that one of these sets is met.

1747. For the "third-party option conditions" to apply the security must be issued to a person who is not connected with the issuer. *Subsection (5)* provides that where those conditions are met but the security is then acquired by a connected person (or the holder becomes such a person) the conditions will cease to apply.

1748. *Subsection (6)* deals with the reverse of the condition provided for in subsection (5). Where a person who is not connected with the issuer acquires a security which fails to satisfy the "third-party option conditions" only because it was issued to a person connected with the issuer, then it ceases to be a deeply discounted security from that date. This subsection also applies where a security which is a deeply discounted security as a result of subsection (5) is acquired.

Section 432: Securities which are not deeply discounted securities

1749. This section excludes certain specified securities from the scope of the general definition of deeply discounted security in section 430. It is based on paragraph 3 of Schedule 13 to FA 1996.

Section 433: Meaning of "excluded indexed security"

1750. This section explains what is meant by an "excluded indexed security" referred to in the previous section. It is based on paragraph 13 of Schedule 13 to FA 1996.

1751. *Subsection (1)* explains that a security is an "excluded indexed security" if the amount payable on redemption depends on any future change in the value of certain assets or on the change in an index of the value of certain assets.

1752. Some securities provide for the investor to get back a percentage of his or her original investment if the value of the assets (or the index) fails to rise to a certain level. This will not prevent the security being a deeply discounted security provided the specified percentage is not more than 10% of the issue price (*subsection (2)*). This means that if £100 is invested the investor must get no more than £10 back, losing the other £90. Unless the investor can lose 90% of the original investment it is not an excluded indexed security but a deeply discounted security.

1753. *Subsection (3)* ensures that interest on redemption is ignored in the calculation under this section. It is clear that this is the intention of the legislation from the fact that paragraph 3(2)(c) of Schedule 13 to FA 1996 takes excluded indexed securities outside the definition of deeply discounted securities and that paragraph 3(6) of that Schedule (rewritten in section 430(4)) excludes interest from the general calculation of deep discounts.

1754. *Subsection (4)* defines "redemption period" for the purpose of this test. This definition differs from the one for the deeply discounted security test in section 430 to allow flexibility for the chargeable assets referred to in subsection (1) to be valued on dates other than, but close to, the issue and redemption dates. Likewise, an index of the value of chargeable assets may not be computed for the actual issue and redemption dates and some approximation is required.

1755. *Subsection (5)* defines "chargeable asset" for the purpose of this test. The underlying premise is that where the disposal of the asset whose value is linked to the security would be within the scope of capital gains tax, then disposals of securities fully linked to the value of such assets should also be subject to capital gains tax and excluded from the income tax regime.

1756. "Chargeable asset" is defined, in paragraph 13(6) of Schedule 13 to FA 1996, as an asset which on disposal can give rise to a chargeable gain for the purposes of TCGA. In order to make this test work it is necessary to make some assumptions about the asset (found in paragraph 13(7) of that Schedule) and these are set out in *subsection (6)*. Section 100 of TCGA applies mainly for corporation tax purposes and unauthorised unit trusts are the only persons liable to income tax benefiting from subsection (6)(b).

Section 434: Securities issued in separate tranches: preliminary

1757. This section introduces two special rules for determining whether securities issued in tranches under a single prospectus are deeply discounted securities. The first rule is called “the basic rule” and the second rule “the nominal value rule”. Broadly, where securities are issued in tranches under a single prospectus, either all of them are treated as deeply discounted securities or none of them is. The section is based on paragraphs 3 and 10 of Schedule 13 to FA 1996.

1758. *Subsection (2)* explains that following an initial issue of deeply discounted securities under a prospectus the nominal value rule will not apply to any of the securities issued at any time under that prospectus but the basic rule will apply.

1759. *Subsection (3)* explains the position where, in contrast to the position in subsection (2), the original issue does not include any deeply discounted securities. In that case both rules may apply to later issues.

Section 435: Securities issued in separate tranches: basic rule

1760. This section sets out the first rule, known as the basic rule. It is based on paragraph 3 of Schedule 13 to FA 1996.

1761. *Subsection (1*) provides that if any of the securities issued under a prospectus at any time are not deeply discounted securities under section 430, then any securities issued subsequently will not be deeply discounted securities, even if they would be deeply discounted securities under that section. But this will not be the case if a security is a deeply discounted security because it is issued to a person connected with the issuer or acquired by a person who becomes so connected (see *subsection (2)*).

1762. The words “(disregarding that paragraph)” from paragraph 3(2)(f) of Schedule 13 to FA 1996 are not rewritten. They may be read in such a way as to conflict with the words “subject to paragraph 10” at the beginning of paragraph 3(2)(f) of that Schedule, which are clearly intended to prevail.

Section 436: Deeply discounted securities issued in separate tranches: nominal value rule

1763. This section sets out the second rule, known as the nominal value rule. It is based on paragraph 10 of Schedule 13 to FA 1996.

1764. *Subsection (3)* sets out the condition that must be satisfied for the rule in this section to apply. It is that the aggregate nominal value of deeply discounted securities issued after an original non-deep discount issue should exceed the aggregate nominal value of all the other securities issued under the prospectus up to that time.

1765. *Subsection (4)* provides the rule, which is that if the condition in subsection (3) is satisfied, all the securities issued under the prospectus will be treated, for the purposes of any later acquisition or disposal, as if they were deeply discounted securities when they were acquired. This applies even if the securities are not deeply discounted securities within the terms of section 430 or are not deeply discounted securities because of the application of the basic rule in section 435.

1766. *Subsections (5)* and *(6)* provide that a security is not a deeply discounted security for the purpose of applying this rule if it is only a deeply discounted security because it is issued to a person connected with the issuer or acquired by a person who becomes so connected as set out in section 435(2) and the person holding it at the relevant time is not so connected.

Section 437: Transactions which are disposals

1767. This section defines the events giving rise to the income tax charge (or loss relief) relating to deeply discounted securities. It is based on paragraphs 1, 4 and 5 of Schedule 13 to FA 1996.

1768. *Subsection (1)* brings together the occasions in Schedule 13 to FA 1996 which give rise to profits. The subsection includes occasions when someone "transfers" a deeply discounted security or "becomes entitled ... to any amount on its redemption" (paragraph 1(2) of that Schedule) and a profit is realised. It also includes the conversion of the security into shares or other securities.

1769. The essential point is that the person no longer owns the security and has realised a profit, or sustained a loss, when ownership ceases. The events giving rise to the tax charge are referred to by the section as "disposals" and all the circumstances in which a disposal occurs (apart from under the special rules applying for strips of government securities) are described in this one section.

1770. *Subsection (3)* deals with a deemed transfer of a deeply discounted security to personal representatives immediately before death, in the source legislation found in paragraph 4(2) of Schedule 13 to FA 1996. It crystallises the increase in value at the time of death. "Personal representatives" is defined in section 878(1) of this Act.

Section 438: Timing of transfers and acquisitions

1771. In most cases it is clear when a disposal occurs. But this section provides a timing rule for transfers and acquisitions where that may be less clear; for example, where the holder of a security enters into an agreement to sell the security to someone else at a future date. The section is based on paragraph 4 of Schedule 13 to FA 1996.

1772. The section provides for the security to be treated as transferred (or acquired) when the agreement for the transfer of the security is made, so long as the person receiving it becomes entitled to it at that time. Where an agreement to transfer a security is conditional, the agreement is treated as made when the condition is satisfied.

1773. The words in brackets in paragraph 4(4) of Schedule 13 to FA 1996 ("whether by the exercise of an option or otherwise") have been omitted as an unnecessary example.

Section 439: Calculating the profit from disposals

1774. This section provides the rules for computing the profit on a disposal. It is based on paragraph 1 of Schedule 13 to FA 1996.

1775. *Subsection (2)* disallows any deduction for incidental costs on acquisition or disposal of a deeply discounted security. But (*subsection (3)*) this is subject to the deductions rule in subsection (4) and the rule on securities held since 26 March 2003 in section 455.

1776. *Subsection (4)* allows a deduction from the profits on disposal for incidental expenses if incurred before 27 March 2003. The term "relevant costs" in Schedule 13 to FA 1996 has been replaced with "incidental expenses".

1777. *Subsection (5)* deals with the case where a security has been sold and re-acquired, ensuring that it is the later acquisition only that is relevant for ascertaining the profit.

Section 440: Market value disposals

1778. This section deals with the situations in which the amount payable on disposal is determined to be the market value. It is based on paragraphs 4, 6, 8 and 9 of Schedule 13 to FA 1996.

1779. In Schedule 13 to FA 1996 these rules importing market values occur in five separate paragraphs but have now been put into this one section. There are now two rules.

1780. *Subsection (1)* introduces the first rule in which the transfer of a security of a type within *subsection (2)* is treated as disposed of for an amount equal to its market value at the time of the disposal. This is subject to the second rule, in subsection (4).

1781. *Subsection (4)* is the second rule. It is a qualification of the first rule and applies for a particular type of transaction. Where a deeply discounted security is converted into shares or other securities the security is instead treated as disposed of for an amount equal to the market value of the shares or securities acquired. But this is subject to a special rule for strips which has been signposted at *subsection (5)*.

Section 441: Market value acquisitions

1782. This section deals with all the situations in which the acquisition cost of deeply discounted securities is to be determined at market value. It is based on paragraphs 4, 5, 8 and 9 of Schedule 13 to FA 1996.

1783. *Subsection (2)* provides a list of the disposals giving rise to acquisitions to which the rule in *subsection (1)* applies. The list includes the acquisition of a deeply discounted security as the result of the conversion of a security into shares or other securities – subsection (2)(b). See *Change 86* in Annex 1.

1784. Also included in subsection (2)(a) of the list is the acquisition of a security transferred to a legatee by personal representatives. See *Change 86* in Annex 1.

Section 442: Securities issued in accordance with qualifying earn-out right

1785. This section provides rules for ascertaining the acquisition value of a security which forms the whole or part of the consideration on the disposal of a business. It is based on paragraph 3A of Schedule 13 to FA 1996.

1786. This section prevents a profit on deeply discounted securities being charged to capital gains tax as well as to income tax under this Chapter. Where a right to securities to be issued at some future date is part of the consideration for the disposal of a business (an "earn-out right"), a chargeable gain will arise on the difference between the right to receive those securities and their value when issued.

1787. When the securities are eventually disposed of, a deep discount may arise on the difference between the value of the right when granted (as for the chargeable gain described above) and the disposal proceeds. But this may include the increase in value that has already been included in the computation of a chargeable gain. By making the acquisition value for the deep discount legislation the same as the disposal value of the right for capital gains tax purposes, the double counting of that proportion of the discount for income tax purposes is avoided.

1788. The provision is rewritten by providing the valuation rule for securities issued as a "qualifying earn-out right" in *subsection (2)* and then defining a "qualifying earn-out right" in *subsections (3)* to *(6)*.

Section 443: Application of this Chapter to strips of government securities

1789. This section acts as an introduction to sections providing special rules for computing profits and gains on strips of securities issued by the government of any territory. It is based on paragraph 14 of Schedule 13 to FA 1996.

Section 444: Meaning of "strip" in Chapter 8

1790. This section defines "strip" for the purposes of this Chapter. It is based on section 47 of FA 1942.

1791. FA 2003 widens the definition of "strip" for Schedule 13 to FA 1996 by including securities issued by *any* government. This applies to strips acquired after 26 March 2003. In accordance with our intention of including within Chapter 8 the rules relating to strips acquired before 27 March 2003 the previous, narrower, definition has been retained in *subsection (1)(c)*. Whether the strips fall under subsection (1)(b) or (c) the conditions set out in subsections (2) to (5) must be met.

1792. *Subsections (2) to (5)* rewrite the relevant conditions in section 47 of FA 1942. The definition in Schedule 13 to FA 1996 cross-refers to that section.

Section 445: Strips of government securities: acquisitions and disposals

1793. This section provides the rules necessary for computing profits on the disposal of government securities. It is based on paragraph 14 of Schedule 13 to FA 1996.

1794. *Subsection (1)* is the first rule. It determines, by means of a formula, the acquisition cost where a gilt-edged security which is not a strip (and therefore under section 432(1)(b) not a deeply discounted security) is "stripped". The acquisition cost of each strip is computed by apportioning the market value of the underlying security between all the strips acquired.

1795. *Subsection (2)*, which contains the second rule, deals with a deemed transaction which counts as a disposal. This is the deemed transfer, followed by immediate reacquisition under *subsection (3)*, of a strip held on 5 April.

1796. Paragraph 14(4) of Schedule 13 to FA 1996 provides for a deemed reacquisition on 6 April for the same value as the disposal on 5 April. This is rewritten as disposal and immediate reacquisition. See *Change 87* in Annex 1.

1797. See paragraph 80 of Schedule 2 to this Act for the application of this rule for 2005-06.

1798. *Subsection (5)* ensures that incidental expenses are not allowed in respect of these deemed transfers even where they were incurred before 27 March 2003.

1799. The rules in subsections (2) to (5) ensure that anyone holding a strip of a government security is taxed year by year on the increase in value of the strip. This is intended to prevent investing in strips, rather than in unstripped government securities (where interest would be taxed year by year), to defer tax liability.

1800. *Subsection (6)*, which contains the final rule, deals with the situation where two or more strips are brought together and turned into a single security. Each strip is disposed of for an amount equal to its market value on consolidation.

1801. *Subsections (7)* and *(8)* ensure that both the first and final rules take precedence over both the rule on timing and transfers in section 438 and the market value rules at sections 440(4) and 441.

Section 446: Strips of government securities: relief for losses

1802. This section allows relief for losses that arise on disposals of strips of government securities. It is based on paragraph 14A of Schedule 13 to FA 1996.

1803. *Subsection (7)* prevents a double claim for loss relief by providing that relief cannot be claimed under this section if section 454 (listed securities held since 26 March 2003: relief for losses) applies.

Section 447: Restriction of profits on strips by reference to original acquisition cost

1804. This section restricts profits to the amount by which disposal proceeds exceed the original acquisition cost. Because there is a 5 April revaluation of strips on a deemed disposal each year the cost taken into account on actual disposal is the last 5 April value. This section ensures that in such cases a profit cannot exceed the difference between the disposal proceeds and the original cost of the security. It prevents taxation of an artificial gain and is the obverse of the loss restriction in section 448. See paragraph 81 of Schedule 2 to this Act where strips are acquired before 15 January 2004. The section is based on paragraph 14D of Schedule 13 to FA 1996.

1805. *Subsection (1)* sets out when the rule in this section applies, namely when a profit would, apart from this section, arise on disposal but the market value of the strip is less than the amount paid by the person to acquire the strip, thus giving rise to a greater profit than would be the case if the market value had not replaced the cost.

1806. *Subsections (2)* and *(3)* restrict that profit to the excess of the disposal proceeds over the cost of acquisition. If there is no excess because the acquisition cost does not exceed the market value, no profit is made.

1807. *Subsections (4)* and *(5)* require that the deemed disposal on 5 April (section 445) is to be ignored in considering the original acquisition cost. Paragraph 14D(6)(b) of Schedule 13 to FA 1996, which provides that the original acquisition cost should reflect the open market value rules, is not rewritten. It is considered unnecessary given that the purpose of the open market value rules for acquisition costs applies for the purposes of the whole Chapter (section 441).

Section 448: Restriction of losses on strips by reference to original acquisition cost

1808. This section restricts losses to the amount by which disposal proceeds exceed the original acquisition cost. Because there is a 5 April revaluation of strips on a deemed disposal each year the cost taken into account on actual disposal is the last 5 April value. This section ensures that in such cases a loss cannot exceed the difference between the disposal proceeds and the original cost of the security. The section is based on paragraph 14D of Schedule 13 to FA 1996.

