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

Schedule 1: Consequential Amendments

Part 1: Income and Corporation Taxes Act 1988

Paragraph 3: section 1A of ICTA

3341. Section 1A of ICTA is an income tax only provision. As this section is primarily concerned with rates of tax it is not rewritten.

3342. The repeal of Schedule F and Schedule D Cases III, IV, V and VI (for income tax purposes) means that it is now possible to restructure section 1A of ICTA to identify more clearly the types of income within the scope of the section. So, for example, instead of bringing in *all* income chargeable under Schedule D Case III, and then excluding certain items, it is now possible to focus directly on the income within section 1A of ICTA.

3343. As a result of the revised approach, section 1A(4)(b) of ICTA – dealing with estate income chargeable under section 695(4)(b) or 696(6) of ICTA – can be repealed. Similarly, it is not necessary to retain section 1A(7) of ICTA which effectively brings purchased life annuities within the scope of section 1A of ICTA – such purchased life annuities are now brought in by the consequential amendment to section 1A(2)(a) of ICTA.

Paragraph 7: section 9 of ICTA

3344. This Act deals in substance with income tax only. As a result the income tax and corporation tax codes will be separated to a much greater extent than in the source legislation.

3345. Corporation tax law, in statute, is made up of a combination of express corporation tax provisions and applied income tax principles, law and practice.

3346. The income tax principles, law and practice are applied by section 9 of ICTA .

3347. Section 9 of ICTA, so far as it operates on statutory provisions, operates in the source legislation on both income tax provisions that are rewritten in this Act and income tax provisions that are not rewritten in this Act (for example, parts of ITEPA). It also extends to case law and practice.

3348. The amendments to section 9 of ICTA maintain this approach in the context of the greater separation of the two codes. But section 9 of ICTA does not operate on the provisions in this Act to convert them into provisions of the Corporation Tax Acts, see section 881.

Paragraph 9: section 18 of ICTA

3349. Paragraph 9 amends section 18 of ICTA so that subsections (1) to (4) apply only for corporation tax purposes. The income tax aspects of this provision are rewritten as follows:

Cases I and II

The income charged under Schedule D Case I or II in the source legislation is rewritten for income tax purposes in Chapter 2 of Part 2 of this Act.

Case III

3350. The income charged under Schedule D Case III in the source legislation is rewritten for income tax purposes in the following places in this Act:

- Part 4 - Chapter 2 (interest), Chapter 7 (purchased life annuity payments), Chapter 8 (deeply discounted securities), Chapter 10 (distributions from unauthorised unit trusts); and
- Part 5 - Chapter 2 (receipts from intellectual property) - but royalties only, Chapter 4 (certain telecommunication rights: non-trading income) and Chapter 7 (annual payments not otherwise charged).

3351. The corporation tax version of Schedule D Case III in section 18(3A) of ICTA will continue to work for corporation tax.

Cases IV and V

3352. Except in respect of foreign dividends, the charge on foreign income under these Cases in the source legislation has been integrated with the charge on equivalent types of UK income in this Act for income tax purposes. The charge under Case V in the source legislation on foreign dividends is rewritten for income tax purposes in Chapter 4 of Part 4 of this Act. The Cases continue to operate as amended by section 18(3A) to (3E) of ICTA for corporation tax purposes.

Case VI

3353. The provisions which are rewritten in this Act for income tax purposes, and which charge income to income tax under Schedule D Case VI in the source legislation, have been replaced by charges on each type of income. See the following Parts of this Act:

- Part 2 – Chapter 2 (income taxed as trade profits, including wayleaves), Chapter 17 (adjustment income: trades, professions and vocations) and Chapter 18 (post-cessation receipts: trades, professions and vocations);
- Part 3 – Chapter 7 (adjustment income: UK property businesses), Chapter 8 (rent receivable in connection with a UK section 12 concern), Chapter 9 (rent receivable for UK electric-line wayleaves) and Chapter 10 (post-cessation receipts);
- Part 4 – Chapter 2 (interest, including funding bond interest), Chapter 9 (gains from contracts for life insurance etc.), Chapter 11 (transactions in deposits) and Chapter 12 (disposals of futures and options involving guaranteed returns); and
- Part 5 – section 579 (royalties and other income from intellectual property), section 583 (income from disposals of know-how), section 587 (income from sales of patent rights), Chapter 3 (films and sound recordings: non-trade businesses), Chapter 4 (certain telecommunication rights: non-trading income), Chapter 5 (settlements: amounts treated as income of settlor), section 682(3) (estates in administration: assessments, adjustments and claims after the administration period) and Chapter 8 (income not otherwise charged).

3354. Additionally, amendments have been made to all of the Schedule D Case VI provisions in ICTA and other enactments which are not being rewritten in this Act but which apply for income tax purposes (see the table in Part 1 of section 836B of ICTA, inserted by paragraph 339 of this Schedule, referred to in the amendment in paragraph 167 of this Schedule for section 392 of ICTA). The amendments remove references to income tax being charged under Schedule D Case VI and create free standing income tax charges. The Schedule D Case VI references have been retained where needed for corporation tax purposes.

