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 6: Exempt income

Chapter 7: Purchased life annuity payments

Overview

2741. This Chapter rewrites the purchased life annuity provisions in sections 656 to 658 of ICTA.

2742. Early case law established that the whole of an annuity payment received by an annuitant is chargeable to income tax (see, for example, the speech of the Lord President (Inglis) in Coltness Iron Co v Black (1881), 1 TC 287, 308, HL, which was cited with approval by Lord Wilberforce in CIR v Church Commissioners for England (1976), 50 TC 516, 566) HL. So there was a contrast between income tax law (where the whole of the payment is regarded as taxable income) and the commercial world (where a part of the payment is regarded as a return of capital).

2743. In 1954 the Report of the Committee on the Taxation Treatment of Provisions for Retirement (Cmd. 9063) recommended changing the law so that only the income element in an annuity payment should be charged to income tax. Sections 27 and 28 of FA 1956 therefore provided for purchased life annuities to be regarded as containing both an income element (chargeable to income tax) and a capital element (not chargeable to income tax). The 1956 legislation, with subsequent amendments, appears in the source legislation as sections 656 to 658 of ICTA.

2744. Section 656(1) of ICTA provides:

> "…a purchased life annuity shall, for the purposes of the provisions of the Tax Acts relating to tax on annuities and other annual payments, be treated as containing a capital element and, to the extent of that capital element, as not being an annual payment or in the nature of an annual payment; but the capital element in such an annuity shall be taken into account in computing profits or gains or losses for other purposes of the Tax Acts in any circumstances in which a lump sum payment would be taken into account.

2745. The purpose of treating the annuity payment as containing a capital element and then treating that capital element as not being an annual payment, is to ensure the capital element is not charged to income tax. These propositions are rewritten as an exemption from income tax (see section 717). Additionally, as the annuity payment is not treated as an annual payment or is not in the nature of an annual payment, that part of the payment is outside the scope of the deduction of tax at source rules (sections 348 and 349 of ICTA). This element of section 656(1) of ICTA is dealt with by the general disregard (see section 783).

2746. The purpose of the second limb of section 656(1) of ICTA is to ensure that a trader for whom the annuity would represent a trading receipt cannot exclude the capital element from the trader's Schedule D Case I tax computation. This is dealt with for traders liable to income tax by the combined effect of the priority rule for trading income (see section 366(1) which gives Part 2 of this Act charging priority over Part 4 of this Act) and *subsection (1)* of section 717. Section 717(1) only exempts from income tax annuity payments charged to tax under Chapter 7 of Part 4 of this Act. So if the annuity payments are not charged to tax under Chapter 7 of Part 4 they cannot benefit from the exemption in Chapter 7 of Part 6 of this Act.

2747. The annuity payments made under a purchased life annuity are generally regarded as investment income in the recipient's hands and are therefore charged to tax under Chapter 7 of Part 4 of this Act. This Chapter deals with the exemption from income tax in respect of annuity payments charged under that Chapter. Annuities taxed under another part of the Act such as Chapter 7 of Part 5, or under other legislation are outside the scope of this Chapter.

Section 717: Exemption for part of purchased life annuity payments

2748. This section is based on section 656 of ICTA and sets out the extent of the exemption.

2749. *Subsection (1)* sets out the exemption and makes it clear that an annuity payment is only exempt to the extent provided in section 719.

2750. *Subsection (2)* makes it clear that not all annuity payments made under a purchased life annuity are exempt and signposts section 718 which sets out the excluded annuities.

2751. The Inland Revenue does not interpret "annual payment" in section 656(1) of ICTA as restricted to annual payments chargeable under Schedule D Case III. So the exemption is not dependent on the source of the annuity payment. Foreign annuity payments may therefore benefit from the exemption.

2752. *Subsection (3)* indicates that a claim needs to be made for the exemption to apply but does not specify to whom that claim is made. Section 878(4) draws attention to the rules in the TMA, which apply for the purposes of this Act. Those rules require claims to be made to "an officer of the Board." See *Change 149* in Annex 1.