1809. *Subsection (1)* sets out when the rule in this section applies, namely when a loss would, apart from this section, arise on disposal but the market value of the strip is less than the amount paid by the person to acquire the strip, thus giving rise to a greater loss than would be the case if the market value had not replaced the cost.

1810. *Subsections (2), (3)* and *(4)* restrict that loss to the excess of the disposal proceeds over the cost of acquisition. If there is no excess because the acquisition cost does not exceed the market value, no loss is made.

Section 449: Strips of government securities: manipulation of acquisition, sale or redemption payments

1811. This section applies where there is a scheme or arrangement and the main, or one of the main, benefits that is expected to accrue is the obtaining of a tax advantage. It substitutes market value in any case where the acquisition cost is more than the market value, or the disposal or redemption proceeds are less than market value. The section is based on paragraph 14B of Schedule 13 to FA 1996.

Section 450: Market value of strips etc.

1812. This section provides the rule for ascertaining the market value of a strip or a security exchanged for a strip. It is based on paragraph 14E of Schedule 13 to FA 1996.

Section 451: Market value of strips etc. quoted in foreign stock exchange lists

1813. This section provides the rules for ascertaining the market value of overseas strips or securities quoted on a foreign stock exchange. It is based on paragraph 14E of Schedule 13 to FA 1996.

1814. *Subsections (4)* and *(5)* make provision for cases where the mechanics of overseas stock exchanges might differ from those in the United Kingdom, in particular where separate buy and sell prices are not given.

1815. *Subsection (6)* acts as a tie-breaker where the strip or security is listed on more than one foreign exchange.

Section 452: Power to modify this Chapter for strips

1816. This section allows the Treasury to make regulations for the treatment of strips as a response to future developments in the strips market. It is based on paragraph 14 of Schedule 13 to FA 1996.

Section 453: Application of sections 454 to 456

1817. This section is the first of four sections providing special rules for securities held since 26 March 2003. FA 2003 introduces several changes to Schedule 13 to FA 1996 which affect securities held after that date. It is based on paragraph 6 of Schedule 39 to FA 2003.

1818. With the one exception for government strips, loss relief is no longer available for disposals on or after 27 March 2003, nor is there a deduction for incidental expenses incurred on or after that date. Where, however, a deeply discounted security held since before that date is disposed of, loss relief is still available if the security is listed on a recognised stock exchange. Although the provisions for these reliefs are repealed by FA 2003 for securities acquired after 26 March 2003 they are rewritten in this Chapter to make it easier for the taxpayer with securities acquired before 27 March 2003 to ascertain the relevant rules. Paragraph 7 of Schedule 13 to FA 1996 which deals with losses on certain exempt income is rewritten in paragraphs 82 and 83 of Schedule 2 to this Act as it is of limited application.

Section 454: Listed securities held since 26th March 2003: relief for losses

1819. This section provides for any loss sustained on the disposal of a listed deeply discounted security to be relieved by set-off and explains when a loss is incurred. It is based on paragraphs 2 and 6 of Schedule 13 to FA 1996.

1820. *Subsection (2)* provides that a loss is incurred where the amount paid on acquisition exceeds the amount paid on disposal disregarding any incidental costs. Incidental costs may increase the loss but not create a loss. See section 455 for how the loss is computed.

1821. *Subsection (3)* signposts section 455(2) to (4) which allow costs in computing the profit where the security has been continuously held since 26 March 2003.

1822. The set-off rules for persons who are not trustees (*subsection (4)*) differ from those for trustees (*subsection (5)*).

1823. See paragraphs 82 and 83 of Schedule 2 to this Act for further provisions on trustees.

Section 455: Listed securities held since 26th March 2003: calculating the profit or loss on disposals

1824. This section gives the rules for computing profits and losses on disposals of securities held continuously since 26 March 2003. Deductions for incidental expenses of acquiring and disposing of deeply discounted securities are only available for listed securities held on 26 March 2003. The section is based on paragraphs 1, 2, 14 and 15 of Schedule 13 to FA 1996.

1825. *Subsections (2)* and *(3)* explain how to compute the loss referred to in section 454(2). The loss sustained is effectively increased by the deduction of the incidental expenses incurred in connection with the acquisition and disposal of the security. This is expressed by allowing the costs, which include both sets of incidental expenses and the cost of acquisition, as a deduction from the disposal proceeds.

Section 456: Securities issued to connected persons etc. at excessive price: subsequent transfers to connected persons

1826. This section prevents a loss arising on the transfer of deeply discounted securities where securities are issued at a value above that at which they are subsequently transferred and the issue and transfer are to connected persons. The section is based on paragraph 9A of Schedule 13 to FA 1996.

1827. The market value rules in sections 440 and 441 do not apply to securities on issue but only to subsequent disposals. The application of those rules therefore produces a loss where a security has been issued at above the market value to a connected person and is then transferred to another connected person at market value. These transactions thereby benefit from the fact that the market value rules do not apply on issue, and when they might apply, on a transfer, the price is at market value.

1828. *Subsection (1)* provides the general rule that no loss will arise where certain conditions are met. These conditions are set out in subsections (2) to (6).

1829. The conditions in*subsections (2)* and *(3)* must both apply, together with either the condition in *subsection (4)* or those in both *subsections (5)* and *(6)*. These conditions provide that the person disposing of the security was either connected with the issuing company or controlled it and that the security was acquired on issue at above market value.

1830. It is considered unnecessary to rewrite paragraph 9A(2)(b) of Schedule 13 to FA 1996, because if the transferor were connected with the issuer condition C (paragraph 9A(1)(b) of that Schedule) would apply.

1831. *Subsections (5)* and *(7)* ensure that the rule also applies where a deeply discounted security is issued by a close company where the person to whom it is issued, together with others, controls the issuing company, wherever the company is resident.

Section 457: Trustees

1832. This section gives rules for applying this Chapter to trustees. It is based on paragraph 6 of Schedule 13 to FA 1996.

1833. Under section 429 the person liable is the person making the disposal.

1834. *Subsection (2)* ensures that the profits are treated, for the purposes of Chapter 5 of Part 5 of this Act, as income arising under a settlement and therefore potentially chargeable on the settlor.

1835. *Subsection (3)* ensures that the profits are treated as income in applying the rules on the liability of trustees in Chapter 1C of Part 15 of ICTA.

1836. Paragraph 6(1) of Schedule 13 to FA 1996 refers to amounts “treated as income chargeable to tax”. This must simply mean ‘chargeable to tax’ since paragraph 1 of that Schedule makes use of a straightforward charge on the gain rather than a deemed income approach. The “deemed” wording has not been reproduced. But the wording of the charge has been reflected in section 427.

1837. *Subsection (5)* disapplies subsections (2) to (4) in the case of unauthorised unit trusts. Under section 469(2) of ICTA income arising to the trustees of unauthorised unit trusts is regarded as income of the trustees and not as income of the unit holders and such income is chargeable at the basic rate.

Section 458: Non-UK resident trustees

1838. This section provides that non-UK resident trustees are not charged to tax on profits and gains from deeply discounted securities. It is based on paragraph 6 of Schedule 13 to FA 1996.

Section 459: Transfer of assets abroad

1839. Sections 739 and 740 of ICTA provide rules to counter avoidance of income tax by the transfer of assets abroad. They depend on income being payable to a person resident or domiciled outside the United Kingdom which a person domiciled or resident within the United Kingdom has the power to enjoy. This section provides that profits on a disposal of deeply discounted securities by a non-UK resident or non-UK domiciled person are regarded as income paid to that person for the purpose of those rules. The section is based on paragraph 12 of Schedule 13 to FA 1996.

Section 460: Minor definitions

1840. This section provides some minor definitions for the provisions in this Chapter. It is based on section 103 of FA 1996 and paragraph 15 of Schedule 13 to FA 1996 and paragraph 14 of Schedule 25 to FA 2002.

Chapter 9: Gains from contracts for life insurance etc.

Overview

1841. This Chapter charges to tax the investment profit from life insurance policies, life annuity contracts and capital redemption policies. It is based on Chapter 2 of Part 13 of ICTA.

1842. The Chapter uses "gains" to describe what is charged to tax, as in the source legislation. The term "profits" is not used because it has different, well established meanings in the context of policies of life insurance etc. For example, the insurance industry uses "profits", as in "with profits" policies, to describe bonuses which are not "gains" within the meaning of this charge.

1843. Whereas the source legislation often deals separately with each type of policy and contract falling within this charge, the Chapter deals with all three types at the same time, so far as possible, while still preserving any differences in the rules for each type.

1844. Most of the policies and contracts to which the Chapter applies are held by individuals or on trusts created by individuals. But the Chapter deals with all circumstances under which gains are charged to income tax, irrespective of the capacity of the policy holder.

1845. Where the gain is charged to corporation tax (that is, when the rights under the policy or contract are held by a company, or on trusts created by a company, or as security for a debt owed by a company, and the company is within the charge to corporation tax), the relevant provisions are in Chapter 2 of Part 13 of ICTA, as amended by Schedule 1 to this Act.

1846. The income tax provisions in this Chapter for charging gains and the corporation tax provisions in ICTA apply independently to any policy or contract. In practice, the same event will occur, and the amount of the gain will be the same, under both sets of provisions. But a charge to tax under one or other tax (sometimes to both taxes) only arises if someone is liable for the respective tax on the gain by virtue of sections 464 to 467 of this Act or section 547(1)(b) of ICTA. The corporation tax provisions do not include the equivalent of sections 530 to 537 (income tax treated as paid and top slicing relief) and 539 to 541 (relief for deficiencies).

1847. Life insurance policies certified by the Inland Revenue as "qualifying policies", under paragraph 21 of Schedule 15 to ICTA, do not generally give rise to gains under this Chapter. The rules in Schedule 15 to ICTA include that:

- the policy must have a minimum term of ten years from the date it was made to the date it is due to end; and

- premiums of fairly even amounts must be payable at regular intervals in every year for at least ten years.

1848. Qualifying policies generally give rise to gains chargeable to tax if a "chargeable event" occurs:

- before the earlier of ten years from the beginning of the policy or three-quarters of the term for which it is due to run; or
- after the policy has – before the earlier of those two periods – been made a "paid up" policy (that is, no further premiums need be paid).

1849. The Chapter makes a number of minor changes to the law. And it includes provisions based on extra-statutory concessions.

1850. The Chapter also incorporates, so far as relating to the income tax charge, the secondary legislation for the special charge on personal portfolio bonds (the Personal Portfolio Bonds (Tax) Regulations 1999 SI 1999/1029, as amended by SI 2001/2724 and SI 2002/455). In this commentary, those regulations are abbreviated as "PPB(T)R".

1851. Date-related provisions (that is, provisions which apply only to policies or contracts issued before a particular date) are located in Parts 6 and 7 of Schedule 2 to this Act rather than in this Chapter. Part 6 is organised chronologically so that policy holders can see, in relation to their own policies or contracts, which rules qualify the provisions in the Chapter. Part 7 is wholly concerned with policies issued in respect of an insurance made before 17 March 1998 and contracts made before that date. Section 546 indicates when Schedule 2 to this Act modifies the operation of the section and the relevant paragraph(s) of the Schedule.

1852. A few date-related provisions have been retained within this Chapter where it would be unhelpful to remove them (for example, section 507(4) (method for making periodic calculations under section 498)).

1853. Some provisions in Part 5 of Schedule 2 to this Act (paragraphs 85 to 91) also apply. These depend on dates other than the date of issue of a policy or contract.

1854. The Chapter is laid out as follows-

- charge to tax under Chapter 9 (sections 461 to 463)
- person liable etc. (sections 464 to 472)
- policies and contracts to which Chapter 9 applies (sections 473 to 483)
- when chargeable events occur: general (sections 484 to 490)
- calculating gains: general (sections 491 to 497)
- part surrenders and assignments: periodic calculations and excess events (sections 498 to 509)
- transaction-related calculations and part surrender or assignment events (sections 510 to 514)
- personal portfolio bonds (sections 515 to 526)
- reductions from gains (sections 527 to 529)
- income tax treated as paid and reliefs (sections 530 to 538)
- deficiencies (sections 539 to 541)
- supplementary (sections 542 to 546)

Section 461: Charge to tax under Chapter 9

1855. This section charges gains from policies and contracts to tax. It is based on, and combines:

- the income tax charge in section 547(1) of ICTA (which stands outside the schedular system);
- the charges under Schedule D Case VI in sections 547(6) and 553(6) of ICTA; and
- the special charge on personal portfolio bonds under section 547 of ICTA by virtue of regulation 6 of PPB(T)R.

1856. The exemption mentioned in *subsection (4)* is not an exhaustive statement of exemptions that may apply.

Section 462: When gains arise from policies and contracts

1857. This section explains when a gain arises and introduces the concept of a “chargeable event”. It is based on sections 540, 542, 545 and 546C of ICTA.

Section 463: Income charged

1858. This section is based on section 547 of ICTA. It sets out the amount charged to tax.

1859. *Subsection (2)* flags the one circumstance where the gain to be charged for a tax year may have arisen in an earlier tax year. That is, the tax year for the charge is not the tax year in which the chargeable event occurred.

Section 464: Person liable for tax: introduction

1860. This section and the following three sections determine who is liable for tax charged under this Chapter. (Sections 466(3) and 468 indicate when a gain arising under this Chapter is not charged under the Chapter but may instead be taken into account for certain other income tax charges.) The section is based on section 547 of ICTA.

1861. The source legislation does not preclude an overlap between the attribution of liability to one “person liable” and to another (say, both to an individual who placed a policy in trust and to the trustees who hold the legal rights in the policy). In practice, liability of a UK resident individual normally prevails over other liability and the gain is not doubly charged to tax. See also the commentary on section 467 as it applies where the rights are held by trustees on charitable trusts (when liability falls on the trustees rather than the settlor).

1862. *Subsection (3)* provides that references in sections 464 to 467 to a surrender or assignment of rights refer, where appropriate, to a surrender or assignment of a part of, or share of, the rights. A *part* of the rights means one or more discrete rights provided by the policy or contract. A *share* in the rights means part of the ownership, where there are multiple owners, of such a discrete right or rights or of all the rights in the policy or contract. (The rule applied in this subsection is also found elsewhere in the Chapter. See in particular section 469(7) (two or more persons interested in policy or contract).)

Section 465: Person liable: individuals

1863. This section sets out three ways of holding or owning the rights under a policy or contract by virtue of any of which an individual may be liable to tax on the gain. Where an individual is so liable, the amount charged is treated as part of the individual’s “total income” (section 835 of ICTA). This section is based on section 547 of ICTA.

1864. Although unfettered beneficial ownership of the rights may be the most commonly met circumstance, policies and contracts are also commonly placed in trust for beneficiaries (whether for the settlor and/or other beneficiaries). Policies and contracts may also be used to secure a loan (such as a mortgage of property). If any of the three ways of holding or owning the rights applies, that is sufficient to attribute liability for tax on the gain to that individual. (But see section 467 when the rights are held on charitable trusts created by the individual.)

1865. *Subsection (1)* incorporates part of ESC B53. Under the concession, the Inland Revenue does not pursue liability to tax on a gain, where a non-UK resident individual is liable, in any of the circumstances mentioned in this subsection. The section achieves the same net effect by a different route. It simply limits attribution of liability to UK resident individuals, so that the non-UK resident individual is not liable to tax on the gain in the first place. See *Change 88* in Annex 1.