3355. Some of the Schedule D Case VI provisions which are not rewritten in this Act are of an administrative nature. These provisions typically withdraw reliefs and operate under the source legislation by way of an assessment under Schedule D Case VI (see particularly section 30(4) of TMA, sections 307(1), 384(8), 384A(6) and 703(3) of and paragraph 4(2) of Schedule 15B to ICTA and paragraph 27(2) of Schedule 16 to FA 2002). These provisions are rewritten as simple assessments (in the case of section 30(4) of TMA, by the omission of subsection (4)). This is because the provisions that apply generally to income and amounts treated as income charged to income tax under Schedule D Case VI (sections 18, 59, 69 and 392 of ICTA) have no application to these provisions.

Paragraph 10: section 20 of ICTA

3356. Section 20 of ICTA, Schedule F, is rewritten in Chapter 3 of Part 4 of this Act (dividends etc. from UK resident companies etc.). It is repealed for all tax purposes.

Section 20(1) paragraph 1 of ICTA – the Schedule F charging provision

3357. Section 20(1) paragraph 1 of ICTA is an income tax only provision. It therefore applies *directly* to persons subject to income tax (unless they are dealers or certain individual members of Lloyd's in which case they are taxed under Schedule D Case I or II).

3358. As an income tax only provision, section 20(1) paragraph 1 of ICTA does not directly apply to persons subject to corporation tax. This is clear from the wording of section 20(1) paragraph 1 of ICTA itself but confirmation of this is also given by section 6 of ICTA.

3359. Therefore, section 20(1) paragraph 1 of ICTA could only apply to corporation tax *indirectly*, that is, via section 9 of ICTA.

3360. However, section 9 of ICTA is subject to exceptions. On one interpretation of the legislation section 208 of ICTA is one such exception.

3361. Applying this interpretation, where section 208 of ICTA applies section 9 of ICTA does not and so section 20(1) paragraph 1 of ICTA cannot apply.

3362. An alternative interpretation is that section 208 of ICTA is not an exception to section 9 of ICTA but an exemption from corporation tax on dividends and other distributions charged under Schedule F.

3363. Applying this interpretation, section 9 of ICTA applies and so section 20(1) paragraph 1 of ICTA applies, but section 208 of ICTA prevents the dividend or other distribution from being chargeable to corporation tax.

3364. On either interpretation, if section 208 of ICTA applies there is no liability under section 20(1) paragraph 1 of ICTA. Conversely, if section 208 of ICTA does not apply, there is.

3365. There are three exceptions to section 208 of ICTA. These are:

- section 95(1A)(c) of ICTA (dealers);
- section 219(4A) of FA 1994 (Lloyd's underwriters); and

- section 434(1) of ICTA (franked investment income and life assurance profits).

3366. However, in each case Schedule F does not apply. Instead, dividends and other distributions are taxed under Schedule D Case I or Schedule D Case VI.

3367. There are therefore no instances where a body corporate acting in a beneficial capacity is chargeable to corporation tax under section 20(1) paragraph 1 of ICTA.

Section 20(1) paragraph 2 of ICTA – the income chargeable

3368. Section 20(1) paragraph 2 of ICTA determines the income chargeable and is expressed to apply for "all purposes of the Tax Acts". It therefore applies directly to a company subject to corporation tax unless there is an express provision to the contrary.

3369. Section 20(1) paragraph 2 of ICTA is expressly disapplied in the case of:

- dealers;
- Lloyd's underwriters; and
- certain life assurance companies.

3370. Where section 20(1) paragraph 2 of ICTA might otherwise be relevant, that is, in order to establish that income is the aggregate of the dividend etc and the tax credit (for example, under section 13 of ICTA (small companies' relief), in connection with the surplus ACT rules etc), the relevant legislation uses the term "franked investment income". Franked investment income is defined in almost identical terms as section 20(1) paragraph 2 of ICTA.

3371. Section 20(1) paragraph 2 of ICTA therefore serves no practical purpose in a corporation tax context.

Section 20(2) of ICTA –priority provision

3372. Section 20(2) of ICTA applies to a distribution "which is chargeable under Schedule F". It does not therefore apply in a corporation tax context because section 20(1) paragraph 1 of ICTA does not apply.

Section 20(3) of ICTA - signpost

3373. In a corporation tax context, section 20(3) of ICTA introduces Part 6 of ICTA but this introduction is no longer required.

Replacement expressions for special tax rates

3374. The following replacement terms are used:

- Schedule F ordinary rate becomes "dividend ordinary rate";
- Schedule F upper rate becomes "dividend upper rate"; and
- Schedule F trust rate becomes "dividend trust rate".

Paragraph 36: section 60 of ICTA

3375. This paragraph omits section 60 of ICTA and the section is repealed by Schedule 3 to this Act.

3376. Section 60(4) of ICTA deals with the death of a taxpayer. It ensures that on the death of a person carrying on a trade the necessary cessation adjustments can be made, and the tax collected from the personal representatives.

3377. The rule in section 60(4) of ICTA dates from the time when adjustments on cessation could involve not only an adjustment for the year of death (the assessment for which might already have been made on a previous year basis) but also adjustments to the two previous years to increase the amount of the assessments to the profits of those years on a current year basis.

3378. Under Self Assessment any return of income for the year of death will naturally take account of the death. And there is no question of adjusting assessments for previous years on account of the death.

3379. The general rule in section 74 of TMA (that the personal representatives inherit the tax liabilities of the deceased) is enough. There is no need for the special rule in section 60(4) of ICTA for trade profits.