2753. The requirement for a claim is not in the source legislation but is in secondary legislation supporting sections 656 to 658 of ICTA (see regulation 4 of the Income Tax (Purchased Life Annuities) Regulations 1956 SI 1956/1230, as amended) ("the 1956 Regulations"). The claim provision has been promoted to primary legislation. That will change the status of the provision as it will no longer be possible to change it or revoke it through further regulations. See *Change 117* of Annex 1.

Section 718: Excluded annuities

2754. This section rewrites section 657(2) of ICTA, which sets out the annuities to which section 656 of ICTA does not apply. Not all of the annuities listed in section 657(2) of ICTA are specified. Some of the annuities referred to in section 657(2) of ICTA are excluded from the exemption in section 717 by the combined effect of the priority provisions (see section 366(3) which gives ITEPA charging priority over Part 4 of this Act) and *subsection (1)* of section 717. Section 717(1) only exempts from income tax annuity payments charged to tax under Chapter 7 of Part 4 of this Act. So if the annuity payments are not charged to tax under Chapter 7 of Part 4 of this Act they cannot benefit from the exemption in this Chapter. It follows that the annuity payments made under the annuities set out in section 657(2) of ICTA which are not charged to tax under Chapter 7 of Part 4 of this Act do not need to be mentioned. Section 718 therefore lists only those annuity payments made under annuities excluded by section 657(2) of ICTA and charged to tax under Chapter 7 of Part 4 of this Act.

2755. Additionally, section 657(2)(a) of ICTA is not rewritten. That section provides that section 656 does not apply to:

“any annuity which would, apart from that section, be treated for the purposes of the provisions of the Tax Acts relating to tax on annuities and other annual payments as consisting to any extent in the payment or repayment of a capital sum.

2756. Section 657(2)(a) appears to be designed to exclude “annuity” payments which, on the analysis in Perrin v Dickson (1924), 14 TC 608 CA, represent interest together with capital repayments. This case concerned a contract under which, in return for a series of annual premiums, an assurance society undertook to pay an “annuity” for seven years if a named individual should live that long. In the event of the individual’s death the total amount of the premiums paid, without any interest, less any amount paid by way of “annuity”, was to be repaid. The individual survived and it was held in the Court of Appeal that the payments received did not constitute an annuity for income tax purposes. Tax was chargeable only on so much of the payments as constituted interest on the original payments.

2757. On a proper analysis, however, the payments are not really “annuity” at all, even if that is what they were called. And if contracts of the type considered in Perrin v Dickson do not give rise to annual payments it is difficult to see what purpose section 657(2)(a) of ICTA is intended to serve.

2758. No true annuity which would need to be excluded in this way from the relief provided by section 656 has been discovered. Section 656(2)(a) of ICTA is otiose and has therefore been dropped.

Section 719: Extent of exemption under section 717

2759. This section sets out the rules to work out the method of calculating the amount that is exempt from tax. The method varies according to the type of purchased life annuity involved. Sometimes a constant proportion of the annuity payment is exempt and sometimes a constant fixed sum is exempt.

2760. By definition (see section 423 of this Act) the term of every purchased life annuity is dependent on the duration of a human life. The amount of the annuity payment may also be dependent on the duration of a human life. However, either might also be dependent on some other contingency.

2761. *Subsections (1)* and *(2)* set the scene by explaining that the method of calculating the amount that is exempt is determined by two factors: the amount of the annuity payments and the term of the annuity.

2762. The first step is to determine whether a constant proportion of each annuity payment is exempt or whether a constant sum is exempt. This depends on whether or not the amount of the annuity payments depends solely on the duration of a human life or lives (see s*ubsection (2)(a)*).

2763. If the amount of the annuity payments does depend solely on the duration of a human life or lives, *subsection (3)* provides that a constant proportion of the annuity payment is exempt. This has been called the “exempt proportion”.