1866. Chapter 1 of Part 4 of this Act provides a general territorial limitation on the scope of the Part. As regards income arising outside the United Kingdom, it limits the charge to such income arising to a UK resident. See section 368 (territorial scope of Part 4 charges) and the related commentary on that Chapter. This section overlaps and supplements that Chapter to ensure that a non-UK resident individual is not liable to tax under this Chapter on any gains, whether arising in the United Kingdom or elsewhere.

1867. *Subsection (6)* indicates that an individual is treated as creating a trust, for the purposes of this Chapter, when a policy or contract is placed in trust under any of three specific Acts. Such trusts are commonly created, for example, when a policy (such as a mortgage protection policy) is to benefit one or both parties to a marriage. But the subsection is not an exhaustive definition of all the circumstances in which trusts are created by an individual.

Section 466: Person liable: personal representatives

1868. This section sets out how a gain is charged to tax when the rights under the policy or contract are held by the personal representatives of a deceased person's estate. It is based on sections 547 and 553 of ICTA. The term "personal representatives" is defined in section 878 of this Act.

1869. There are two possible treatments. The first is conditional on the policy or contract being one that, were an individual liable to tax in respect of the gain arising on that policy or contract, no lower rate income tax allowance would be available under section 530. Broadly, that allowance is not given where the investment profits underlying the policy or contract are not subject to tax in the hands of the insurer. That may be because the investment profits were not so taxed in the hands of a UK based insurer or the policy or contract was held with a non-UK based insurer (and there was no equivalent foreign tax charge on investment profits in the hands of the insurer).

1870. Where this condition applies, the gain is taxable on the personal representatives as their income in that capacity. The personal representatives are thus liable for the tax.

1871. If the condition does not apply, the gain is not charged on the personal representatives under this Chapter. Instead, the gain falls into the "aggregate income of the estate of the deceased" for the purposes of Chapter 6 of Part 5 of this Act (see section 664 (the aggregate income of the estate)) and of Part 16 of ICTA.

Section 467: Person liable: UK resident trustees

1872. This section sets out to what extent UK resident trustees are liable for the tax charged on a gain. It is based on section 547 of ICTA. The section sets out four circumstances under any of which trustees are liable. All four circumstances depend wholly or partly on how the rights under the policy or contract are held immediately before the chargeable event in question occurs. There are significant differences of treatment between trustees of charitable trusts and non-charitable trusts.

1873. Where the rights are held on *charitable trusts*, the liability falls on the trustees rather than on any settlor. However, the tax charge on the trustees is at the lower rate only. So there is no net liability where the lower rate income tax allowance under section 530 is available.

1874. If the rights are held on *non-charitable trusts*, the trustees are liable where:

- the settlor is non-UK resident, or is dead, or is a company or foreign institution that no longer exists (that is, the settlor could not be liable to tax on the gain or – as regards a foreign institution – be instrumental in the gain being taken into account for the purposes of section 740 of ICTA – see section 468); or
- the rights are held in any other circumstances *excluding* those already taken into account under sections 465 (where an individual is liable) or 466(1) (where personal representatives are liable), or under section 547(1)(b) of ICTA (where a company is liable).

1875. The trustees of both charitable trusts and non-charitable trusts are liable where condition D applies.

1876. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 468: Non-UK resident trustees and foreign institutions

1877. This section sets out in what circumstances a gain treated as arising under this Chapter is taken into account under section 740 of ICTA (liability of non-transferors). It is based on section 547 of ICTA.

1878. It applies when the rights under the policy or contract are held by, or held as security for a debt owed by:

- non-UK resident trustees; or
- a "foreign institution".

1879. As regards trustees, the same four circumstances (conditions A to D) of section 467 apply, with the substitution of non-UK resident trustees for UK resident trustees, to determine whether this section applies. But the section makes no other distinction between cases where rights are held on charitable trusts or non-charitable trusts.

1880. A gain taken into account for the purposes of section 740 of ICTA, as modified by this section, is not charged under this Chapter.

1881. *Subsection (6)*qualifies the meaning of "rights", where there has been an assignment or surrender of a part of or share in the rights, in the same way as does section 464 (see the commentary on that section).

Section 469: Two or more persons interested in policy or contract

1882. This section, together with sections 470 to 472, is based on section 547A of ICTA. These sections deal with cases where the rights in a policy or contract (or a share in those rights) are held immediately before the chargeable event:

- by more than one person;
- by one person in respect of different shares held in different capacities; or
- on non-charitable trusts created by two or more persons.

1883. The most common instance of this is where a husband and wife are co-owners of a policy or contract.

1884. The section apportions the gain in proportion to the "material interest" of each person with such an interest (see section 470). It treats each person with a material interest separately, for the purpose of assigning liability to tax etc, disregarding for this purpose how the Chapter applies in respect of a material interest held by another person. It also apportions deficiencies for the purposes of the relief given by section 539.

1885. Although the source legislation has effect for the purposes of section 547 of ICTA only, this section operates by reference to provisions that apply for the purposes of the Chapter. As a result of the significant reordering of the source legislation when rewriting it, section 547 of ICTA is the basis of numerous sections at various locations. The application of this section to sections that operate in a Chapter-wide context is a necessary consequence of the rewrite of section 547 of ICTA.

1886. *Subsection (6)* applies the section to someone who has two or more interests in a policy or contract exactly as the section applies where two or more persons have such interests. For example, a person may hold one interest beneficially and the other as a trustee. Each of those interests is treated separately. But there is an exception where all the material interests are held by that person only (that is, the interests are not shared) and are held in the same capacity. For example, one share may be beneficially owned by A, but held in a trust, and another share held by A absolutely. Both shares are held in the same capacity.

1887. *Subsection (7)* is similar in effect to the equivalent subsection in section 464 and section 468. See the commentary on section 464.

Section 470: Interests in rights under a policy or contract for section 469

1888. This section provides the meaning of "material interest" for the purposes of section 469. It is based on section 547A of ICTA. The circumstances in which someone is regarded as having an interest in rights under a policy or contract for this purpose mirror the circumstances set out in sections 465 to 468 (and, as regards companies chargeable to corporation tax, in section 547 of ICTA) for attributing liability to tax on gains or otherwise taking gains into account for tax purposes.

Section 471: Determination of shares etc.

1889. This section determines each person's share of the rights in the policy or contract where, because the rights are held jointly by, or as security for a debt owed by, two or more persons, that share has to be established to work out the liability of one or more persons in respect of a gain. It is based on section 547A of ICTA.

1890. *Subsections (2)* to *(5)* deal with a person's interest in a policy or contract held as security for one or more debts owed by two or more persons. Each debtor is treated as the sole debtor in respect of a separate debt. For each liable person, the share of any gain is proportionate to the share of the total debt for which security was provided.

1891. *Subsection (7)* deals with the case where different rights under a policy or contract are held by different people. For example, the right to a death benefit under a policy may be held by one person and the right to critical illness benefit under the same policy may be held by another person. The rights are shared between them on a just and reasonable basis. See *Change 14* in Annex 1.

Section 472: Trusts created by two or more persons

1892. This section determines each settlor's share of the rights, or of a share in the rights, in policies or contracts where, immediately before the chargeable event in question, the rights (or that share) are held on non-charitable trusts created by two or more persons. It also sets out how that share is determined if the property held on trust was added by different settlors, whether at the time the trust was created or at a later date. It is based on section 547A of ICTA.

1893. *Subsections (3)* to *(7)* determine the appropriate share if settlors contribute different property to the trust or a new settlor adds property to a trust already created. The trust is treated as if it had been created by all of them, including the new settlor where applicable, and each is treated as the only settlor for the purposes of this section. The rules set out explicitly when someone is regarded as having contributed property to the trust. For example, subsection (7) applies when A contributes property to what is essentially B's settlement because B has made an equivalent contribution to A's settlement. Although B's contribution is treated as property provided by A for the purposes of subsection (6), A's contribution under reciprocal arrangements with B is disregarded.

1894. Subsection (4)(c) allocates a bundle of types of property between settlors on the basis of a "just and reasonable" apportionment where this is necessary for the purposes of subsections (2) and (3). See *Change 14* in Annex 1.

Section 473: Policies and contracts to which Chapter 9 applies: general

1895. This section is based on section 539 of ICTA.

1896. *Subsection (2)* provides definitions. The definition of a "life annuity" is by reference both to this Act and to ICTA because the policy holder and the person liable (whether the tax charge is to income tax or corporation tax) may not be the same and may not be subject to charges under the same tax. The Chapter does not provide a definition for the more readily understood term "policy of life insurance" (nor is one provided in the source legislation). But section 545 indicates that "policy", unless the context otherwise requires, means both a policy of life insurance and a capital redemption policy.

1897. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 474: Special rules: qualifying policies

1898. This section is based on sections 553 and 553A of ICTA. "Qualifying policy" is defined in section 832(1) of ICTA as "a policy of insurance which is a qualifying policy for the purposes of Chapter 1 of Part 7 [of ICTA]". That is, it is in effect a policy meeting the conditions set out in Schedule 15 to ICTA.

1899. *Subsection (4)* takes away qualifying policy status from a policy issued by a non-UK resident insurer once it ceases to meet one of the conditions in paragraph 24(3) of Schedule 15 to ICTA (by virtue of which it was a qualifying policy). Broadly, the conditions in that paragraph are met when the policy forms part of business done through the insurer's UK permanent establishment.

1900. *Subsection (5)* denies qualifying policy status to a policy which is part of the overseas life assurance business of the insurer, that is, a policy taken out by a non-UK resident policy holder with an insurer operating in the United Kingdom. The subsection applies only in relation to the chargeable event in question.

Section 475: Special rules: personal portfolio bonds

1901. This section is new.

Section 476: Special rules: foreign policies

1902. Although gains from foreign policies and contracts are taxable under this Chapter alongside gains from UK policies and contracts, there are a number of differences of treatment. Primarily, these arise from the fact that the underlying investment profit has not usually been subject to UK tax (or to an equivalent tax regime). However, subject to these differences, any rule in this Chapter referring to a policy or contract, or to one or more of the insurance products listed in section 473(1), applies to foreign policies and contracts. This section is based on sections 553, 553A and 553B of and paragraph 24(1) of Schedule 15 to ICTA.

1903. The source legislation uses the terms "new non-resident policy", "overseas policy" and "new offshore capital redemption policy". The "new" in those terms indicates such policies were issued on or after the commencement date for the legislation that introduced special rules. The terms used in this Chapter simply add "foreign" to the descriptions used for comparable UK policies and contracts.

1904. The definitions for a "foreign policy of life insurance" and a "foreign capital redemption policy" each contain two categories. This reflects the introduction at different times of the modifications of treatment for policies of life insurance and capital redemption policies, which:

- are issued by a non-UK resident insurer (introduced by FA 1984); or
- are other policies forming part of the insurer's overseas life assurance business (introduced by FA 1998).

1905. Some policies in the second category may also fall into the first. However, other than for the construction of the definitions themselves, certain rules in sections 474 and 531, and paragraphs 106 and 110 of Schedule 2 to this Act, the distinction between the categories is not material to the operation of this Chapter.

1906. There is no provision in the Chapter (or relevant paragraph of Schedule 2 to this Act) that applies exclusively to a foreign contract for a life annuity (although most of the contracts affected by, say, section 531(3)(c) are foreign). No definition is therefore provided for such contracts.

1907. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 477: Special rules: certain older policies and contracts

1908. This section is new.

Section 478: Exclusion of mortgage repayment policies

1909. This section is based on section 539 of ICTA. It excludes a particular type of policy taken out in connection with a mortgage. Other types of policy taken out in that connection may be affected by the rules for qualifying policies, such as section 485. See section 879 of this Act for the meaning of "mortgage" in the application of this section to Scotland.

Section 479: Exclusion of pension policies

1910. This section is based on section 539 of ICTA. The term "registered pension scheme" reflects the FA 2004 rules about pension schemes which apply from 6 April 2006 and include a substituted definition in section 539 of ICTA. Paragraph 86 of Schedule 2 to this Act ensures that the unamended definition of a "pension policy" in section 539 of ICTA applies for the tax year 2005-06.

Section 480: Exclusion of excepted group life policies

1911. This section is based on section 539(2) and (3) of ICTA. A group life policy is typically one taken out for members of trades unions, professional associations and partnerships, paying out successively on the death of any of the lives insured. But for the exclusion provided by this section, each such death would give rise to a chargeable event under section 484(1)(b).

1912. See also section 546 (table of provisions subject to special rules for older policies and contracts) and paragraph 90 of Schedule 2 to this Act (gains from contracts for life insurance etc: pure protection group life policies).

Section 481: Excepted group life policies: conditions about benefits

1913. This section is based on section 539A of ICTA. The conditions set out here and in the next section ensure that the only policies benefiting from the exclusion are those:

- providing death benefits on equal terms for all lives covered; and
- having a minimal surrender value (if any).

1914. For example, condition A (*subsection (2)*) sets an upper age limit of 75 for any age-related restriction of the payment of benefits on death in any circumstances. It also disregards any limitation on payment of death benefits for particular reasons (for example, suicide) if the same limitation ("the same specified circumstances") applies to all lives assured.

Section 482: Excepted group life policies: conditions about persons intended to benefit

1915. This section completes the conditions relating to an excepted group life policy. It is based on section 539A of ICTA.

1916. *Subsection (3)* uses the term "connected". Section 878 of this Act applies section 839 of ICTA (how to tell whether persons are connected) for this purpose.

Section 483: Exclusion of credit union group life policies

1917. This section excludes a particular type of group life policy. It is based on section 539 of ICTA.

1918. *Subsection (2)* defines "credit union group life policy" in terms of the single stringent condition such a policy must meet to qualify for exclusion.

Section 484: When chargeable events occur

1919. This section is the first of a group of sections which set out what does or does not constitute a chargeable event under this Chapter. This section is based on sections 539, 540, 542, 545 and 546C of ICTA, and regulation 6 of PPB(T)R. Later sections in this Chapter operate by reference to this list of chargeable events (see sections 485, 491, 493, 496, 499, and 540).

1920. *Subsection (1)* groups together in paragraph (a) the events applicable to all policies and contracts and, in paragraphs (b) to (e), the events specific to one or more type of policy or contract.

1921. The source legislation treats the events in subsection (1)(a)(iii), (d) and (e) as a surrender of the rights under the policy or contract, which then triggers a chargeable event (see sections 539(4) and 542(2) of ICTA). The section treats the events themselves as chargeable events without the preliminary treatment of them as surrenders.

1922. Subsection (1)(e) makes clear that, where a capital sum is taken as an alternative to annuity payments, such payments include future payments.

1923. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 485: Disregard of certain events in relation to qualifying policies

1924. This section is based on section 540 of ICTA. It deals with circumstances in which qualifying policies do not give rise to chargeable events.

1925. Broadly, there is no chargeable event if:

- the event is:

  - the death of a person whose life is insured; or
  - the maturity of the policy; or
- the policy has run for a period measured by the earlier of:
  - ten years; or
  - three-quarters of the policy's term;

so long as the policy has not been made "paid-up" within that same period.

1926. *Subsection (6)* re-starts this time calculation of how long the policy has run from the date of variation, if the policy is varied to increase the premiums payable.

1927. *Subsections (2)* and *(3)* do not rewrite the words in brackets in the opening of section 540(1)(b) of ICTA "whether or not the premiums thereunder are eligible for relief under section 266". These words add nothing of substance.

1928. Paragraph (b) in each of subsections (2) and (3) reflects a circumstance in which the restriction of what is a chargeable event for a qualifying policy is itself disapplied. It operates where a company would, by virtue of section 547(1)(b) of ICTA, be a person liable to corporation tax on a gain treated as arising on the policy or contract. As described in the commentary on section 464, attribution of corporation tax liability to that company does not prevent other persons, such as an individual, also being attributable with income tax liability in respect of the gain. This rule operates at a level – what is a chargeable event – where there is no difference between the two tax regimes. See also section 546 (table of provisions subject to special rules for older policies and contracts).