3380. See also the commentary on the repeal of section 113(6) of ICTA.

Paragraph 43: section 71 of ICTA

3381. This paragraph omits section 71 of ICTA and that section is repealed in Schedule 3 to this Act.

3382. Section 71 of ICTA applies to all the Cases of Schedule D when a preceding year basis of assessment applies. It provides that a person will remain chargeable in a year when no income from the relevant source arises. It is based on section 22 of FA 1928 which was enacted in response to the House of Lords decision in Whelan v Henning (1926), 10 TC 263 to the effect of "no income in year of assessment, no liability to tax".

3383. There is no longer a preceding year basis of assessment for any Schedule D Case. So the provision is redundant.

Paragraph 45: section 74 of ICTA

3384. Section 74(1) of ICTA lists various items in respect of which no deduction is allowed in computing profits to be charged under Schedule D Case I or II.

3385. Section 74(1)(b) of ICTA prohibits deductions in respect of expenditure on "maintenance of the parties, their families or establishments, or any sums expended for any other domestic or private purposes distinct from the purposes of the trade, profession or vocation".

3386. Section 74(1)(b) of ICTA is not rewritten for income tax purposes because the deductions which it prohibits are covered by section 34 which rewrites the general prohibition on deductions not "wholly and exclusively laid out for the purposes of the trade, profession or vocation" in section 74(1)(a) of ICTA. And because it applies only to individuals, there is no need to preserve section 74(1)(b) of ICTA. It is therefore omitted.

3387. Section 74(1)(h) of ICTA prohibits deductions for interest forgone on capital used in the trade or in improving the trade premises. It is unlikely that any accounts drawn up in accordance with generally accepted accounting practice would include a deduction for notional interest. Section 74(1)(h) of ICTA is not rewritten for income tax purposes as it is considered to be redundant.

3388. Section 74(1)(k) of ICTA prohibits deductions for "any average loss beyond the actual amount of loss after adjustment". This rule applies to the practice in shipping and aviation trades of sharing between all parties with a financial interest in a vessel and its cargo the financial loss incurred where *part* of a vessel or its cargo is lost or damaged in an attempt to save the vessel, the crew and passengers or the rest of the cargo. The term "average loss" is applied to the share of the loss allocated to each party. The amount of the average loss "after adjustment" may not be known for some years after the actual loss has occurred.

3389. Section 74(1)(k) of ICTA is not rewritten for income tax purposes. This allows the tax treatment of the average loss to follow the generally accepted accountancy practice in such cases. This is to make a provision in the year of loss and to review that provision in subsequent years.

3390. Section 74(1)(m) of ICTA prevents a deduction for any annuity and other annual payment "payable out of the profits". Because the rule applies only to amounts payable "out of the profits", it has no application to the calculation of those profits. The rule is not rewritten for income tax purposes.

3391. Section 74(1)(o) of ICTA prevents a deduction in calculating trade profits for any interest that has qualified for Mortgage Interest Relief At Source. When MIRAS was available for mortgage interest generally this rule against double deductions served an important function. Since 1999 MIRAS has been available only on loans to buy a life annuity and secured on the private residence of a person aged 65 years or over. The relief is given only to loans in existence on 9 March 1999 or replacement loans.

3392. It is very unlikely that any interest would satisfy the conditions to qualify both for MIRAS and as a deduction in calculating trade profits. For this reason this Act does not rewrite section 74(1)(o) of ICTA.

Paragraph 53: section 82 of ICTA

3393. This paragraph omits section 82 of ICTA and the section is repealed in Schedule 3 to this Act.

3394. There are two reasons for repealing this section:

- the section no longer achieves its original purpose; and
- the section is, in part, out of step with modern tax principles.

3395. Section 82 of ICTA is a complex provision which prevents a deduction in computing trade profits for payments of annual interest to a non UK resident except in two circumstances.

3396. The first is when the payer has made the payment as required by section 349(2) of ICTA under deduction of tax and has accounted to the Inland Revenue for the tax: section 82(1)(a) of ICTA. (This is interpreted to include payments within section 349(2) of ICTA made gross solely because of a double taxation agreement.)

3397. The second is when the interest is not within section 349(2) of ICTA but is paid by a UK resident trader under a liability incurred exclusively for the purposes of the trade. The interest has to be payable and paid outside the United Kingdom and either incurred for the purposes of activities outside the United Kingdom or paid in foreign currency: section 82(1)(b) of ICTA.

3398. Section 82 of ICTA originates from FA 1949. At the time it was introduced annual interest was not a permitted trading deduction: relief was obtained by the payer deducting income tax before paying the interest. But in certain circumstances, notably where the source of the interest was outside the United Kingdom, the payer could not legally deduct tax and could therefore get no effective relief for the interest. So what is now section 82(1)(b) of ICTA was introduced to give relief by allowing the gross payment as a Schedule D Case I or II deduction.

3399. FA 1969 ended deduction of tax at source from most interest paid and with it the general relief for interest paid that the deduction at source system gave. New rules were introduced which gave relief for interest only on loans for particular purposes, mainly the purchase or improvement of land. Where, however, the interest was for a trading purpose it could be deducted in computing trading profits.

3400. The FA 1969 reforms preserved deduction of tax at source for payments of annual interest only in a limited number of circumstances and the tax deducted had to be paid over to the Inland Revenue (rather than be retained by the payer). One such circumstance was when it was paid to a person whose usual place of abode was outside the United Kingdom. It was recognised that what is now section 82(1)(b) of ICTA could no longer operate as an exception to the former general rule against allowing interest as a deduction in computing trading profits: that rule had gone. But it was preserved in a form which allowed a deduction only when its original conditions were satisfied. In addition, what is now section 82(1)(a) of ICTA was grafted onto it as new legislation to take account of the new deduction at source rule.