2764. If the amount of the annuity payments does not depend solely on the duration of a human life or lives (in other words the amount depends additionally on a non-life contingency) *subsection (4)* provides that a constant sum is exempt (assuming the period covered by each payment is the same). This has been called the “exempt sum”.

2765. Under the type of purchased life annuity covered by subsection (4) it is possible for the exempt sum to exceed the amount of a particular annuity payment. ESC A46 deals with this by allowing the excess of the exempt sum over the gross annuity payment to be carried forward and added to the exempt part of the next payment. *Subsection*

(5) legislates ESC A46. See *Change 119* in Annex 1. Special provision has also been included in Schedule 2 (see paragraph 144) to deal with the carry forward of excess capital elements which accrued before 6 April 2005.

2766. The next step is to work out the exempt proportion or the exempt sum. This depends on whether or not the term of the annuity depends solely on the duration of a human life or lives.

2767. If the term of the annuity does depend solely on the duration of a human life or lives, s*ubsection (7)* points the way to the two provisions containing the formulas for calculating the exempt proportion or the exempt sum. Under virtually all purchased life annuities, the term of the annuity depends solely on the duration of a human life or lives.

2768. But if the term of the annuity also depends on a non-life contingency, *subsection (8)* explains that the exempt proportion or the exempt sum is calculated on a just and reasonable basis. In making this calculation, account must also be taken of the additional contingencies and the relevant formula. Although the source legislation refers to a "just" basis of calculation, just and reasonable is used in subsection (8) in line with the approach which has been adopted throughout the Act that all apportionments are on a just and reasonable basis. See *Change 14* in Annex 1.

2769. If both the amount of the annuity payment and the term of the annuity (in addition to depending on the duration of human life) depends on a non-life contingency, section 656(3)(b) and (e) of ICTA provide for the exempt capital element of each payment to be computed as a constant proportion. But, as section 656(2) of ICTA recognises, actuarial techniques do not provide any mechanism for calculating the (exempt) capital element as a constant proportion if the amount of the annuity payment is dependent on a non-life contingency. So section 719(4) provides for the exempt sum method to apply in this case. See *Change 118* in Annex 1. And, as it will be possible for the exempt sum to exceed the annuity payment, ESC A46 has been extended so that it too applies. See *Change 119* in Annex 1.

Section 720: Exempt proportion: term dependent solely on duration of life

2770. This section sets out the formula for calculating the exempt proportion of an annuity payment for the most common type of annuity, that is, an annuity whose term and the amount of the annuity payments, depend solely on the duration of a human life or lives.

2771. Under this type of annuity the amount of the annuity payment may change, but only in a pre-determined way. For example, the amount may increase by a fixed percentage at set intervals or, if written on two lives, may reduce on the first death. The method of calculation calculates the exempt part as a constant proportion of each annuity payment and thus caters for increases and decreases in the amount of the annuity payments.

2772. The source legislation does not set out how the actuarial value is to be calculated. However, the source legislation ensures a consistent approach is adopted by setting out when the value is to be calculated (see section 656(4)(c) of ICTA rewritten as *subsection (3)*) and requiring (see section 656(4)(c) and (7)(b) of ICTA rewritten as *subsection (4)*) that:

- the same tables of mortality are always used (the tables prescribed by the regulations are those comprised in Table A8 set out in Appendix A on pages 113 to 115 of the booklet entitled "Continuous Mortality Investigation Reports Number 10" published by the Institute of Actuaries and the Faculty of Actuaries in 1990 (regulation 6 of the 1956 Regulations));
- the age of the person during whose life the annuity is payable is taken as a whole number of years; and
- no discount is given in arriving at the present value of a future payment.

2773. Subsection (4)(b) reflects Inland Revenue practice (which follows actuarial practice). See *Change* 120 in Annex 1.

Section 721: Exempt sum: term dependent solely on duration of life

2774. This section sets out the formula for calculating the exempt sum where:

- the term of the annuity does not depend on any contingency other than the duration of a human life or lives; but
- the amount of the annuity payments does depend on some contingency other than the duration of a human life or lives.