1929. Such a disapplication of the restriction is unnecessary in *subsection (5)*. This subsection is based on section 546B of ICTA. Section 540(5A) of ICTA (on which the restriction in subsections (2) and (3) is based) does not apply to the restriction provided for qualifying policies by section 546B(1A) of ICTA, in relation to events that are found by applying section 546B of ICTA (see section 546C(7)(a) of ICTA for when such events arise).

1930. *Subsection (7)* deals with the circumstance where a qualifying policy replaces another policy (which may not have been a qualifying policy). It requires certain terms in paragraph 25 of Schedule 15 to ICTA to be met. The new policy will in part have been designated a qualifying policy under Schedule 15 to ICTA because those circumstances were met. This subsection is based on section 553 of ICTA.

Section 486: Exclusion of maturity of capital redemption policies in certain circumstances

1931. This section is based on section 545(1) of ICTA. The source legislation refers in part to "annual payments chargeable to tax under Schedule D". The income tax charge on such income is rewritten in the Chapters listed in the section. The corporation tax charge on such income is still under Schedule D.

Section 487: Disregard of certain assignments

1932. This section is based on sections 540, 542, 544 and 545 of ICTA. In the source legislation the assignments mentioned here are ignored only for the purposes of particular provisions under which assignments are chargeable events. But, because the assignments in question are disregarded for the purposes of this Chapter, not only is such an assignment not a chargeable event, it is ignored, as regards that policy or contract, in the operation of the rest of the Chapter.

Section 488: Disregard of some events after alterations of life insurance policy terms

1933. This section and the next are based on ESC A96. See *Change 89* in Annex 1.

1934. The disregard applies where a policy which is at least 20 years old is effectively made paid-up by the insurer. A chargeable event which might have arisen afterwards as a result of that variation is disregarded if the changes made to the policy would not themselves give rise to a chargeable event.

1935. *Subsection (3)* extends the disregard to a replacement policy issued by the insurer in lieu of the old, where the issue of such a policy is what the insurer does to give effect to the alteration of the original policy's terms.

Section 489: Conditions applicable to alterations of life insurance policy terms

1936. This section is based on ESC A96. See *Change 89* in Annex 1. The conditions in *subsections (2)* to *(8)* ensure among other things that the disregard provided by section 488 falls away if the policy is reactivated for investment purposes.

Section 490: Last payment under guaranteed income bonds etc. treated as total surrender

1937. This section supplements section 484. It is based on section 79 of FA 1997.

1938. Section 504 deals with the treatment of payments under guaranteed income bonds prior to the last payment. Subsection (7) of that section defines the term "guaranteed income bond contract". See the commentary on that section for further background.

Calculating gains: general

Overview

1939. Section 491 to 497 set out how to calculate a gain on a chargeable event *other than* one arising on any part surrender or part assignment, or an event in respect of the special charge for personal portfolio bonds.

1940. Section 491 introduces a number of terms which are used throughout the Chapter for the computation of gains (and defines them in subsection (4)). These are:

- "calculation event" (an umbrella term for events, the occurrence of which is dependent on the outcome of one of several prescribed calculations); and
- "excess event", "part surrender or assignment event" and "personal portfolio bond event" (the types of event which may flow from such a calculation).

Section 491: Calculating gains: general rules

1941. This section deals with the calculation rules for all chargeable events other than those triggered by a part surrender or part assignment of rights under the policy or contract, or by the special charge on personal portfolio bonds. It is based on sections 541, 543 and 545 of ICTA and section 79 of FA 1997. (For the relevance of section 79 of FA 1997, see section 490.)

1942. *Subsection (2)* introduces the concepts of the "total benefit value" and the "total allowable deductions". These terms are used in other sections in this Chapter (for example, section 541 (calculation of deficiencies)).

1943. *Subsection (5)* indicates that gains on a previous calculation event include gains on a "related policy" (defined in *subsection (6)*). See *Change 90* in Annex 1.

Section 492: The total benefit value of a policy or contract

1944. This section is based on sections 541, 543, 545 and 548 of ICTA, and section 79(3) of FA 1997.

1945. The "total benefit value" of a policy or contract consists of the value of the policy or contract in relation to the event (paragraph (a)) added to capital sums (or benefits or amounts treated as such) derived from the policy or contract prior to the chargeable event itself (paragraph (b)).

1946. *Subsection (2)* makes clear that capital amounts derived from a related policy are brought in for this purpose.

Section 493: The value of a policy or contract

1947. The value of a policy or contract is determined by reference to the particular kind of event. This section is based on sections 541, 542, 543, and 545 of ICTA, and section 79 of FA 1997.

1948. *Subsections (1)* and *(2)* provide for the value in the majority of events.

1949. In relation to the reference in *subsection (6)* to connected persons, see section 878 of this Act (which applies section 839 of ICTA).

Section 494: The total allowable deductions for a policy or contract

1950. This section is based on sections 541, 543, 545 and 548 of ICTA.

1951. Step 1 in *subsection (1)* lists amounts to be taken into account as deductions. Paragraph (a) deals with the vast majority of cases, where the only item to be taken into account is the total of premiums paid before the chargeable event. See also section 546 (table of provisions subject to special rules for older policies and contracts).

1952. Step 2 in subsection (1) reduces the total allowable deductions for a purchased life annuity by the exempt amount (or capital element) in payments to date. The exempt amount is determined under Chapter 7 of Part 6 of this Act and (as regards the capital element) under ICTA as appropriate (see the commentary on section 473).

1953. Paragraph (b) in Step 1 deals with the repayment of loans which were treated as a part surrender of the rights under the policy or contract.

1954. *Subsection (2)* caters for assignments for money or money's worth of capital redemption policies. In the case of such assignments paragraph (a) in Step 1 in subsection (1) applies to the price paid in respect of the most recent such assignment instead of the premiums paid before that assignment.

1955. *Subsection (3)* makes clear that premiums etc. paid in respect of a related policy (as defined in section 491) are included in the calculation of total allowable deductions.

Section 495: Disregard of certain amounts in calculating gains under section 491

1956. This section contains rules which exclude various amounts from the calculation of the total benefit value under section 492 and the total allowable deductions under section 494 in arriving at the amount of a gain under section 491. It is based on sections 541, 543 and 545 of ICTA.

1957. *Subsections (1)* and *(2)* deal with a retained replacement policy premium. This disregard is based on paragraph 20 of Schedule 15 to ICTA, which deals with the replacement of one qualifying policy by another, where the value of the old policy is used as a premium for the new policy. The old and new policies are treated as a single policy (see section 542). The value of the old policy is disregarded both in working out the total benefit value of that single policy and, as regards use of the value of the old policy as a premium for the new policy, in working out the total allowable deductions for the single policy.

1958. *Subsection (4)* reflects an amendment in FA 2002 of a rule introduced by FA 2001, under which an assignment which is not for money or money's worth (such as a gift) is not treated as giving rise to a chargeable event. But assignments which were not for money or money's worth still have to be taken into account in calculating gains if they occurred in an "insurance year" (see section 499) ending before 6 April 2001.

Section 496: Modification of section 494: qualifying endowment policies held as security for company debts

1959. Although this section refers to a policy held as security for a company's debt (a circumstance in which liability to corporation tax on a gain arises under section 547(1)(b) of ICTA), this modification is part of the income tax rules because liability on that gain can also be attributable to a person to whom sections 464 to 468 apply or are relevant. It is based on section 541 of ICTA. Where this section applies, the eligible amount of the debt is substituted for premiums paid under the policy in calculating any gain. A claim by the debtor company is required.

Section 497: Disregard of trivial inducement benefits

1960. This section is based on ESC B42. It excludes non-monetary benefits costing no more than £30, which are offered as inducements to attract life insurance business, from the computation of any gain under this Chapter. See *Change 91* in Annex 1.

1961. ESC B42 refers to "gifts" but the section refers to "benefits" as a more accurate description of what is provided. It also matches more closely the drafting of the various sections for calculating gains.

1962. *Subsection (3)* provides for a future increase (or increases), but not for any decrease, in the monetary limit set on this disregard. See section 873 of this Act for the procedural rules which apply to secondary legislation made under powers in this Act.

1963. The monetary limit is applied by reference to the "policy or contract and any linked policy or contract" taken as one. This caters for an insurance industry practice of issuing "clusters" of policies to give the policy holder any required flexibility in managing the total investment.

Part surrenders and assignments: periodic calculations and excess events

Overview

1964. Sections 498 to 509 perform the same function for chargeable events which are excess events as do sections 491 to 496 for the chargeable events those sections relate to. They set out when this type of part surrender or assignment (including something treated as a part surrender) gives rise to a chargeable event, and how to calculate the amount of the gain arising on that event. The calculation of the gain is made by reference to the history of the policy or contract from when the insurance or contract was made up to the end of the insurance year in which the surrender or assignment occurred. This is the more commonly occurring type of chargeable event arising on a part surrender and assignment.

1965. The sections introduce further expressions, such as "periodic calculations" (this term is not defined but refers to situations where sections require calculations and the incidence of chargeable events is linked to the result of the calculation).

1966. The meaning of "insurance year" and "final insurance year" is provided by section 499. These terms are widely used in this Chapter in calculating gains and in determining when a gain arises and when a chargeable event occurs.

Section 498: Requirement for periodic calculations in part surrender or assignment cases

1967. This section based on sections 540, 542, 545 and 546 of ICTA.

1968. *Subsection (1)* states that the section applies when there has been an assignment for money or money's worth or a surrender. The section omits the requirement in the source legislation that a calculation is carried out at the end of each insurance year, regardless of whether there has been any such assignment or surrender. But, in an "event-less" year, there could not be any gain, so the calculation would be pointless. See *Change 92* in Annex 1.

Section 499: Meaning of "insurance year" and "final insurance year"

1969. This section is based on sections 546, 546B and 546C of ICTA.

1970. *Subsection (1)* defines an "insurance year". The definition is applied for the purposes of this Chapter, whereas in the source legislation the application of the definition of "year" is more limited. The source legislation to which the definition is relevant, section 546 of ICTA, is rewritten in a great number of locations in this Chapter. It is no longer practical, or indeed necessary, to limit the application of the definition.

1971. *Subsection (3)* sets out how the basic rule is varied when the sequence of insurance years is broken by certain of the events listed in section 484(1). Where such an event occurs, the year ends at that point and is called the "final insurance year". An assignment of all the rights under the policy or contract is not such an event, as the policy or contract continues in existence despite the change of ownership of the rights.

1972. Where the term "final insurance year" is used in this Chapter, it therefore indicates that one of the specified events in section 484(1) has occurred.

1973. One of those events is "a death giving rise to benefits" under a policy of life insurance. The source legislation for the meaning of "insurance year" merely refers to a "death", and does not cross-refer to the definition of a chargeable event in sections 540, 542 and 545 of ICTA. A cross-reference to events under section 484, rather than words describing the event, is more precise. It also disregards a death which does not give rise to benefits.

1974. *Subsection (5)* caters for when the final insurance year would begin and end in the same tax year. But for the rule in this subsection, the previous insurance year would end in the same tax year as the final year, and any part surrender or assignment in that year might give rise to a gain that would be charged for that year in addition to the gain on the final event. To avoid (in most cases) the complexity of two sets of computations in one tax year, the previous insurance year is merged with the final year as a single insurance year, the "final insurance year".

1975. Where the year is the final insurance year, section 509(5) accordingly sets aside any chargeable event that would arise on a periodical calculation under section 507 following a part surrender or assignment,. But, where the circumstances in section 510 apply, and the year in question is the final insurance year, there will be more than one computation in that year, and there may be a gain on a transaction-related calculation as well as a gain under section 491. In most cases the persons liable in respect of the gain on the transaction-related calculation and the gain on the final event are different.

Section 500: Events treated as part surrenders

1976. This section deals with some circumstances that would not otherwise be regarded as a surrender of part of the rights under a policy or contract. Paragraph (a) is based on section 539 of ICTA, paragraph (b) on section 542 of ICTA, paragraph (c) on section 548 of ICTA and paragraph (d) on section 79 of FA 1997.

1977. Note that an “event” within this section is not a “chargeable event”, unless:

- the calculation under section 507 results in a gain; and
- there is a chargeable event by virtue of section 509 or section 514.

1978. Paragraph (b) makes explicit the treatment of the circumstance where a capital sum is taken as an alternative to part of annuity payments under a contract for a life annuity. See *Change 93* in Annex 1.

1979. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 501: Part surrenders: loans

1980. This section is based on section 548 of ICTA. It counters the avoidance of tax when the profit accrued on the policy or contract is paid to the policy or contract holder in the form of a loan.

1981. The section includes references to a loan to a company, and to section 547 of ICTA, for reasons comparable to those given in the commentary on sections 485 and 496.

1982. See paragraph (c) of step 1 in section 494(1) for the inclusion, as an allowable deduction in certain calculations, of any repayment in whole or in part of a loan which is treated by virtue of this section as a part surrender under section 500.

1983. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 502: Exception from section 501 for loans to buy life annuities

1984. This section is based on section 548 of ICTA.

Section 503: Exception from section 501 for certain loans under qualifying policies

1985. This section is based on section 548 of ICTA.

1986. Condition B reflects the saving provided for certain loans made before 6 April 2000 by paragraph 18(3) of Schedule 4 to FA 1999 (when tax relief for interest was largely withdrawn).

Section 504: Part surrenders: payments under guaranteed income bonds etc.

1987. This section is based on section 79 of FA 1997. It applies to payments by the insurer from a certain type of life insurance policy – “guaranteed income bonds” – that would otherwise be taken into account for tax purposes as interest or an annual payment.

1988. *Subsection (6)* strips such a payment of any character it has as interest or an annual payment so that it is not charged to income tax in that capacity. It is treated instead as a part surrender of the rights under the contract under section 500.

1989. The meaning of “guaranteed income bond contract” is given, in *subsection (7)*, by reference to the statutory instrument regulating insurance business (under powers provided by the Financial Services and Markets Act 2000).

1990. *Subsection (5)* excludes the final such payment from the application of this section. But see section 490, under which that payment is treated as the surrender of all remaining rights under the contract.

Section 505: Assignments etc. involving co-ownership

1991. This section and section 506 are based on section 546A of ICTA. They cater for changes in the person(s) having beneficial ownership of the whole or a part of, or a share in, the rights under the policy or contract, however the change comes about. That ownership is described in these sections as the "ownership interest" (see *subsection (4)*). But this section does not apply when there is a complete change of ownership of that interest (for example, when all the rights are assigned by the old owner or owners to a completely different person or persons).

1992. These sections ensure that only those owners who have reduced their share in the ownership interest (whether partly or completely) are treated as having made an assignment which may give rise to a gain and a chargeable event. Whether the deemed assignment is an assignment for money or money's worth (which is material for section 498(1)) depends on how the change of ownership was effected between the parties.

1993. This section applies for the purposes of the Chapter (other than this section and section 506, which of necessity refer to the actual assignment). References elsewhere to an assignment have therefore to be construed in accordance with the rules in these sections.

Section 506: Assignments occurring when there is a co-ownership transaction

1994. This section introduces the term "co-ownership transaction" to describe a transaction to which section 505 applies. It is based on section 546A of ICTA.

1995. *Subsections (2)* to *(4)* define the deemed assignment for the particular permutation of before and after ownership described in each. They should be construed in the light of *subsections (5)* and *(6)*, which substitute ownership in equal shares (so that each owner is treated as having a distinct share) for joint ownership (where all owners have an interest in all rights attached to the share).