3401. The current position is that what started life as a permissive provision, allowing relief as a trading deduction in circumstances where none would otherwise have been available, has become a restrictive one. It restricts relief where, on general principles, it would otherwise be due: interest paid gross would normally have to satisfy only the "wholly and exclusively" test in section 74(1)(a) of ICTA to be deductible. The linking of a right to deduction as a trading expense with the obligation to deduct tax on payment does not reflect modern principles of determining deductibility of trade expenses.

3402. The section no longer fulfils any practical purpose and is therefore redundant.

Paragraph 60: section 86 of ICTA

3403. This section allows a person carrying on a trade to deduct the cost of an employee who is seconded to a charity or educational establishment in calculating the profits of the trade.

3404. Section 86(5) of ICTA lists educational establishments in Scotland for the purposes of relief under section 86 of ICTA. Section 86(5)(d) of ICTA refers to "a self-governing school within the meaning of the Self-Governing Schools etc (Scotland) Act 1989".

3405. Section 86(5)(d) of ICTA is not rewritten for income tax purposes because such schools were abolished on 1 April 2003. But there is a transitional rule in paragraph 21 of Schedule 2 to this Act to deal with the case of a secondment being relevant to a period of account ending on or after 6 April 2005.

Paragraph 65: section 89 of ICTA

3406. Section 89 of ICTA is not rewritten for income tax purposes. See the commentary on section 35 and *Change 7* in Annex 1.

Section 92 of ICTA (no paragraph in Schedule 1)

3407. Section 92 of ICTA applies to regional development grants under Part 2 of the Industrial Development Act 1982. The Industrial Development Act 1982 was repealed by the Statute Law (Repeals) Act 2004 with effect from 22 July 2004. No applications under Part 2 of the 1982 Act could be made after 31 March 1988 and there are no payments outstanding in respect of grants made before that date. So section 92 of ICTA is not rewritten for income tax purposes.

Paragraph 94: section 113 of ICTA

3408. This paragraph omits section 113 of ICTA and the section is repealed in Schedule 3 to this Act.

3409. Section 113(1) of ICTA applies to trade profits. But it is extended to property businesses by section 21B of ICTA. It ensures that a trade is treated as ceasing when there is a change in the persons carrying it on. The need for the rule arises from the fact that some rules in ICTA are expressed in terms of the commencement and cessation of a trade, rather than the position of the person carrying it on.

3410. The rewritten basis period rules in Chapter 15 of Part 2 of this Act are expressed in terms of the person carrying on the trade. Other rules that depend on the commencement or cessation of a trade are also rewritten in terms of the person carrying on the trade.

3411. So there is no need for a special rule deeming there to be a cessation where the trade is carried on by a successor.

3412. In many cases, a rule in ICTA is explicit that a change in the persons carrying on a trade to which section 113(1) of ICTA applies is to be treated as a cessation for the purposes of the rule: for instance, the post-cessation receipts rules in sections 103 to 109A of ICTA (see section 110(2)(a) of ICTA).

3413. In other cases there is no explicit indication that section 113(1) of ICTA applies to treat the trade as ceasing. In each of the following sections the rewritten rule makes it clear that the trade is not treated as ceasing unless there is a complete change in the persons carrying it on. This retains the effect of section 113(1) of ICTA as limited by section 113(2):

- Section 77: Payments in respect of employment wholly in employer's trade;
- Section 79: Additional payments;
- Section 173: Valuation of trading stock on cessation; and
- Section 182: Valuation of work in progress on cessation.

3414. Section 113(6) of ICTA deals with the death of a taxpayer. It ensures that on the death of a person carrying on a trade the necessary cessation adjustments can be made and the tax collected from the personal representatives.

3415. The rule in the subsection dates from the time when adjustments on cessation could involve not only an adjustment for the year of death (the assessment for which might already have been made on a previous year basis) but also adjustments to the two previous years to increase the amount of the assessments to the profits of those years on a current year basis.

3416. Under Self Assessment any return of income for the year of death will naturally take account of the death. And there is no question of adjusting assessments for previous years on account of the death.

3417. The general rule in section 74 of TMA (that the personal representatives inherit the tax liabilities of the deceased) is enough. There is no need for the special rule in section 113(6) of ICTA for trade profits (or property income, to which it is applied by section 21B of ICTA).

3418. See also the commentary on the repeal of section 60(4) of ICTA.

Paragraph 106: section 122 of ICTA

3419. In section 122(2) of ICTA the reference to section 121(2) of ICTA has been amended to "section 121(3)". This corrects a minor error in ICTA.

3420. Section 122(4) of ICTA has been omitted. It became redundant when FA 1995 removed the requirement to deduct income tax from the payment of rent within section 119 of ICTA.

Paragraph 141: section 333 of ICTA

3421. Section 333 of ICTA is rewritten in Chapter 3 of Part 6 of this Act but section 333(4)(e) of ICTA allows the regulations to include provisions generally for the administration of corporation tax. Since this cannot be rewritten in this Act and a repeal of all of section 333 of ICTA but for that small part would be ungainly this new section has been substituted.