2775. Under this type of annuity the amount of the annuity payment may change in an unpredictable way. As changes in the amount of the annuity payments are unpredictable, any actuarial valuation of them would be virtually impossible. So the exempt part of each annuity payment is calculated as a constant sum.

2776. An example of an annuity of this type is an index-linked annuity where the amount of the annuity fluctuates with movements in the Retail Prices Index. Initially the return under this type of annuity is low and the annuity payments may fall short of the amount of the exempt sum. With inflation the amount of the annuity payments is likely to rise and in due course to overtake the amount of the exempt sum.

2777. The term of the annuity can only be predicted by an actuarial calculation. Again, a consistent approach to that calculation is ensured by *subsections (3)* and *(4)* (see further the commentary on section 720(3) and (4)).

Section 722: Consideration for the grant of annuities

2778. This section contains rules to deal with the case where the purchase of the annuity is part of a composite transaction. It is based on section 656(4) of ICTA.

2779. For example, capital protected annuities, which provide for the return on death of the purchase consideration less the annuity payments made to date, could be regarded as a composite of an annuity and a life insurance. However, under *subsection (2)* the consideration given for a capital protected annuity is treated as given for the annuity alone.

2780. *Subsections (3)* and *(4)* provide for the consideration to be apportioned on a just and reasonable basis. Although the source legislation refers to apportionment on a “just” basis, just and reasonable is used in subsections (3) and (4) in line with the approach which has been adopted throughout the Act that all apportionments are on a just and reasonable basis. See *Change 14* in Annex 1

Section 723: Determinations

2781. The exemption requires a claim to be made. This allows the Inland Revenue to determine whether an annuity is a purchased life annuity and the amount of any annuity payment which is exempt. This section deals with those questions and the consequences for the payer so far as deduction of tax at source is concerned. It is based on section 658 of ICTA.

2782. *Subsection (1)* provides that such questions are to be determined by the Inland Revenue. See *Change 149* in Annex 1. *Subsection (2)* provides for appeals against determinations to go to the Special Commissioners.

2783. Under *subsection (3)* the payer of an annuity payment is entitled to rely on a determination, made and notified by the Inland Revenue, in determining how much income tax it may or must deduct from the annuity payments. But the words “and has not been notified of any alteration of that decision” in section 656(5) make little sense unless the payer is entitled to rely on that notification. *Subsection (4)* clarifies the position by making it clear that that notification is itself a determination.

2784. Special transitional provisions have been included in Schedule 2 (see paragraphs 143 and 145) to deal with determinations made before 6 April 2005 and to make it clear which provision applies if a false statement or representation is made either before or on or after 6 April 2005.

Section 724: Regulations

2785. This section contains powers for the Board of Inland Revenue to make regulations for dealing with purchased life annuities. It rewrites equivalent provisions in sections 656 and 658 of ICTA.

2786. *Subsection (1)* covers three general matters:

- prescribing the procedures to be used;
- applying provisions of the Income Tax Acts (modified if appropriate); and
- prescribing the tables of mortality.

Section 725: Annual payments under immediate needs annuities

2787. This section is based on section 580C of ICTA. It exempts from income tax certain annual payments made under a contract for an immediate needs annuity.

2788. *Subsections (2)* and *(3)* define an immediate needs annuity. "Annuity" here refers to a contract, as is made clear in the section, rather than payments made or received. Because purchased life annuities payments have their own charge within this Act the definition of a "relevant annual payment" in section 580C(2) of ICTA which places these payments within Schedule D Case III or V can be omitted.

Section 726: Meaning of "care provider"

2789. This section defines "care provider" for the purposes of section 725(1). It is based on section 580C of ICTA.

2790. *Subsection (3)* is drafted slightly differently from the wording on which it is based, namely section 580C(4)(b) of ICTA, which refers to "care which is registered under the relevant enactment". The section reflects the fact that it is the service of care that is registered under that Act, rather than "care".