1996. Subsections (2) and (4) deal with the reduction in a person's share in the rights under the policy or contract. Subsection (3) deals with the complete disposal of a person's share in the rights.

Section 507: Method for making periodic calculations under section 498

1997. This section provides the core calculation rules which determine whether there is a gain and, if so, the amount of the gain, when there has been an assignment for money or money's worth or a surrender of part of, or a share in, rights under the policy or contract. The calculation introduces the terms "net total value of rights surrendered or assigned" and "net total allowable payments". Subsequent rules (see section 509) determine whether a chargeable event occurs in respect of that gain. It is based on sections 540, 541, 542, 543, 545, and 546 of ICTA.

1998. But the calculation under this section is displaced when certain transactions have occurred (see section 510).

1999. *Subsection (4)* sets out how the net total value of rights surrendered or assigned is found. Step 1 identifies, and step 2 totals, all relevant amounts from the current and previous insurance years. Step 3 then subtracts all such amounts taken into account on previous "calculation events". That leaves the total of those amounts since the last such event. These amounts may relate to a period of one or more insurance years, depending on when the latest calculation event occurred (the value of the rights assigned or surrendered may have been too low for this calculation to show a gain). Section 508 contains rules for how the values of part surrenders or assignments of rights are to be measured.

2000. *Subsection (5)* sets out how to calculate net total allowable payments, that is, the amount that may be deducted from the product of the calculation in subsection (4). It is similar in approach to the calculation of total allowable deductions in section 494, but treats the premiums paid in a special way. An allowance is made, equal to 5% for each insurance year to date (including the year in which the premium was paid), of each premium payment or payments. The allowance, in respect of any particular premium payment, or the payments for a particular year, cannot exceed 100% of that premium or premiums.

2001. Through the definition of "allowable payment", *subsection (6)* excludes a "retained replacement policy premium" from the amounts that can be taken into account as allowable payments in the calculation under subsection (5). As mentioned in the commentary on section 495, a retained replacement premium is a sum which becomes payable by the insurer in connection with the ending of the policy, but which is retained by the insurer and used to meet some or all of the premiums payable under a later policy.

2002. The source legislation provides that retained replacement premiums are to be ignored in calculating the amount of premiums taken into account under sections 540 and 541 of ICTA. But, in the case of a chargeable event within section 540(1)(a)(v) of ICTA, it is section 546 of ICTA that provides the method of calculating gains. In particular, section 546(1)(b) of ICTA deals with premiums to be taken into account in the calculation of part surrenders and assignments. Clearly, it is that section that paragraph 20(3) of Schedule 15 to ICTA was intended to affect, although it does not refer to section 546 of ICTA.

2003. The calculation of net total allowable payments in subsection (5), read with the definition of "allowable payment" in subsection (6), therefore rewrites the source legislation so that retained replacement premiums are ignored in the calculation of the gain arising on a part surrender or assignment.

2004. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 508: The value of rights partially surrendered or assigned

2005. This section is based on section 546 of ICTA and section 79 of FA 1997.

2006. *Subsection (1)* sets out the general rule for valuing part surrenders. It is similar to the rule for valuing the surrender of all rights under a policy or contract (see section 492(1) and (2)). This rule fills a gap in the source legislation. In the FA 1968 legislation for taxing chargeable event gains, a gain (including a gain on a part surrender or assignment) was calculated by reference to "the amount or value of the sum payable or other benefits arising by reason of the event" (see paragraph 12(1)(b) of Schedule 9 to that Act). However, when introducing the provisions now in the source legislation, FA 1975 used slightly different wording for gains in respect of part surrenders and assignments. Section 546(1) of ICTA refers to "the value, as at the time of surrender or assignment, of any part of or share in the rights conferred by the policy or contract...".

2007. No change was intended from the value used previously for the regime. The wording in section 546(1) of ICTA was intended to refer to the amount that is paid as a result of the part surrender or assignment; that is, what the policy holder receives for the part surrender or assignment. So this section provides that, where there is a surrender of a part of, or share in, rights under a policy or contract, the value of the part or share surrendered is the amount or value of the sum payable or other benefits arising because of the surrender, unless another rule applies.

2008. *Subsection (2)* is based on section 548 of ICTA. That section provides that, in the case of the loan in question, the same results are to follow as if, at the time the sum was lent, there had been a surrender of part of the rights conferred by the policy or contract, and the sum had been paid as consideration for the surrender. This section drops the fiction that the amount of a loan is the consideration for a surrender.

Section 509: Chargeable events in certain cases where periodic calculations show gains

2009. This section is based on sections 540, 542, 545, 546 and 546B of ICTA.

2010. The transactions mentioned in conditions A and B are those that trigger the operation of section 510. *Subsection (6)* signposts what happens in such circumstances.

2011. The effect of condition C is that there cannot be a chargeable event as a result of a gain arising under the calculation in section 507 when the insurance year is the final insurance year.

Transaction-related calculations and part surrender or assignment events

Overview

2012. These sections perform the same function as sections 498 to 509 for a particular circumstance. This is where, in any insurance year, there has been:

- a part assignment of rights under the policy or contract for money or money's worth; or
- an assignment of such rights by gift after a part surrender of rights in that year.

2013. Each transaction in that year is the subject of a separate calculation. The rules here ensure that liability attaches to the person who profits from the transaction regardless of the change in the ownership of the rights in the policy or contract (otherwise liability on the gain would attach to the new owner).

Section 510: Requirement for transaction-related calculations in certain part surrender and assignment cases

2014. This section is based on section 546C of ICTA.

2015. Where the section applies, *subsection (2)* substitutes a fresh calculation under section 511, for each "relevant transaction" in the insurance year, for the discarded single calculation for that year under section 507. This is a change of approach from that taken in the source legislation, which is drafted in terms of a "section 546 excess occurring at the end of any year" being charged to tax under section 546C of ICTA. But the outcome is the same whichever approach is taken.

2016. Any assignment for money or money's worth in that year of a part of, or share in, the rights is *relevant*. Any surrender in that year of a part of, or share in, the rights is *relevant*. That is, the section applies to any such surrender in the year, regardless of whether that surrender was instrumental in triggering the section or whether it preceded or followed an assignment of any kind. This is described by *subsection (3)* as a "relevant transaction". That term is used also in sections 511 to 514.

2017. By carrying out a series of calculations, any of which may give rise to a chargeable event (see section 514), the gain is attributed to those liable at the time of that event, in accordance with sections 464 to 468, rather than to those liable by reference to how the rights are held in respect of chargeable events occurring at the end of the insurance year.

2018. *Subsection (6)* indicates that *subsections (2)* and *(4)* are modified by the rules in section 513 for the final insurance year (which provides that no subsequent calculations are made once a "gains limit" has been reached).

Section 511: Method for making transaction-related calculations under section 510

2019. This section and the next set out the calculation required by section 510. This section is based on section 546C of ICTA.

2020. The calculation in these sections is designed to isolate, for each relevant transaction, the value of the transaction in question and how much of the premiums paid to the end of the insurance year in question is available to set against that value. The excess of that value over the available premium is the chargeable gain.

Section 512: Available premium left for relevant transaction

2021. This section is based on section 546C of ICTA. *Subsection (1)* provides a calculation method to isolate the available premium for the purposes of section 511. This is described as the excess of the "available net allowable payments" over the "available net total values".

2022. The method works by identifying how much is left, after franking certain amounts, of the gross amount of allowable premiums paid under the policy or contract to the end of the insurance year, applying the twentieths rule in section 507(5). This is step 1 in *subsection (3)*. As a result of applying the rule in section 507 for net total allowable payments, so much of the premiums as has been deducted in calculating gains on a calculation event in a previous insurance year has already been removed from the pool of allowable premiums.

2023. Subsection (3) continues by deducting (in step 2) the total of the transaction values for any previous relevant transactions in this insurance year that did not give rise to a gain when the calculation in section 511 was made. This effectively mops up the equivalent amount of the gross allowable premiums.

2024. *Subsection (4)* next calculates an amount labelled the "available net total values", for the purpose of the calculation in *subsection (1)*. This is the amount found by deducting:

- the total value of all part surrenders and part assignments for money or money's worth in the insurance year (step 2); from
- the total value of all part surrenders and part assignments (as in section 507(4) steps 1 and 2; that is, including assignments not for money or money's worth if they are in an insurance year beginning on or before 5 April 2001) *less* all such values taken into account in gains on calculation events in previous insurance years (step 1).

2025. The computation in subsection (4) isolates and quantifies the value of any part surrender or part assignment between the last calculation event and the beginning of the present insurance year. That value will have been insufficient to give rise to a gain in the relevant insurance year. Again this effectively uses up the equivalent amount of the allowable premiums.

2026. Having thus deducted:

- the amount of allowable premiums used in earlier calculation events (subsection (3) step 1, by virtue of the calculation under section 507(5));
- the amount of any values for part surrenders and part assignments in years since then, but before the current year (subsection (4)); and
- the amount of any values in relevant transactions of this year which did not produce a gain (subsection (3), step 2);

there is available, against the transaction value of the relevant transaction in question, any "allowable payment" (that is, part of the premiums) accrued between the last calculation event in an earlier year and the end of the present year, as reduced by the amounts mentioned in the second and third bullets.

2027. *Subsection (2)* short-circuits the whole process for any relevant transaction of the year which occurs after the first relevant transaction to yield a gain. For such subsequent relevant transactions, the amount of available premium is nil. The gain equals the transaction value for the relevant transaction.

Section 513: Special rules for part surrenders and assignments in final insurance year

2028. This section is based on section 546D of ICTA. The purpose of the section is to ensure that the total amount of gains calculated under section 511 on relevant transactions, added to the gain subsequently calculated under section 491 on the event that brings the final insurance year to an end, is not greater than the gain on the final event would have been without relevant transaction calculations.

2029. For this purpose, the gain under section 491 is calculated disregarding gains on relevant transactions (as defined in section 510(3)). That re-calculated gain acts as a cap on the total gains to be charged in respect of the policy or contract for that year.

2030. In effect, that cap is placed on the latest gain on a relevant transaction, where that gain, added to previous gains on relevant transactions, would exceed the cap. Where that happens, so much of the gain as would exceed the cap is ignored, and the gain on any subsequent relevant transaction or on the event that brings about the end of the final insurance year is treated as nil. But the value of such transactions will already have been taken into account as appropriate in calculating the gains limit, and so have contributed to the size of the cap.

2031. *Subsection (4)* expresses this as a reduction in the transaction value for the particular relevant transaction in relation to which the total of the transaction values for the first and successive relevant transactions in the year (see *subsection (2)*) first exceeds the "gains limit". The reduction in the transaction value for that relevant transaction is the amount that eliminates the excess over the gains limit.

Section 514: Chargeable events where transaction-related calculations show gains

2032. This section provides that, if the calculation under section 511 shows a gain, the relevant transaction is itself the occurrence of a chargeable event at that time. This contrasts with chargeable events under section 509, which occur at the end of the insurance year, regardless of when in that year the part surrender or part assignment took place. This section is based on sections 546B and 546C of ICTA.

2033. *Subsections (3)* and *(4)* nevertheless allot the gain on the chargeable event under this section, for the purposes of sections 464 to 467, to the tax year in which the insurance year ends where liability to tax on the gain would otherwise fall into the preceding tax year. The date of the chargeable event may therefore be in an earlier tax year than that for which the gain is charged.

2034. *Subsection (5)* clarifies the order in which chargeable events take place in the final insurance year, when there is a transaction-related chargeable event in that year. The order prescribed here avoids any suggestion that amounts relevant only to the calculation on the final event enter into the calculations under section 511, even though both calculations take the full period of the final insurance year into account.

Section 515: Requirement for annual calculations in relation to personal portfolio bonds

2035. Sections 515 to 526 set out the special charge in respect of personal portfolio bonds.

2036. This section is modelled on the approach taken in sections 498 and 510. It is based on regulation 5(1) of PPB(T)R.

2037. *Subsection (1)* makes clear that it is the status of the policy or contract as at the end of the insurance year, that is, whether it is a personal portfolio bond at that time, which determines whether this requirement applies.

2038. *Subsection (3)* gives the time as at which the calculation is to be done. Section 553C of ICTA (the section providing the powers used to make PPB(T)R) does not use "insurance year" but instead refers to a "yearly charge", using section 546(4) of ICTA to construe "yearly". The latter section is the source legislation for the definition of "insurance year" in section 499. The section makes explicit that "yearly" refers to an insurance year.

2039. *Subsection (4)* provides that the calculation required by this section is to be made regardless of any other calculation also required by this Chapter. So a gain, treated under section 525 as arising on the chargeable event mentioned in subsection (3) of that section, is added to any other gains arising in the same tax year on other chargeable events in respect of the personal portfolio bond.

Section 516: Meaning of "personal portfolio bond"

2040. This section is based on regulation 4 of PPB(T)R. All of the types of policy or contract mentioned in section 473(1) have the potential to be a personal portfolio bond, if conditions A and B in this section are met. But, even if those conditions were met, the exclusions mentioned in section 473(3) would apply to take such policies and contracts out of the scope of this special charge.

2041. *Subsection (2)* sets out condition A. This is the *portfolio* element in a personal portfolio bond.

2042. *Subsection (4)* sets out condition B. This is the *personal* element in a personal portfolio bond. The list of persons who may be able to select property or an index includes, for example, a financial adviser who acts on behalf of a policy holder, as well as anyone "connected" with the policy holder. Section 878 of this Act applies the "connected persons" rules in section 839 of ICTA for the purposes of this Act.

2043. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 517: Policies and contracts which are not personal portfolio bonds

2044. This section introduces a let-out from the charge on personal portfolio bonds for policies and contracts where an index or property is, broadly speaking, of a public or not unusually restricted nature (as defined in sections 518 to 521). Many unit-linked policies benefit from this let-out. This section is based on regulation 4 of PPB(T)R.

Section 518: The index categories

2045. This section is based on regulation 4 of PPB(T)R.

2046. Schedule 4 to this Act indicates that the definitions of "retail prices index" in section 833(2) of ICTA and "recognised stock exchange" in section 841(1) of ICTA apply.

Section 519: The index selection conditions

2047. This section is based on regulation 4 of PPB(T)R. The selection conditions seek to ensure that the opportunity to select is not narrowly restricted. While occasionally such an opportunity is made available to all policy holders of an insurer, or their agents (the "general selection condition"), more often various products are linked to a number of indices, when the opportunity to select is offered to one or more large classes of policy holder, or their agents (the "class selection condition").

2048. It is made explicit that it is immaterial, in respect of both the general and the class selection conditions, whether the opportunity is offered to the policy holders themselves or to their agents (such as financial advisers).

Section 520: The property categories

2049. This section is based on regulation 4 of PPB(T)R.

2050. Categories 1 to 4 and 7 are types of collective investment scheme, whether based in the United Kingdom or elsewhere, which satisfy the appropriate rules of investment regulatory bodies.

2051. Category 5 is cash, so long as the cash is not held to realise a profit on selling it. Such a profit may only be realised on foreign currency.

2052. Category 6 is an investment in a policy or contract to which this Chapter applies, other than one that is, or is in any way related to, a personal portfolio bond. "Related property", a term used in *subsection (3)(c)*, in relation to any policy or contract (or the premiums paid on it), means income which derives directly or indirectly from holding the policy or contract, or investing in it. In the source legislation, this term is defined by reference to section 660A(10) of ICTA, but that provision is rewritten in Chapter 5 of Part 5 of this Act.

Section 521: The property selection conditions

2053. This section is based on regulation 4 of PPB(T)R. The commentary on section 519 applies equally here.

Section 522: Method for making annual calculations under section 515

2054. This section is based on regulation 5 of PPB(T)R. It takes a similar approach to that used in the other required calculations in this Chapter, that is, a calculation formula plus supporting method statements to find the amounts relevant to the formula.