Paragraph 146: section 347A of ICTA

3422. In the source legislation, section 347A(1) of ICTA makes provision about the tax treatment of certain annual payments both from the perspective of the payer and the recipient. Section 347A(1) of ICTA provides that a payment to which the section applies is not a charge on income for the person paying it. Section 347A(1)(a) of ICTA then denies the payer a deduction from his income in respect of the payment and section 347A(1)(b) of ICTA deals with the recipient and gives the recipient an exemption from income tax or corporation tax (as the case may be).

3423. Section 347A(2) of ICTA describes the payments to which section 347A(1) of ICTA applies for both these purposes.

3424. The income tax exemption is rewritten in Chapter 8 of Part 6 of this Act. So section 347A(1)(b) of ICTA has been amended by this Schedule (see paragraph 146(2)) so that section 347A(1)(b) of ICTA is an exemption from corporation tax only.

3425. Further, the Schedular/Case system of classification of income has been abolished for income tax purposes. So section 347A(2) of ICTA now applies to annual payments which, but for the exemption, would be within the charge to corporation tax under Schedule D Case III of Schedule D (except to the extent those payments are excluded by subparagraphs (a) to (d)). And a new subsection "(2A)" has been inserted by this Schedule (see paragraph 146(3)) to deal with the income tax equivalent of section 347A(2) of ICTA (as amended). Because the conditions in section 347A(2) of ICTA are rewritten in sections 727 to 729 of this Act, new subsection (2A) refers to the payments which are exempt from income tax as a result of section 727 of this Act.

3426. This Schedule also omits section 347A(5) of ICTA (see paragraph 146(4)) and the subsection is repealed by Schedule 3 to this Act.

3427. Section 347A(5) of ICTA is rewritten so far as deductions under sections 65(1)(b) and 68(1)(b) of ICTA are concerned. The reference to section 355 of ITEPA in section 347A(5) of ICTA is not rewritten. Section 347A(5) of ICTA denies a deduction for an annual payment paid out of certain foreign income if that annual payment would not have been within the charge to tax if the payment had arisen in the United Kingdom.

3428. Section 355 of ITEPA allows an employee to claim a deduction against foreign earnings for certain payments made abroad which if the payments had been made in the United Kingdom would have given rise to tax relief. If there is no such tax relief in the United Kingdom, section 355 of ITEPA effectively denies a deduction. So in the context of section 347A(5) of ICTA the reference to section 355 of ITEPA is superfluous.

Paragraph 147: section 348 of ICTA

3429. Paragraph 147(3) of this Schedule inserts a new subsection into section 348 of ICTA. It is based on sections 233(1)(c), 249(4)(c), 249(6)(c), 421(1)(c), 547(5)(c) and 699A(6) of ICTA. The new subsection applies for the purposes of section 348 and 349 of ICTA. The new subsection gathers together the provisions which would otherwise be "stranded" in the source legislation about amounts not being brought into charge to tax for the purposes of sections 348 and 349.

Paragraph 148: section 349 of ICTA

3430. The new section 349ZA(3) of ICTA defines "the net amount of the proceeds or instalment" for the purposes of the application of section 349 of ICTA in the context of section 524 of ICTA (taxation of receipts from sale of patent rightrs). Any incidental expenses of the sale which are deducted before payment are taken into account for this purpose. The source legislation does not explicitly mention incidental expenses of sale, although the words "net proceeds of sale" in section 524(1) of ICTA imply that some deduction is available.

3431. The reference in section 524(3) of ICTA to the net proceeds of sale had significance for the purposes of the rule that the payer must deduct income tax from the capital sum comprised in the net proceeds of sale. In deducting tax, the payer is required to leave out of account certain matters that affect the seller's ultimate liability to tax. Although the seller's liability may be reduced if he bought the rights for a capital sum, such a reduction does not affect the amount of tax that is to be deducted by the payer (see section 524(7) to (9) of ICTA). And if the seller makes an election to spread his tax liability over six years, that election does not affect the amount of tax that is to be deducted by the payer (see section 524(4)(a) of ICTA).

3432. These rules ensure that the payer is not required, in deducting tax, to take account of matters that may be outside his knowledge. Against this background, it makes sense for the rule requiring the deduction of income tax at source to require the payer to take into account only those incidental expenses that are deducted before payment of the sale proceeds. The payer would otherwise be required to take into account matters that he could not readily ascertain. The rule requiring the payer only to take account of those incidental expenses that are deducted before payment does not affect the seller's ultimate liability to tax.

Paragraph 167: section 391 of ICTA

3433. Section 391 of ICTA provides relief for the losses of a trade, profession or vocation taxed under Schedule D Case V. Such losses can be used only against the losses of another Case V trade, profession or vocation (or certain income within ITEPA).

Paragraph 168: section 392 of ICTA

3434. The amendment of section 392 of ICTA by paragraph 168 of this Schedule preserves the loss regime that applies to income that is, in the source legislation, income within Schedule D Case VI.

3435. Section 392 of ICTA is an income tax only provision that provides relief for losses in income types that, in the source legislation, are charged to tax under Schedule D Case VI. It provides the only avenue of relief available in respect of such losses.

3436. In the source legislation the charge under Schedule D Case VI comprises three elements:

- a cornerstone, "sweeping-up" charge that catches any income not caught by the other Schedules and Cases;
- a range of specific charges on miscellaneous transactions and receipts; and
- a range of specific charges of an administrative nature to recover excess relief or undercharges of tax.

