

# INCOME TAX ACT 2007

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## EXPLANATORY NOTES

### COMMENTARY ON SECTIONS

#### **Part 2: Basic provisions**

##### **Overview**

#### *Chapter 3: Calculation of income tax liability*

##### **Overview**

76. This Chapter deals with the calculation of a person's income tax liability for a tax year.
77. The calculation sets out how the rules about the rates at which income is charged, and provisions about reliefs, allowances, tax reductions etc, are applied to the components of a person's total income to arrive at the person's income tax liability.
78. The calculation does not deal with amounts of tax suffered (eg under PAYE or by way of deduction of tax at source) as these are set off against a person's liability rather than deducted in arriving at it. See section 59B(1) of TMA.
79. Nor does it deal with relief given by discharge or repayment, as here too the relief can operate only once the amount of a person's liability has been determined. Examples of such reliefs include paragraph 6 of Schedule 14 to ICTA (life insurance relief for non-residents) and section 416 of CAA (mineral extraction allowance - expenditure on restoration within 3 years of ceasing to trade).

#### *Section 22: Overview of Chapter*

80. This section provides an overview of the Chapter. It is new.
81. The persons liable to income tax include individuals, trustees, personal representatives, non-UK resident companies, and companies acting in a fiduciary or representative capacity.
82. But where non-UK resident companies carry on a trade in the United Kingdom through a permanent establishment, they are liable to corporation tax instead of income tax on their chargeable profits. See the commentary on section 5.

#### *Section 23: The calculation of income tax liability*

83. This section sets out the steps to be taken in calculating a taxpayer's liability to income tax for a tax year. It is based on many provisions in the source legislation, in particular section 835 of ICTA.
84. *Step 1* brings together all the amounts of income on which a taxpayer is charged to income tax for the tax year. The sum of these amounts is called "total income", and each of the amounts is a "component" of total income.

*These notes refer to the Income Tax Act 2007 (c.3)  
which received Royal Assent on 20 March 2007*

85. In the source legislation there were some contexts in which “total income” was used in a different sense (eg in section 1 of ICTA, where it meant what is defined in Step 2 as “net income”). But in this Act it is used consistently to denote this first stage result. And the consequential amendments to other legislation in Schedule 1 ensure that it will always be used in this sense elsewhere.
86. *Step 2* deals with those reliefs (other than personal allowances) which are given by deduction from income.
87. Most of the reliefs listed in section 24 may be deducted from any type of income. But some may only be deducted from certain components of total income. See section 25(3).
88. Step 2, combined with the provisions about the reliefs themselves and the rules in section 25 about the way in which deductions are made, ensures that the reliefs are allowed in the proper way to arrive at “net income”.
89. It is important that this is done by reference to the components of total income, to pave the way for Step 4.
90. *Step 3* deals with the deduction of the personal allowance and blind person’s allowance from the components of net income. This step only affects individuals. The rule that these deductions come last is based on section 835(5) of ICTA.
91. Again, it is important that this is done by reference to the components of total income, to pave the way for Step 4.
92. *Step 4* applies the rates of tax specified in Chapter 2 (and, where the taxpayer is a trustee, the relevant Chapters of Part 9 of this Act) to the amounts of the components remaining after Step 3.
93. *Step 5* adds together the amounts of tax on each component.
94. *Step 6* then deducts any tax reductions. These are listed in section 26. Further rules about how these tax reductions are made are in sections 27 to 29.
95. *Step 7* then adds on certain other amounts of income tax for which a taxpayer may be liable, as listed in section 30.

***Section 24: Reliefs deductible at Step 2***

96. This section lists all the reliefs that may be deducted from components of total income at Step 2 of the calculation. It is based on many provisions in the source legislation.
97. The section is arranged to highlight those reliefs which apply only to individuals, and to avoid duplication of references to particular reliefs.
98. This section, and others in the Chapter, contains lists of provisions some of which are in this Act and some which are elsewhere. Such lists are arranged by reference to the order that the provisions appear in this Act and by reference to the date on which other legislation was enacted.
99. The entries in the lists are not each given their own sub-paragraph reference. This will reduce the scope for confusion should any amendments need to be made to the lists in future Finance Acts.
100. One of the reliefs deducted at this step is for annual payments and patent royalties under Chapter 4 of Part 8. See *Change 81* in Annex 1 and the overview commentary on Chapter 4 of Part 8.
101. The opportunity has been taken to clarify the way in which reliefs under sections 446 and 454 of ITTOIA work. See the amendments made to those sections in Schedule 1.

102. The list of reliefs does not include section 811 of ICTA. That section allows a reduction of a component of income for foreign tax suffered on that income where no credit is available. It has been excluded on the basis that the relief reduces the amount of income from the source (and where appropriate can create or augment a trading loss) before it enters into the calculation in section 23.
103. For the same reason, the list does not include relief under section 798C of ICTA which was introduced by FA 2005.
104. For the rules about what (if anything) may be done with any excess relief over the amount of income from which it can be deducted it is necessary to refer to the particular provisions dealing with the relief concerned. But see also the provisions of section 25.