2055. However, whereas in those other calculations the figure found by applying the formula produces the amount of the gain, *subsection (4)* sets the gain at 15% of the figure found by applying the formula.

2056. Any year in which the policy or contract was not a personal portfolio bond nevertheless enters the calculation. So the relevant premiums, previous gains under this section and excess events are those of any insurance year of the policy or contract. Where regulation 5 of PPB(T)R refers to a year in which the bond was in existence, this means a year when the policy or contract was in existence, rather than a year in relation to which the policy was a personal portfolio bond. The term "personal portfolio bond" is used in the regulation merely to identify the policy or contract in question.

Section 523: The total amount of personal portfolio bond excesses

2057. This section is based on regulation 5 of PPB(T)R.

Section 524: The total amount of part surrender gains

2058. This section is based on regulation 5 of PPB(T)R.

2059. The exclusions made by *subsections (4)* and *(5)* affect assignments. That type of transaction has frequently been used in tax planning to avoid the charge rewritten in this Chapter.

2060. Because of the change of approach mentioned in the commentary on section 510, the calculations under sections 507 and 511 are independent (albeit sharing some features). It is therefore unnecessary to rewrite paragraph 5(2B)(c) of PPB(T)R, as the provisions mentioned there contribute only to the calculation under section 511.

Section 525: Chargeable events where annual calculations show gains

2061. This section is based on regulations 5 and 6 of PPB(T)R.

Section 526: Power to make regulations about personal portfolio bonds

2062. This section is based on section 553C of ICTA. But the powers given here for the Treasury to make regulations apply only to certain aspects of the charge on gains treated as arising under section 525. See *Change 94* in Annex 1.

2063. The regulations contained in PPB(T)R, in so far as they apply to determine the amount of the gain under the special charge and how that gain is charged to income tax, are rewritten in the preceding sections. The regulations remain in place in respect of calculating and charging gains to corporation tax. The regulations also remain in place as regards the duties of insurers in sections 552 to 552B of ICTA.

2064. To the extent that the regulations are rewritten for income tax purposes in these sections, the powers in section 553C of ICTA are spent.

2065. The power given is to make regulations about the administration of this charge, which in practice means regulations in connection with the duties of insurers.

Section 527: Reduction for sums taken into account otherwise than under Chapter 9

2066. This section is based on section 547 of ICTA. It prevents a double charge to tax where a sum, which is taken into account in calculating a gain under this Chapter, also falls to be taken into account in computing another type of taxable income. For example, it might also constitute a trading receipt.

2067. This rule is provided because the process for determining when a chargeable event occurs, and how much the gain is, does not sit well with the usual procedure for ensuring that income is taxed under one charging provision only (such as the priority rules in section 366 of this Act). That is, it may be necessary for such receipts to be brought into a calculation under this Chapter before it can be determined whether a chargeable event has occurred or a gain has arisen. Section 366(4) permits inclusion of such receipts in more than one computation.

2068. Although the source legislation is in terms of an amount taxable under section 547(1) of ICTA and an "amount which is chargeable to tax" apart from that subsection, this section reduces the gain otherwise chargeable by the "amount of the receipt or other credit item" taken into account in the other calculation. "Credit item" is not a defined term, but is used in, for example, section 4of this Act. See *Change 95* in Annex 1.

Section 528: Reduction in amount charged: non-UK resident policy holders

2069. This section is based on section 553 of ICTA. In effect, it exempts the part of the gain on foreign policies that represents investment profit for the period when the policy holder was not resident in the United Kingdom. The reduction does not apply to gains arising on life annuity contracts.

2070. The reduction is proportionate to the period during the course of the policy, measured to the date the chargeable event occurred, in which the policy holder was not UK resident. This method reverses the approach in the source legislation, where the calculation produces the amount of the reduced gain, rather than the amount by which the gain is reduced.

2071. The policy holder and the person or persons liable to tax on the gain may not be the same.

2072. *Subsections (5)* and *(6)* provide a special rule for a "new policy". Under paragraph 17 of Schedule 15 to ICTA, a "new policy" is a policy which is issued in substitution for, or on the maturity of, an earlier policy (as a result of exercising an option contained in the earlier policy). Where there has been one or more replacement policies, the course of the policy is taken to run from the earliest original policy.

Section 529: Exceptions to section 528

2073. This section is based on section 553 of ICTA.

2074. Because the reduction under this section is not made if the policy is held by non-UK resident trustees, it is the unreduced gain which is taken into account for the purposes of section 740 of ICTA where section 468 applies.

2075. *Subsection (2)* applies the rules in section 110 of FA 1989, which determine when a body of trustees, one or more of whom would be regarded as resident in the United Kingdom and one or more of whom would not be so regarded, are all to be regarded as resident in the United Kingdom or not so resident.

2076. The source legislation does not take account of section 110 of FA 1989. Although section 110 of FA 1989 applies only to 1989-90 and subsequent years, it is applied here in respect of all earlier years where necessary, as it would be impractical to apply the provision using two different tests of residence status. See *Change 96* in Annex 1.

2077. See also section 546 (table of provisions subject to special rules for older policies and contracts). *Change 96* is not applied in paragraph 106 of Schedule 2 to this Act as that paragraph refers to a time wholly before the rule introduced by FA 1989 applies (see paragraph 106(3)).

Section 530: Income tax treated as paid etc.

2078. This section sets out when (subject to section 531) an income tax allowance is available to set off against the tax chargeable on the gain. It is based on section 547 of ICTA.

2079. The allowance is an amount equivalent to the lower rate of income tax on the gain (see section 1A(1B) of ICTA). It is treated as tax paid by the individual or trustees liable to tax on the gain. The allowance is not available to personal representatives who are so liable.

2080. An individual whose income is chargeable at the higher rate (see section 1(2)(b) of ICTA) will pay tax at that rate on the gain, against which the allowance can be set.

2081. The trustee or trustees of a non-charitable trust pay tax at the rate applied by section 686(1AA)(b) of ICTA, subject to the set-off of the allowance. The trustee or trustees of a charitable trust pay tax on gains at the lower rate (see section 467(7)(a)), and therefore have no net liability where the allowance is due.

2082. Taxpayers whose income is chargeable at the starting, lower or basic rates only, and non-taxpayers, have no further income tax liability when the allowance is due.

2083. *Subsection (2)* provides that the tax treated as paid is not repayable even if the individual (or the trustee or trustees) is a non-taxpayer or the allowance exceeds the tax charged on the gain.

2084. *Subsection (3)* caps the allowance when the net income chargeable to tax is reduced below the amount of the gain because of other deductions. The allowance is reduced accordingly.

2085. *Subsection (6)* ensures that the starting rate of tax (section 1(2)(aa) of ICTA) does not apply when calculating the liability to tax on a gain of an individual who is entitled to the allowance.

2086. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 531: Exceptions to section 530

2087. Broadly, this section denies the income tax allowance provided by section 530 to policies and contracts where the underlying investment profit is not subject to UK tax. Where this section applies, the tax charge for the person liable includes the starting rate of income tax (section 1(2)(aa) of ICTA) where applicable. It is based on sections 547, 553 and 553A of ICTA.

2088. This section is disregarded for the purposes of a top-slicing relief calculation (see sections 535 to 537) so that the calculation assumes there was an income tax allowance.

2089. And the income tax allowance may be available where the policy or contract is with a European Economic Area ("EEA") or other non-UK resident insurer (*subsection (2)*), or where a foreign policy of life insurance is issued by the UK permanent establishment of a non-UK resident insurer (*subsections (5)* and *(6)*). In these circumstances, the underlying investment profit has been subject to UK tax or to comparable tax in an EEA or other country.

2090. Subsection (5) refers only to policies which are foreign policies of life insurance under the first part of the definition in section 476(3), and not to policies under the second part. This preserves the intended operation of section 553(7) of ICTA for such policies despite the apparent override of that provision in section 553A(3) of ICTA for *all* foreign policies. See *Change 97* in Annex 1.

2091. *Subsection (3)* sets out the types of policies and contracts which are excepted by this section from section 530.

2092. Paragraph (a) makes clear that life annuity contracts issued by a friendly society in its tax-exempt business are within the exception, as well as life insurance policies so issued, despite the reference in the source legislation to policies only. Section 547(7) of ICTA applies to gains under both sections 541 and 543 of ICTA. Its opening words are "Where under section 541, 543 or 546C(7)(b), a gain is to be treated as arising in connection with a policy…". However, while section 541 of ICTA deals with gains on policies, section 543 of ICTA deals with gains on contracts for life annuities. Section 547(7) of ICTA therefore applies to contracts for life annuities.

2093. Paragraph (b) indicates section 530 does not apply to a gain on a foreign policy of life insurance unless the policy meets conditions which indicate that the underlying investment profit earned by the policy has borne UK tax.

Section 532: Relief for policies and contracts with European Economic Area insurers

2094. This section and the following section are based on sections 547 and 553 of ICTA. This section sets out when the income tax allowance provided by section 530 may be available for a gain on a foreign policy or contract, despite the exception in section 531. It applies where:

- a claim is made under this section;
- the insurer conditions (conditions A and B) are satisfied; and
- reinsurance of a particular type (see the definition of "excluded reinsurance contract" in *subsection (5)*) has not been made in respect of the policy or contract (condition C).

2095. In relation to "policies", the section makes clear that the relief provided extends to foreign capital redemption policies as well as to life insurance policies.

2096. *Subsection (1)* sets out that a claim under this section must simply be made, rather than made to the Inland Revenue, or (as in the source legislation) to the Board of Inland Revenue. See *Change 149* in Annex 1.

2097. The definition of "policy period" in *subsection (5)* excludes any period when the policy or contract has already been subject to UK tax on the underlying investment profit.

Section 533: Meaning of "comparable EEA tax charge"

2098. This section sets out the requirement for the purposes of section 532 that the tax charge applied to the EEA insurer is at least broadly equivalent to that applying to insurers operating in the United Kingdom. This section is based on sections 547 and 553 of ICTA.

2099. The term "insurer" in *subsection (1)* recognises that the range of bodies issuing policies or contracts in another EEA country may be different from that met in the United Kingdom, and is not necessarily equivalent to an insurance company. And for that reason, the term "insurance company" (which is defined in section 545) has not been used here.

Section 534: Regulations providing for relief in other cases where foreign tax chargeable

2100. This section is based on section 56(3) of FA 1995. It gives the Board of Inland Revenue power to make regulations which provide the same relief as does section 532 where:

- the insurer is not resident in a EEA country or territory;
- the insurer is subject to tax in that non-EEA country or territory (as described in section 532); and
- a claim for the relief is made.

2101. No regulations have been made yet under section 56(3) of FA 1995.

Section 535: Top slicing relief

2102. This section, and sections 536 and 537, are based on section 550 of ICTA. They provide a relief where the gain charged under this Chapter takes an individual's taxable income into the higher rate of tax. The relief reduces or eliminates the higher rate charge.

2103. The relief is given by reducing the amount of tax charged on the gain, or by repayment. It is given without a claim being required. See *Change 98* in Annex 1.

2104. The relief is calculated by comparing the tax chargeable on the gain (or gains) with the tax that would be chargeable on a fraction of the gain, in both cases after setting off the appropriate income tax allowance under section 530. The fraction (the "annual equivalent") is calculated by reference to the number of years the policy or contract has been in existence. The relief is the difference between the tax otherwise chargeable on the full gain and the tax that would be charged if the full gain were taxed at the rate of tax chargeable on the fraction.

2105. How to determine the fraction, and how the tax chargeable on the fraction is calculated, depends on whether the individual is taxable under this Chapter in the tax year on a gain from one chargeable event (section 536) or on gains from more than one event (section 537).

2106. *Subsection (3)* sets out how to calculate the tax on the gain(s) before any relief under this section has been given. The gain is treated as the "top slice" of the individual's total income.

2107. *Subsection (5)* ignores certain items of income in working out an individual's "total income" for these purposes. Section 835 of ICTA defines "total income", in relation to any person, as "the total income of that person from all sources estimated in accordance with the provisions of the Income Tax Acts".

Section 536: Top slicing relieved liability: one chargeable event

2108. This section is based on sections 550 and 553 of ICTA.

2109. The method employed in *subsection (1)* takes three steps. The first step determines a fraction of the gain (called the "annual equivalent"). The second calculates the net tax charge that would apply to that fraction. The third step works out the tax on the whole gain (called the "relieved liability") by multiplying the tax calculated under step 2 by the factor ("N" – see step 1) which was used to find the fraction.

2110. "N" represents the *number* of complete years the policy or contract has run before the chargeable event.

2111. *Subsections (2)* to *(8)* contain rules which modify how "N" is worked out. For example, where the gain is from a "calculation event", that is, a part surrender or assignment that gives rise to a gain, subsection (2) substitutes the number of years since the latest "calculation event" which arose on that policy or contract. (But, where the policy is a "new policy" (see subsection (5)) in relation to a replaced policy, any calculation event which arose on the replaced policy is disregarded for the purposes of subsection (2), even though the life of the "new policy" is, under subsection (4), dated from the commencement of the earlier replaced policy.)

Section 537: Top slicing relieved liability: two or more chargeable events

2112. This section is based on section 550 of ICTA. It employs the same method approach as section 536, and the same rules modifying the calculation of the factor ("N") by which each gain is to be divided for the purposes of the calculation.

2113. However, the actual method employed differs in two respects. First, the fractions (the "annual equivalent") of each gain are totalled, so that the tax calculation under step 2 is made in respect of the totalled amount.

2114. Second, the relieved liability is found by multiplying the net tax on the total annual equivalents by the aggregated gains and dividing the result by the total annual equivalents. (Roughly speaking, this gives a result based on a weighted average of "N".) This method statement expresses explicitly the calculation described in section 550(6) of ICTA for such cases.

2115. The product of this calculation is compared with the unrelieved liability on the full gains (as calculated under section 535(3)) to work out how much top slicing relief is available.

2116. For example, if an individual is chargeable on gains totalling £31,000 under this Chapter (say, gains of £6000 from one policy where "N" is four years and gains of £25,000 from another policy where "N" is ten years), and the net tax chargeable on those gains before relief (the "unrelieved liability") would be, say, £2400:

- the "total annual equivalent" is £4000 (£1500 from the first policy plus £2500 from the second);
- the "total relieved liability" on the total annual equivalent is, say, £200;
- the relieved liability is £1550 (the total relieved liability £200 multiplied by the total gains £31,000, divided by the total annual equivalent £4000);
- top-slicing relief is £850 (unrelieved liability £2400, less relieved liability £1550).

Section 538: Recovery of tax from trustees

2117. This section provides a right of recovery for an individual who, although the rights in question under the policy or contract are held by non-charitable trustees, is liable to tax on a gain or gains under this Chapter because section 465(1)(b) applies. It is based on section 551 of ICTA.

2118. *Subsection (1)(c)* defines the tax that may be recovered from the trustees. Broadly, it is the extra tax paid on the gain or gains after any top slicing relief. Where top slicing relief is available and there is more than one chargeable event in the year, with at least one gain giving liability by virtue of section 465(1)(b), *subsection (4)* provides that the relief is to be apportioned between the gains charged in working out the extra tax.

2119. *Subsection (3)* sets a cap on the amount that can be recovered from trustees, by reference to what they have derived from the relevant chargeable event.

2120. *Subsections (5)* and *(6)* allow the individual to require the Inland Revenue (rather than the Board of Inland Revenue) to certify an amount recoverable from the trustees. See *Change 149* in Annex 1.