3437. On account of its breadth and diversity, Schedule D Case VI is often referred to as a "sweep-up" charge. Subject to some important qualifications mentioned below, the purpose of section 392 of ICTA is to allow set-off of losses arising from these different types of swept-up income against swept-up profits. Losses are allowed, and profits relieved, on an undifferentiated basis. That is, once within section 392 of ICTA, a loss can be set off against a profit of any sort (provided it is a Schedule D Case VI profit or, in addition, since ITEPA, certain pension profit) and is not limited to set off only against profit of the same type.

3438. But not all of the items within the Schedule D Case VI charge fall automatically within the section 392 of ICTA loss regime because not all are inherently capable of producing a loss. And section 392 of ICTA requires the presence of a "transaction" from which the loss or profit must arise.

3439. If there *is* a transaction, section 392 of ICTA provides:

- (where a loss can arise) for the loss to be allowable provided that, had the transaction from which it arises been profitable, that profit would have been chargeable under Schedule D Case VI; and
- for the set-off of such a loss against the profits of any other transactions chargeable under Schedule D Case VI (or against certain pension income chargeable under ITEPA) for the current year and carry-forward of any surplus against similar profits of later years.

3440. This Act makes wide-ranging changes in the way Schedule D Case VI income is charged. Specifically:

- the labels "Schedule D" and "Case VI" disappear;
- certain income charged under Schedule D Case VI is transferred to other heads of charge such as trading income or property income;
- other income is charged under various bespoke sections in Parts 4 and 5; and
- there is a pure "sweep-up" section in Part 5 (section 687).

3441. The amendment of section 392 of ICTA will ensure that, notwithstanding these recategorisations, the scheme of loss relief provided by the source legislation will continue unchanged. The table in the new section 836B of ICTA lists the provisions that, as they apply before the commencement of this Act, contain a Schedule D Case VI charge and to which section 392 of ICTA is, therefore, potentially relevant. Provisions of an administrative nature to recover excess relief and undercharges of tax are excluded: see the commentary on the amendment in Schedule 1 to this Act of section 18, Schedule D Case VI, of ICTA . These are:

FA 1950

- section 40(3) (recovery of relief);

TMA

- section 30(4) (recovery of over-repayment of tax; repealed, see paragraph 15 of this volume of Explanatory Notes and Schedule 3);

ICTA

- section 118ZH(3) (recovery of relief);
- section 307(1) (withdrawal of relief not due);
- section 384(8) (withdrawal of certain loss relief);
- section 384A(6) (withdrawal of certain loss relief);
- section 399(3) (withdrawal of certain loss relief);
- section 703(3) (recovery of inappropriate tax repayment);
- section 788(7) (double taxation relief adjustment);
- section 790(11) (double taxation relief adjustment);
- paragraph 4 of Schedule 15B (recovery of venture capital trust relief); and

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- paragraph 27(2) of Schedule 16 (withdrawal of community investment tax relief).

3442. There is one Schedule D Case VI provision in the source legislation where the position in the source legislation has not been preserved. That is section 127 of ICTA (enterprise allowance) which is rewritten as section 207 in Chapter 15 of Part 2 of this Act. The amount charged under Schedule D Case VI in the source legislation is dealt with in this Act as part of the calculation of trade profits: see *Change 53* in Annex 1. So it does not need to be included in the amendment of section 392 of ICTA.

Section 443 of ICTA (no paragraph in Schedule 1)

3443. Section 443 of ICTA is repealed for income tax purposes. This is achieved by retaining the text of this provision, as Schedule D Cases I and VI will apply solely for corporation tax purposes after this Act.

3444. Section 443 of ICTA deals with the case in which the proceeds of a life assurance policy are paid out in the form of assets and not in cash. When section 443 of ICTA was introduced as section 35 of FA 1967 the section governed the treatment of the assets for the purposes of both capital gains and short term gains (Schedule D Case VII).

3445. At that time the disposal by the insurance company would usually be taxed as a capital gain. The main purpose of the 1967 legislation was to make clear that the disposal was at market value. It seems the reference to Schedule D Cases I, VI and VII was to deal with the less common case in which the corporation tax charge on the company on disposal was taxed under these Cases.

3446. The section also put it beyond doubt that the base cost of the asset to the policy holder was market value either for capital gains or short term gains purposes.

3447. The reference to short term gains was repealed in 1971. And with the consolidation of the capital gains tax code, the capital gains tax rule can now be found in section 204(3) of TCGA. These changes to the section mean that, in the income tax context, section 443 of ICTA now deals only with the policy holder’s acquisition of the assets for the purposes of Schedule D Cases I and VI. But of course the mere acquisition of the assets cannot give rise to any liability under Schedule D Cases I or VI.

3448. The value of the assets acquired would be reflected in a Schedule D Case I computation only if the policy itself were held as trading stock. In that unlikely event the Inland Revenue is content to follow generally accepted accounting practice in calculating the profits of the trade.

3449. It is very difficult to envisage any circumstances in which the disposal of assets acquired on the maturity of an insurance policy would give rise to a Schedule D Case VI liability. But in that most unlikely event the application of the decision in Curtis Brown Ltd v Jarvis (1929), 14 TC 744 HC would suggest a similar result as for Schedule D Case I.