### ***Section 25: Reliefs and allowances deductible at Steps 2 and 3: supplementary***

105. This section contains rules about the way deductions are made against components of income. It is based on section 835(3), (4) and (5) of ICTA.
106. The main rule, in *subsection (2)* is that deductions are allowed in the way that results in the greatest reduction of income tax liability.
107. This rule means that where a deduction may be set against more than one component of income or there are two or more deductions available, they are allowed in the way that produces the least income tax liability. The order in which deductions that are allowable against a particular component of income are made under Step 2 cannot affect the liability for the tax year concerned. If there is sufficient income then all deductions are allowed in full. If there is insufficient income then unrelieved income is nil. But the order in which they are made can affect the amount of relief that is available to carry forward or back (in the case of reliefs where that is a possibility).
108. *Subsection (3)* is a signpost to provisions that modify the rule in subsection (2), in particular in the case of reliefs given only against certain types of income.
109. *Subsections (4) and (5)* ensure that a deduction is only given to the extent that there is income to absorb the deduction, taking into account deductions already made.
110. Some, but not all, of the source provisions contain the rule that income cannot be reduced below nil, but even where not explicitly mentioned, it has always been the accepted practice that a deduction can only be made from income to the extent that there is income to absorb the deduction. The position is now explicit for all income deductions.
111. A similar point arises in connection with deductions that operate as tax reductions. See the commentary on section 29.

### ***Section 26: Tax reductions***

112. This section lists the tax reductions that are allowed in terms of tax at Step 6 of the calculation in section 23. It is based on many provisions in the source legislation.
113. The approach adopted to the layout of this section is in line with that adopted in relation to section 24.
114. One of the tax reductions is for relief under section 539 of ITTOIA. See *Change 3* in Annex 1.

### ***Section 27: Order of deducting tax reductions: individuals***

115. This section provides rules about the order in which tax reductions are to be given for individuals. It is based on many provisions in the source legislation.

116. In the source legislation, many of the provisions dealing with tax reductions contain rules which specify how that reduction interacts with other tax reductions. These rules, so far as they relate to individuals, are brought together in *subsections (4) to (6)*.
117. But those rules are not comprehensive. As well as bringing the existing rules together into one place, the section introduces a new rule in *subsections (2) and (3)* providing that, subject to the following subsections, the reductions are allowed in the way that gives the greatest reduction in liability for the year. See *Change 4* in Annex 1.
118. Subsections (4) and (5) list those provisions where rules setting out some priority are contained in the source legislation. Subject to the point mentioned in the next paragraph, the provisions are listed in the order in which the source rules require the reliefs to be allowed. If any other reduction (except double taxation relief) is due then it may be allowed at whatever stage (before or after any of the provisions in subsection (5)) gives the maximum reduction.
119. It is clear from section 256 of ICTA that reductions under Chapter 1 of Part 7 of ICTA are given after all other reductions (except double taxation relief), but no order of priority between the two reductions within that Chapter is given. Since the reduction for married couples and civil partners is transferable whereas the reduction under section 273 of ICTA is not, it will always be beneficial if any reduction under section 273 of ICTA comes first. Subsection (5) reflects this. See *Change 4* in Annex 1.

### ***Section 28: Order of deducting tax reductions: other persons***

120. This section provides rules about the order in which tax reductions are to be given for persons other than individuals. It is based on sections 790(3) and 796(1) of ICTA and sections 26 and 27(1) of FA 2005.
121. There are fewer tax reductions available than for individuals, so the rules are less complex. *Subsection (2)* corresponds to section 27(2) in providing a new rule that the reductions are allowed in the way that gives the greatest reduction in liability. See *Change 4* in Annex 1 and the commentary on section 27.
122. *Subsection (5)* is a special rule concerning the tax reduction given to certain trustees under section 26 of FA 2005.

### ***Section 29: Tax reductions: supplementary***

123. This section contains additional rules about the giving of tax reductions. It is based on a number of provisions in the source legislation.
124. *Subsections (2) and (3)* ensure that a reduction is only given to the extent that there is tax to absorb the reduction, taking into account reductions already made. Many of the source provisions contain the rule that the tax cannot be reduced below nil (see for example section 256(2) of ICTA). And top-slicing relief under section 535 of ITTOIA cannot give a greater tax reduction than the tax increase resulting from including the gain concerned within total income. The position is now explicit for all tax reductions. See the commentary on section 25.
125. *Subsection (4)* ensures that the rules in this section limiting the amount of a tax reduction by reference to the amount of tax against which it is set will not affect the calculation under section 796 of ICTA of the limit on income tax credit relief for double taxation. It also ensures that those rules will not affect the operation of any other provisions limiting the amount of a tax reduction.
126. *Subsection (5)* ensures that any reference in this Chapter to double taxation relief under section 788 of ICTA brings in relief allowed in accordance with arrangements made under that section.

***Section 30: Additional tax***

127. This section lists provisions under which amounts of tax are added to the tax liability at Step 7 of the calculation. It is based on a number of provisions in the source legislation.

***Section 31: Total income: supplementary***

128. This section provides supplementary rules, in particular about the tax year in which income received under deduction of tax or with a tax credit is to be taken into account. It is based on section 835(6) and (7) of ICTA.

***Section 32: Liability not dealt with in the calculation***

129. This section lists income tax liabilities not dealt with in the calculation. It is new.
130. These liabilities arise in connection with:
- the recovery of excessive relief (eg the withdrawal or reduction of EIS relief or the recovery of excess credit for overseas tax) where the taxpayer's self-assessment for the tax year is final;
  - deduction of tax at source (eg Chapters 15 to 17 of Part 15 and the reverse charge provisions), where the liability is not in respect of the person's own liability; and
  - stand-alone charges (eg Chapter 1 of Part 13, or in relation to the administration of pension schemes).