Section 539: Relief for deficiencies

2121. Together with sections 540 and 541, this section is based on section 549 of ICTA. These sections provide a sort of "loss" relief where:

- the overall gain on a policy or contract is less than the amounts that were charged as gains on chargeable events occurring in earlier policy years; and
- the individual in question was the person liable to tax on those gains.

2122. The relief is only available to an individual. It only reduces tax charged at the higher rate or the "dividend upper rate" (the Schedule F upper rate in the source legislation).

2123. Under *subsection (1)*, the relief is only given to an individual who would have been liable on a gain, had one arisen on the chargeable event in question. For this purpose, the requirement in section 465(1), that an individual must be UK resident to be liable, is disregarded. The effect of this is that a non-UK resident individual, who is not liable under section 465(1), but is chargeable to income tax on other income, is not denied the benefit of this relief.

2124. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 540: When deficiencies arise: events following calculation events

2125. This section is based on section 549 of ICTA. Under *subsections (2)* to *(4)*, a deficiency may only arise where:

- there is a chargeable event within certain of the categories of chargeable event listed in section 484(1);
- there has previously been a gain on a "calculation event" (see section 491(4)), other than a "personal portfolio bond event", in respect of that policy or contract; and
- the calculation carried out under section 491 does not produce a gain.

2126. Although the amount of the deficiency to be relieved ignores any gains on personal portfolio bond events under section 522, the calculation under section 491 does not exclude such gains in arriving at the overall "loss".

Section 541: Calculation of deficiencies

2127. This section explains how to calculate the amount of a deficiency. It is based on section 549 of ICTA. It uses the "total benefit value" of the policy or contract, and the "total allowable deductions", in respect of the event, as calculated for section 491, to find the amount. What those terms mean in detail is shown by the calculation methods in sections 492 and 494 respectively.

2128. There are two possible amounts. Where the investor has made no overall gain, on comparing the "total benefit value" of the policy or contract and the "total allowable deductions", all earlier gains which formed part of that individual's total income are "refunded" as the amount of the deficiency. If there is a gain, but it is less than those earlier gains, the amount of the deficiency is those gains minus the net overall gain. (In determining for this purpose whether there has been an overall gain and, if so, its amount, the earlier gains are themselves disregarded.)

Section 542: Replacement of qualifying policies

2129. This section treats a qualifying policy and another qualifying policy which it replaces as a single policy for the purposes of certain sections in this Chapter (the general rules for when chargeable events occur and how gains are calculated). The commonest circumstance in which this section applies is where a life is added to or removed from a policy on marriage or divorce. It is based on paragraph 20 of Schedule 15 to ICTA.

2130. See also section 546 (table of provisions subject to special rules for older policies and contracts).

Section 543: Issue time of qualifying policy replacing foreign policy

2131. This section substitutes the start date of the old policy as the start date of the new policy for a particular circumstance where one policy has been substituted for another. It is based on section 553 of ICTA.

Section 544: Application of Chapter to policies and contracts in which companies interested

2132. This section deals with the circumstance where the application of this Chapter, that is, whether there is a chargeable event and what the amount of the gain is, has to take into account anything that occurred (or may yet occur) in respect of the policy at a time when any liability may, wholly or in part, arise or have arisen under the equivalent corporation tax provisions. It is new. (Paragraph 210 of Schedule 1 to this Act inserts section 539ZA of ICTA for the equivalent corporation tax purposes.)

2133. The section makes clear that this Chapter applies in respect of any other circumstance regardless of any application of “the corporation tax provisions” at that time. For example, if there has been a chargeable event under section 509 at a time when liability on the gain arose wholly or in part under section 547(1)(b) of ICTA (so that there was also a chargeable event under, say, section 540(1)(a)(v) of ICTA), that event is taken into account in the later application of this Chapter, even if there would then be no liability under section 547(1)(b) of ICTA.

Section 545: Minor definitions

2134. This section provides minor definitions for the purposes of this Chapter.

2135. The definitions of “charitable trust”, “friendly society” and “non-charitable trust” are based on section 539 of ICTA.

2136. The definition of “insurance company” is new for the purposes of this charge, although the Tax Acts provide a definition for other purposes. See *Change 99* in Annex 1. (There is no Chapter-wide definition of “insurer”. Depending on the provision, that word may mean the insurer for the time being or the original insurer with whom the insurance or contract was made. Where a definition is needed, it has been provided for the purposes of the section in question (for example, see section 501)).

2137. The definition of “market value” is based on the definition provided by regulation 2(1) of PPB(T)R for the purposes of those regulations. The term is not otherwise defined in the source legislation. See *Change 100* in Annex 1.

2138. The definitions in *subsection (2)* of “premium”, and in *subsection (3)* of “the amount of premiums paid” are based on the definition in regulation 2(2) of PPB(T)R. They clarify rather than replace “premium” as the term is generally understood, and are not regarded (in so far as they apply for the purposes of the Chapter rather than for the special charge on personal portfolio bonds only) as a change in the law.

Section 546: Table of provisions subject to special rules for older policies and contracts

2139. This section provides an index to the paragraphs of Parts 6 and 7 of Schedule 2 to this Act that modify the operation of certain provisions in the Chapter for older policies and contracts. It is new.

2140. The section also indicates those paragraphs in Part 5 of that Schedule that are relevant to this Chapter but depend on time factors other than the date on which the policy or contract was made.

Chapter 10: Distributions from unauthorised unit trusts

Section 547: Charge to tax under Chapter 10

2141. This section is based on sections 18(1) and (3) and section 469(3) and (4) of ICTA.

2142. This section refers to "schemes to which section 469 of ICTA applies" as a definition of "unauthorised unit trusts" would involve setting out a number of provisions used in ICTA.

2143. For the purposes of this Act unit holders liable to income tax are treated as receiving "income" rather than "annual payments". But for other tax purposes, for example sections 348 and 349 of ICTA, unit holders continue to be treated as receiving annual payments which are subject to deduction of tax. This is achieved by consequential amendment to section 469(3) of ICTA. This is a temporary measure until those provisions which impact on distributions from unauthorised unit trusts which are not rewritten in this Act are rewritten.

Section 548: Income charged

2144. This section sets out the amount of income treated as received by a unit holder from an unauthorised unit trust scheme which is charged to tax. It is based on section 469 of ICTA.

2145. *Subsection (2)* contains a method statement setting out the steps to be taken to calculate the amount of income on which the investor is charged to tax. The definition of "distribution period" in section 469(6) of ICTA has been provided in *subsection (5)* to assist in the calculation.

Section 549: Person liable

2146. This section states who is liable for any tax charged. It is based on sections 59(1) and 469(3) of ICTA.

Section 550: Income tax treated as paid

2147. This section is based on sections 348(1)(d) and 469(3) of ICTA.

2148. Where the unit trust has been treated as making annual payments under section 348 of ICTA (payment out of profits or gains brought into charge to income tax) or under section 349 of ICTA (payment not out of profits or gains brought into charge to income tax) the tax deducted will be treated as tax paid by the unit holder.

2149. Under section 348(1)(d) of ICTA tax deducted from annual payments under section 348(1)(b) of ICTA is treated as paid by the recipient. Case law extends this to tax deducted under section 348(2) of ICTA and section 349 of ICTA. In allowing all tax deducted under sections 348 and 349 of ICTA to be treated as tax paid by the unit holder section 550 fills a gap otherwise filled by case law. For more detail see the commentary on section 426.

Chapter 11: Transactions in deposits

Overview

2150. This Chapter charges profits from the disposal of deposit rights to tax. It is based on sections 56 and 56A of ICTA.

2151. Until 2003, "deposit rights" generally took the form of a "certificate of deposit". A certificate of deposit is created when money has been deposited with a person who issues a certificate containing a promise to pay a certain amount, with or without interest, to whoever holds the certificate. Such certificates are transferable. There is a paperless version of this arrangement where no certificate is issued but someone is entitled to call for its issue.

2152. What is now section 56 of ICTA was introduced by section 26 of FA 1973. The purpose of the legislation was to stop a tax avoidance device whereby certificates of deposit were sold just prior to maturity. The certificates were sold at a profit but, because the increase in value was not interest, the seller escaped tax under Schedule D Case III. Furthermore, because certificates of deposit do not constitute a debt on a security, the seller also escaped capital gains tax. Section 26 of FA 1973 stopped the avoidance by providing that, where the right to receive the amount stated in a certificate of deposit is disposed of, the gain arising is treated as an annual profit or gain charged to tax under Schedule D Case VI.

2153. Under the source legislation, paperless deposit rights (that is, those deposit rights not evidenced by a paper certificate, where the holder is nevertheless entitled to call for the issue of a certificate) are dealt with by section 56A of ICTA. That provision was introduced by section 34 of and Schedule 8 to F(No 2)A 1992. It applies the charge under section 56 of ICTA.

2154. Administration of the UK market in certificates of deposit and their paperless equivalents, and other forms of money market instrument, has become increasingly centralised and computerised. In 2001 the Treasury made regulations under section 207 of the Companies Act 1989 to facilitate the computerisation of the market (the Uncertificated Securities Regulations 2001 SI 2001/3755). The regulations introduced the concept of "units of a security to be evidenced otherwise than by a certificate and transferred otherwise than by a written instrument".

2155. After a period of preparation, existing money market instruments, including certificates of deposit, migrated to a new, wholly computerised and uncertificated system in September 2003. It remains possible, in theory at least, for a paper certificate of deposit to be issued (and a paper version of other types of money market instrument). But conventionally it is now units of an "eligible debt security" that are issued.

2156. The Treasury made regulations in June 2003, again under section 207 of the Companies Act 1989, amending SI 2001/3755 to cater for, among other things, "eligible debt securities" (the Uncertificated Securities (Amendment) (Eligible Debt Securities) Regulations 2003 SI 2003/1633 – the "2003 regulations"). That term is defined in regulation 3(h) as:

"(a) a security that satisfies the following conditions-

(i) the security is constituted by an order, promise, engagement or acknowledgement to pay on demand, or at a determinable future time, a sum in money to, or to the order of, the holder of one or more units of the security; and

(ii) the current terms of issue of the security provide that its units may only be held in uncertificated form and title to them may only be transferred by means of a relevant system;

(b) an eligible Northern Ireland Treasury Bill; or

(c) an eligible Treasury Bill.

2157. The 2003 regulations also modify numerous provisions to cater for the new type of money market instrument where legislation applies to one or other type of migrated instrument. Some of the legislation is tax provisions, including section 56 of ICTA. Paragraph 6 of Schedule 2 to the 2003 regulations deals with certificates of deposit. In an enactment to which paragraph 3 applies:

"(a) a reference to a certificate of deposit includes a reference to uncertificated units of an eligible debt security where the issue of those units corresponds, in accordance with the current terms of issue of the security, to the issue of a certificate of deposit which is a certificate of deposit for the purposes of that enactment; and

(b) a reference to an amount stated in a certificate of deposit includes a reference to a principal amount stated in, or determined in accordance with, the current terms of issue of an eligible debt security of the kind referred to in subparagraph (a).

2158. Although the modification applied by the 2003 regulations does not amend the text of the statute in question, it has the same effect as an amendment. Section 552 therefore defines "deposit rights" to encompass all types of deposit, old and new.

2159. While the vast majority of deposit rights in 2005-06 and later years will take the form of units of uncertificated eligible debt securities, there are likely to be a few extant old certificates of deposit (or the previous paperless equivalent) or new certificated deposits, and this Chapter applies to them.

2160. A number of consequential amendments in Schedule 1 to this Act add, for income tax purposes, the modification applied by the 2003 regulations (see, for example, paragraph 148 which amends section 349 of ICTA). As regards the reference to "rights" in section 398 of ICTA (which modifies loss relief under sections 392 or 396 of ICTA in relation to the disposal of deposit rights), the modification applied by the 2003 regulations is provided, for income tax purposes, through the consequential amendment in that Schedule inserting a reference to this Chapter.

2161. In so far as sections 56 and 56A of ICTA continue to apply after 2004-05 for corporation tax purposes (but see section 56(4A) and (4B) of ICTA), the modification is still provided by the 2003 regulations. For corporation tax purposes, the reference to "rights" in section 398 of ICTA is modified accordingly.

2162. For the purposes of the exemptions provided by section 56(3)(b) and (c) of ICTA, which are not rewritten in this Act, the modification is also still provided by the 2003 regulations.

2163. This Chapter does not rewrite section 56(3)(a) of ICTA, under which there is no charge in respect of a right to receive an amount stated in a certificate of deposit issued before 7 March 1973. As certificates of deposit are in practice issued for a maximum term of five years, section 56(3)(a) of ICTA is obsolescent, if not obsolete. Paragraph 92 of Schedule 2 to this Act provides a saving for extant pre-7 March 1973 certificates (if any).

Section 551: Charge to tax on profits from disposal of deposit rights

2164. This section is based on sections 56 and 56A of ICTA.

2165. As deposit rights consist of the right to receive interest and the right to the return of the principal amount, *subsection (2)* makes clear that receiving the principal amount is a disposal of rights for the purposes of the charge to tax but receiving interest is not. Such interest is taxable under Chapter 2 of this Part.

Section 552: Meaning of "deposit rights"

2166. This section is based on sections 56 and 56A of ICTA, as modified by the 2003 regulations.

2167. S*ubsection (2)* defines various terms. The definitions of terms in relation to "uncertificated eligible debt security units" are based initially on the modification provided by the 2003 regulations, although the definitions themselves are based individually on earlier regulations. The definition of a "certificate of deposit" is based on sections 56(5) and 56A(4) of ICTA. The definition of a "security" is based on section 56(5) of ICTA, which uses the definition in section 132 of TCGA. The definition of an "uncertificated right" is based on section 56A(1) of ICTA. Paragraph 93 of Schedule 2 to this Act preserves the commencement rule for this category, in so far as any pre-16 July 1992 arrangements are extant.

Section 553: Income charged

2168. This section sets out the amount of income charged to tax. It is based on section 69 of ICTA.

Section 554: Person liable

2169. This section states who is liable for any tax charged. It is based on section 59 of ICTA.

2170. Section 56(2) of ICTA, as extended by section 56A(3)(a) of ICTA, sets out in rather elaborate terms the persons whose exercise of a deposit right results in the profits being charged to tax. But section 59 of ICTA achieves the same effect by simpler means, so those parts of sections 56 and 56A of ICTA are not rewritten.

Chapter 12: Disposals of futures and options involving guaranteed returns

Overview

2171. This Chapter rewrites the provisions in Schedule 5AA to ICTA on guaranteed returns on transactions in futures and options. It taxes as income profits and gains on a disposal of a future or option which, but for this Chapter, would be taxed as chargeable gains.

Section 555: Charge to tax under Chapter 12

2172. This section charges to tax profits and gains arising on a disposal of a future or option to which the Chapter applies. It is based on paragraph 1 of Schedule 5AA to ICTA.

2173. The section refers to "profits and gains", as in the source legislation, since the profits arising may also be gains for the purposes of TCGA. There are provisions to ensure that a double charge under both this Chapter and TCGA does not arise. See new section 148A of TCGA (futures and options involving guaranteed returns) in paragraph 435 of Schedule 1 to this Act.

2174. The word "disposal" (see section 562 (when disposals of futures or options occur: general)) replaces "transaction to which this Schedule applies" since a gain can only arise on a disposal, although not all transactions are necessarily disposals.

2175. *Subsection (1)* refers to a disposal of a future or option rather than a disposal of futures or options as in paragraph 2(1) of Schedule 5AA to ICTA. A taxpayer is taxed on a disposal of a future or an option. A similar reference to a disposal of a future or option appears in sections 559 and 560 where the source legislation refers to a disposal of futures or options.

2176. *Subsection (2)* provides that profits which, but for this Chapter, would be capital profits, may be charged under this Chapter.