Paragraphs 209 to 228: sections 539 to 554 of ICTA

3450. The amendments for these sections do three things. First, they ensure that any liability arising under Chapter 2 of Part 13 of ICTA is chargeable to corporation tax only (see, in particular, the amendments of sections 539 and 547 of ICTA). Second, sections 552 to 552B of ICTA (information: duty of insurers) are amended to reflect the fact that the same event will be a chargeable event under both Chapter 2 of Part 13 of ICTA and Chapter 9 of Part 4 of this Act, and the gain produced by the event is treated as arising under both Chapters. (But the gain, or a part of the gain, is only charged on any taxpayer under or by virtue of one of those Chapters according to that taxpayer’s liability for tax.) Third, the redundant section 554 of ICTA is repealed.

3451. The amendment of the definition of a life annuity in section 539 of ICTA recognises that the determination of what is, or is not, a purchased life annuity depends on whether the annuitant is within the corporation tax or income tax charge. The annuitant may be subject to one tax charge and the person who is liable for a gain arising on a chargeable event in respect of the annuity contract may be subject to the other. Both provisions for determining an annuity have to be mentioned here to avoid restricting the scope of the charge under section 547(1)(b) of ICTA. The amendment of section 543 of ICTA is made for the same reasons as regards the calculation of the gain.

3452. A new section, section 539ZA (policies and contracts in which persons other than companies are interested), is inserted in ICTA. This section deals with the circumstance where the application of Chapter 2 of Part 13 of ICTA (and related provisions) – 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 or contract at a time when any liability may, wholly or in part, arise or have arisen under Chapter 9 of Part 4 of this Act. It mirrors section 544 of this Act.

3453. The section makes clear that Chapter 2 of Part 13 of ICTA and related provisions, "the corporation tax provisions", apply in respect of any other circumstance regardless of any application of Chapter 9 of Part 4 of this Act at that time. For example, if there has been a chargeable event under section 540(1)(a)(v) of ICTA (so that there was also a chargeable event under section 509) at a time when liability on the gain arose wholly or in part under Chapter 9 of Part 4 of this Act, that event is still to be taken into account in the later application of the corporation tax provisions to that policy or contract.

3454. This new section therefore recognises that both the corporation tax provisions and the provisions in Chapter 9 of Part 4 of this Act apply to a policy or contract. There is a chargeable event under each, but the two sets of provisions apply separately as regards liability. (There are a number of reliefs and other rules that affect income tax liability only.)

3455. As a consequence of the repeal of section 547(1)(a) of ICTA (rewritten in section 465) and section 547(1)(e) of ICTA (rewritten in section 468), the subsections in section 547 of ICTA interpreting the meaning of trusts created by an individual and providing the definition of a "foreign institution" have been relocated to section 547A of ICTA.

3456. The amendments of sections 552 to 552B of ICTA provide for a single certificate to be given to each relevant policy holder (and, where required, to the Inland Revenue) in respect of an event and the gain which it produces, notwithstanding that the event is a chargeable event under both Chapter 2 of Part 13 of ICTA and Chapter 9 of Part 4 of this Act, and the gain is treated as arising under both Chapters. The amendments also reflect the different language in the two Chapters and the fact that certain provisions of Chapter 9 of Part 4 of this Act have no equivalent in the amended Chapter 2 of Part 13 of ICTA.

3457. Section 553C of ICTA is amended so that it is a corporation tax provision, as the income tax application of the section and the related parts of the Personal Portfolio Bonds (Tax) Regulations 1999 (SI 1999/1029, as amended by SI 2001/2724 and SI 2002/455) are rewritten in Chapter 9 of Part 4 of this Act.

3458. Section 553C(9A) to (9E) of ICTA enables regulations under that section to provide for a chargeable event gain to arise in relation to a policy or contract which is a personal portfolio bond despite the fact that, at the time, rights in the policy or contract are so held that liability on a gain would be charged under, or by virtue of, Chapter 9 of Part 4 of this Act. The power is limited so that the regulations may make provisions only for the purposes of enabling the gain to be taken into account on the later application of Chapter 2 of Part 13 of ICTA to the policy or contract.

3459. Section 554 of ICTA is omitted. It is spent.

Paragraph 247 and 248: sections 586 and 587 of ICTA

3460. These amendments repeal sections 586 and 587 of ICTA for income tax purposes. Both sections apply only when the United Kingdom is in a declared state of war. They disallow payments made in connection with war damage indemnity schemes and in respect of war injuries to employees. The sections were enacted to deal with the particular circumstances of the second world war when high rates of taxation meant that payments could be made almost entirely at the Exchequer's expense. They are now obsolete.

Paragraphs 284 and 285: sections 695 and 696 of ICTA

3461. This concerns the amendment of sections 695(4)(b) and 696(6) of ICTA so that they will apply for corporation tax purposes without references to the charge to income tax under Schedule D Case IV.

3462. Part 16 of ICTA deems certain payments made to beneficiaries from estates in administration to be income. Although Part 16 of ICTA principally applies to beneficiaries within the charge to income tax, it is also capable of applying to beneficiaries within the charge to corporation tax. Chapter 6 of Part 5 of this Act rewrites the provisions which apply for income tax purposes, and Schedule 1 amends Part 16 of ICTA so that it will only apply for corporation tax purposes.

3463. Section 695 (limited interests in residue) and section 696 (absolute interests in residue) of ICTA apply respectively to persons who have a limited interest in the residue of an estate at any time during the administration period or an absolute interest in the residue.

3464. Under sections 695(2) and 696(3) of ICTA payments made in respect of those interests are deemed to be paid to the persons with the interests as income for the tax year in question. Section 695(4) of ICTA makes different provision about the amount of the income deemed to have been paid and the way it is treated for tax purposes according to whether the estate is a United Kingdom estate or a foreign estate in the tax year in which the amount is deemed to have been paid. Similar provision is made by section 696(4) and (6) of ICTA for persons with absolute interests in estates. (The relevant parts of these sections are rewritten for income tax purposes in sections 649(1), 656 and 657.)