2177. Profits and gains from a trade, whether arising in the United Kingdom or abroad, are excluded and dealt with under Part 2 of this Act. See section 366(1) which gives the charge in Part 2 priority. That aside, the charge under this Chapter is on both UK and foreign profits and gains. See *Change 101* in Annex 1.

Section 556: Income charged

2178. This section sets out the amount charged to tax on profits and gains that arise on the disposal of a future or option. It is based on paragraph 1 of Schedule 5AA to ICTA.

2179. Schedule 5AA to ICTA provides no precise computational rules for computing the profit or gain arising on the future or option chargeable to tax. It refers only to the profits being "realised". This is rewritten by providing that the profits are the full amount of profits and gains arising when the disposal occurs. In most cases the quantum of profits will be the difference between the disposal proceeds and the acquisition cost of the future or option.

Section 557: Person liable

2180. This section states who is liable for any tax charged. It is based on paragraph 1 of Schedule 5AA to ICTA.

Section 558: Meaning of "future", "option" etc.

2181. This section explains what is meant by future and option for the purposes of this Chapter. It is based on paragraphs 4 and 4A of Schedule 5AA to ICTA.

2182. *Subsection (2)* reproduces the definition of "traded option" in section 144(8) of TCGA rather than relying on a cross-reference to that Act, as paragraph 4(6) of Schedule 5AA does. But the section does not employ the term "traded option". The distinction between a traded option and any other option is relevant only for paragraph 4(3) of Schedule 5AA to ICTA. Section 562 (when disposals of futures or options occur: general), which rewrites that paragraph, applies the substance of the definition without using the term.

2183. *Subsection (3)* has, for the sake of convenience, been introduced from TCGA.

Section 559: When disposals involve guaranteed returns

2184. This section explains for the purposes of this Chapter when a disposal involves guaranteed returns. It is based on paragraph 2 of Schedule 5AA to ICTA.

2185. *Subsection (1)* provides that where the conditions in *subsections (2)* to *(4)* are met a disposal will involve guaranteed returns. These conditions are that there must be at least one other related transaction, apart from the disposal giving rise to the charge, and that this, and the related transaction, are intended to produce a guaranteed return. (What is meant by "related transactions" is explained by section 566 (when transactions are related)). The guaranteed return should consist of the return from the disposal in question or a number of disposals of which the disposal in question is one.

2186. *Subsection (5)* explains the phrase used in the first condition "two or more related transactions designed to produce a guaranteed return". A "main purpose test" is applied to the two or more related transactions. Considering them together, it must be reasonable to assume that their main purpose or one of their main purposes is to produce that guaranteed return.

2187. *Subsection (6)* then explains what factors may be considered in making a "reasonable assumption". These are the same factors as in section 566 (when transactions are related).

Section 560: Production of guaranteed returns

2188. This section explains, for the purposes of this Chapter, what is meant by producing a guaranteed return from a disposal of a future or option. It is based on paragraph 3 of Schedule 5AA to ICTA.

2189. *Subsection (1)* gives the basic rule for ascertaining whether a guaranteed return is produced from a disposal of a future or option. A risk of fluctuations in the underlying subject matter (defined at *subsection (6)*) of the future or option must be eliminated or reduced so that the return on the disposal meets the two conditions in subsections (3) and (4).

2190. *Subsection (2)* supplements the rule in subsection (1) where there is more than one disposal.

2191. *Subsections (3)* and *(4)* provide two conditions that must be met for the basic rule to apply. Broadly, the return on the investment must be predictable and have more similarity to interest than to the risk expected on a future or option.

2192. *Subsection (5)* extends the circumstances in which risks are treated as eliminated or reduced. A main reason for the choice must be the expectation that the value of an asset of that nature will be liable to only minimum fluctuation.

Section 561: The return from one or more disposals

2193. In order to ascertain whether there is a guaranteed return for the purposes of this Chapter, section 559 (when disposals involve guaranteed returns) requires a consideration of "the return from one or more disposals". This section explains what is meant by "the return from one or more disposals". It is based on paragraph 5 of Schedule 5AA to ICTA.

2194. *Subsection (1)* contains the basic rule. The charge under section 555 (charge to tax under Chapter 12) is on a profit or gain from an individual disposal. But, in deciding whether there is a guaranteed return, more than one disposal in the scheme or arrangement can be taken into account and the overall result of that disposal or those disposals considered, that is to say the profits or gains less losses on those disposals or on all but an insignificant part of them.

2195. *Subsection (2*) provides that profits or gains or losses are to be treated as made by the same person, notwithstanding that they are realised by different persons, if they are made by persons who are associated with each other.

2196. *Subsections (3)* to *(6)* explain when persons are associated with each other. (This is quite unconnected with the associated person test in section 227 of ICTA.) All disposals must be part of the same scheme or arrangements (defined in *subsection (7)*) and all must share in the net return of all the profits and losses incurred on those disposals in a sharing arrangement agreed for that scheme or arrangements.

2197. The references in paragraph 5(3) of Schedule 5AA to ICTA to "associated companies" have not been reproduced. See *Change 102* in Annex 1.

Section 562: When disposal of futures or options occur: general

2198. Tax is charged under this Chapter on the profits and gains arising from a disposal of a future or option. This section explains when there is a disposal. It is based on paragraph 4 of Schedule 5AA to ICTA.

2199. *Subsection (1)* refers to the relevant sections of TCGA which decide whether and when a disposal occurs. Section 143(5) and (6) of TCGA treat as disposals futures contracts which are closed out by entering into another contract or which are settled by payment. Section 144 of TCGA treats as disposals grants and abandonments of options (but not the exercise of an option). Section 144A of TCGA provides that the exercise of an option which is settled by cash is treated as a disposal both in respect of the grantor of the option and the grantee. These last two sections also provide rules as to when a future or option in these circumstances has been disposed of.

2200. The assumptions that apply in interpreting subsection (1) are set out in subsections (2) to (4).

2201. *Subsection (2)* requires, for the removal of doubt, that all futures are to be considered as assets in applying the TCGA sections. (Options are already listed as chargeable assets in section 21(1) of TCGA.)

2202. *Subsection (3)* requires section 143(5) and (6) of TCGA to be read without the words "in the course of dealing in commodity or financial futures" since the range of futures transactions covered by this Chapter extends beyond commodity and financial futures as defined in section 143 of TCGA.

2203. *Subsection (4)*, by requiring references to a financial option in section 144 of TCGA to exclude only listed options, extends the provisions of that section to cover options that would otherwise be excluded under the definition in subsection 144(8) of TCGA. (Section 144 of TCGA provides for the grant and abandonment of options to be treated as disposals and for premiums to be included in the computation of the gain or loss.) These listed options are referred to as "traded options" in paragraph 4 of Schedule 5AA to ICTA. The context demands that the listing should be at the time of disposal and this has been added for clarification.

2204. *Subsection (5)* provides a cross-reference to sections 563 (timing of certain grants of options where related disposals occur later) and 564 (deemed disposal where futures run to delivery or options are exercised).

2205. Section 563 provides timing rules for deemed disposals where futures run to delivery or option contracts are exercised. Section 564 provides that futures running to delivery and options exercised are treated as disposals for the purposes of this Chapter if they would not otherwise be.

2206. This section does not rewrite paragraph 4(1) of Schedule 5AA to ICTA. That subparagraph explains that a disposal is a disposal of futures or options if it is the disposal of one or more futures or one or more options or both combined. Because a taxpayer is charged on a disposal of a future or option and more than one future or option may already be taken into account in ascertaining whether there is a guaranteed return (see section 561), it is considered that this sub-paragraph adds nothing but simply serves to confuse.

Section 563: Timing of certain grants of options where related disposals occur later

2207. This section provides that certain grants of options are to be treated as having taken place after other transactions. The purpose is to allow loss relief arising on the grant of an option to be set against a later profit. The section is based on paragraph 4 of Schedule 5AA to ICTA.

2208. *Subsection (1)* sets out the general rule. There are three conditions that must be satisfied for the rule to apply.

2209. *Subsections (2)* to *(4)* set out these three conditions. There must be a number of related transactions designed to produce a guaranteed return of which one is the grant of an option. At least one of the other transactions should be entered into after the grant and should be a disposal that is not a grant of an option.

2210. *Subsection (5)* then provides that the grant of the option is deemed to take place at the same time as the next one of the transactions referred to in subsection (4) takes place. As a result, a loss on the grant of an option will coincide with any profit arising on the later transaction. Because losses under Schedule 5AA to ICTA are allowable against

Schedule D Case VI profits they may be carried forward against other Schedule D Case VI profits arising in a later year or set off against other Schedule D Case VI profits of the same year, but not carried back. Since the Schedule D Case VI set-off rule is rewritten, this section allows that later profit to be reduced by a loss which, but for this section, could arise in a later year than that profit.

2211. *Subsection (6)* consequently requires that the two timing rules in sections 144(2) and 144A(2) of TCGA, should they apply, take precedence over the timing rule in this section. But in most cases the two rules will give the same result. (Sections 144(2) and 144A(2) of TCGA treat grants of options and transactions by the grantor to fulfil his obligations as a single transaction.) The purpose of this is to allow the sum received on the grant to fall within the same capital gains computation as arises when the option is exercised, etc. Where it applies for this Chapter, the timing rules in these two sections of TCGA will generally achieve the same results as this section. But the rules in sections 144(2) and 144A(2) of TCGA will not always apply because certain transactions within this Chapter fall outside them.

Section 564: Deemed disposal where futures run to delivery or options are exercised

2212. This section provides that futures which are allowed to run to delivery and option contracts which are exercised will be treated as disposals for the purposes of this Chapter if they would not otherwise be disposals under this Chapter. Paragraph 94 of Schedule 2 to this Act ensures that these transactions are not disposals if they took place before 6 February 1998. This section is based on paragraph 4A of Schedule 5AA to ICTA.

2213. *Subsections (2)* and *(3)* provide the conditions that must apply for there to be a deemed disposal. There must be two or more related transactions (section 566 explains what is meant by a related transaction). One of these must be the creation or acquisition of a future or option and the other the running to delivery of that future or exercise of that option but which is not already a disposal for the purposes of this Chapter.

2214. Under *subsection (4)* a disposal is deemed to have taken place the moment before the future runs to delivery or the option is exercised and that disposal is deemed to be a disposal provided for in a scheme or arrangements.

2215. Both parties to the future or option are affected by the deemed disposal.

2216. Under s*ubsection (5)* the person whose rights and entitlements have a value immediately before the option is deemed to dispose of that right or those rights for their market value. Thus the same disposal proceeds are deemed to arise as if the person had disposed of the contract to another and a profit or gain had arisen in those circumstances.

2217. Under *subsections (6)* and *(7)* any other party to the future or option is deemed to have received nothing on the disposal but to have incurred costs equal to the amount the person would have been expected to pay in an arm's length transaction for the release of the person's obligations under the contract.

2218. *Subsection (8)* requires that section 144(2) and (3) of TCGA should be disregarded in applying subsections (1) to (3). This is because under these two subsections of section 144 of TCGA (applicable as a result of section 562 (when disposals of futures or options occur: general)) the grant and exercise of an option are treated as a single transaction (to enable the premium to be set against the disposal proceeds). But, in order for this section to apply, subsections (1) to (3) require *two* related transactions, the creation of the future or option and its running to completion or being exercised, so those two transactions must not be taken to be a single transaction.

Section 565: Interpretation of section 564

2219. This section provides explanations necessary to understand the previous section. It is based on paragraph 4A of Schedule 5AA to ICTA.

2220. *Subsection (3)* defines “party” in relation to the future or option in terms of rights, entitlements, obligations and liabilities, ensuring that both “grantors” and “grantees” of both futures and options fall within the definition.

Section 566: When transactions are related

2221. This section provides an explanation of what is meant by related transactions. The rules given in this section are necessary for the definition of what constitutes a guaranteed return in section 559, for the timing of disposals in section 563 and for applying the provisions on deemed disposals in section 564. This section is based on paragraph 6 of Schedule 5AA to ICTA.

Section 567: Losses

2222. This section gives some rules on losses, when they arise and how they are relievable. It is based on paragraph 1 of Schedule 5AA to ICTA.

2223. *Subsection (4)* gives a link to three sections which have been inserted into TCGA by paragraph 435 of Schedule 1 to this Act. They rewrite paragraph 4A(5) to (9) of Schedule 5AA to ICTA. The rules in these two new sections prevent gains which have been charged under this Chapter from being taxed again under TCGA and losses relieved under this Chapter from being relieved again under that Act. Because these rules are properly relevant to the capital gains regime they are rewritten as consequential amendments to TCGA.

Section 568: Special rule for certain income of trustees

2224. This section provides, with some exceptions, that profits or gains arising to trustees under this Chapter are chargeable to tax at the rate applicable to trusts in section 686 of ICTA. It is based on paragraph 7 of Schedule 5AA to ICTA.

2225. The reference in *subsection (4)* to a superannuation fund to which section 615(3) of ICTA applies has effect for the tax year 2006-07 onwards only. There is a transitional rule in paragraph 95 of Schedule 2 to this Act which gives the rules for 2005-06. Changes to the rules on superannuation funds in FA 2004 only apply from 2006-07.

2226. *Subsection (6)* qualifies the meaning of “trustees” for the purposes of this section. Paragraph 7(3) of Schedule 5AA to ICTA simply refers to section 686 of ICTA but the definition in that section is rewritten in full here.

Section 569: Anti-avoidance: transfer of assets abroad

2227. Sections 739 and 740 of ICTA provide rules to counter the avoidance of income tax by the transfer of assets abroad. They apply where income is payable to a person resident or domiciled outside the United Kingdom but which a person domiciled or resident within the United Kingdom has the power to enjoy. This section enables sections 739 and 740 of ICTA to apply to profits arising under this Chapter by ensuring that the profits or gains are treated as income payable to a person resident or domiciled outside the United Kingdom. It is based on paragraph 8 of Schedule 5AA to ICTA.

Chapter 13: Sales of foreign dividend coupons

Overview

2228. This Chapter rewrites the charge to tax in section 18(3B) to (3E) of ICTA on the proceeds of the sale of coupons and warrants attached to foreign securities and shares, where the sale is made through a bank or to a dealer in coupons and both are in the United Kingdom.

Section 570: Charge to tax under Chapter 13

2229. This section charges to tax income which is treated as arising from foreign holdings where a dividend coupon attached to the holding is (a) sold or otherwise realised by a bank in the United Kingdom or (b) sold to a coupon dealer in the United Kingdom by someone other than a bank or a coupon dealer. The term "foreign holdings" is defined in section 571. The section is based on section 18 of ICTA.

2230. *Subsection (3)* sets out the first circumstance in which income is treated as arising from foreign holdings. This is where the UK office of a bank pays over the proceeds of a sale or realisation of dividend coupons or carries those proceeds to an account. Section 18(3B)(a) of ICTA refers simply to "a bank in the United Kingdom". See *Change 103* in Annex 1.

2231. *Subsection (4)* sets out the second circumstance. This is where a person who is neither a bank nor another coupon dealer sells the dividend coupons to a coupon dealer in the United Kingdom. Section 18(3B)(b) of ICTA refers to "a dealer in coupons in the United Kingdom". See *Change 103* in Annex 1.

Section 571: Meaning of "foreign holdings" etc

2232. This section gives the meaning of "foreign holdings" and "dividend coupons" and of words used within these definitions. It is based on section 18 of ICTA.

Section 572: Income charged

2233. This section sets out the amount charged to tax on income arising from foreign holdings. It is based on section 65 of ICTA.

Section 573: Person liable

2234. This section states who is liable for any tax charged. It is based on section 59 of ICTA.