3465. In the case of UK estates, a free-standing non-Schedular charge is imposed because the provisions merely say that the amount is income, but do not specify a charging Schedule. In the case of foreign estates, sections 695(4)(b) and 696(6) of ICTA provide that the amount deemed to have been paid as income is to be “chargeable to income tax under Schedule D Case IV as if it were income arising from securities in a place out of the United Kingdom”. This operates successfully for persons liable to income tax. But there is no longer any charge under Schedule D Case IV for corporation tax purposes. Paragraph 5 of Schedule 14 to FA 1996 introduced a new Schedule D Case III for corporation tax purposes to replace the previous Cases III and IV (see section 18(3A) of ICTA). This income does not fall within the ambit of the new Schedule D Case III.

3466. So, since there are no Schedular charges imposed on this income from foreign estates for corporation tax purposes, the amendments of sections 695(4)(b) and 696(6) of ICTA in Schedule 1 omit the words referring to the charge under Schedule D Case IV. This leaves the income subject to non-Schedular charges in the same way as the income from United Kingdom estates.

Paragraph 327: section 817 of ICTA

3467. This amendment repeals section 817 of ICTA for income tax purposes. The section is an income calculation rule because it applies “in arriving at the amount of profits or gains for tax purposes”. It can trace its origins back almost unchanged to the 1803 Act.

3468. The primary purpose of the section is set out in subsection (1)(a). This provides no deduction is allowed in calculating the profits unless it (the deduction) is “expressly enumerated in the Tax Acts”. This clarification may have served some purpose in the early years of income tax. But as both ITEPA and this Act set out what deductions are to be allowed there is no need for a general rule that says no other deductions are to be allowed.

Paragraph 333: section 827A of ICTA

3469. This new section replaces the territorial provisions in section 18(1)(a) of ICTA, which will be repealed for income tax purposes, as they affect those charges under Schedule D Case VI which are not rewritten in this Act.

3470. Such charges would otherwise lose the benefit of the territoriality rules in section 18(1)(a) of ICTA. This new section aims to replace those rules. It is modelled on the territorial scope sections in Chapter 1 of Parts 4 and 5 of this Act.

3471. See the commentary on section 368 of this Act as to how section 18(1)(a) of ICTA and the rules on territorial scope apply to charges under Schedule D Case VI.

3472. Some provisions in Tables 1 and 3 of new section 836B of ICTA have their own territoriality rules or the provisions may otherwise make clear how income from a source outside the United Kingdom is to be taxed. For this reason the territoriality rules are to apply, subject to any express or implied provision to the contrary (*subsection (5)*).

Paragraph 338: section 833 of ICTA

3473. Section 531(6) of ICTA provides that income from the disposal of know-how is to be earned income in certain cases. However, the concept of earned income is not rewritten in this Act. This paragraph rewrites section 531(6) of ICTA as subsection (5A) of section 833 of ICTA.

3474. Section 529 of ICTA provides that “income from patent rights” is to be earned income in certain cases. However, the concept of earned income is not rewritten in this Act. This paragraph rewrites section 529 of ICTA as subsections (5B) to (5E) of section 833 of ICTA.

3475. There is no definition of “income from patent rights” in Chapter 1 of Part 13 of ICTA. Section 833(5B) of ICTA provides for “patent income” to be earned income in certain circumstances, mirroring the circumstances specified in section 529(1) of ICTA. The definition of “patent income” in new section 833(5D) of ICTA follows the definition of “income from patents” in section 533(1) of ICTA (except that it is drafted by reference to the intellectual property provisions in this Act rather than in ICTA). See *Change 152* in Annex 1.

Paragraph 348(3): paragraph 7A of Schedule 22 to ICTA

3476. This new paragraph rewrites paragraph 7(1), (3) and (4) of Schedule 13 to FA 1996. These sub-paragraphs deal with how relief is to be given for losses on deeply discounted securities incurred by pension trustees where the securities have been held since 26 March 2003 and are listed on a recognised stock exchange. Because this provision is likely to be of extremely limited application and will disappear with the repeal of Schedule 22 to ICTA with effect from 6 April 2006 it has been relegated from Chapter 8 of Part 4 of this Act to this Schedule.

Paragraph 352(2): paragraph 5 of Schedule 30 to ICTA

3477. This amendment repeals paragraph 5 of Schedule 30 to ICTA for income tax purposes.

3478. Paragraph 5 of Schedule 30 to ICTA is a transitional measure that relates to the pre-1963 version of Schedule A. Under that version of Schedule A a trader who owned the property from which he or she carried on a trade was allowed a Schedule D Case I deduction equal to the amount of the Schedule A charge on the property. The right to the deduction was removed when Schedule A moved from a charge on the annual value of the property to a charge on the rent received.

3479. Timing differences between Schedule D Case I and Schedule A could result in a loss of relief if the taxpayer ceased to occupy the property for the purposes of the trade in a period in which he or she did not also cease to carry on the trade. FA 1963 introduced a relief to compensate for this loss of relief. It is based on the relief that would have been given for the tax years 1963-64 and 1964-65 and is allowed as a deduction in calculating the trade profits for the tax year in which they cease to carry on the trade.

3480. While in theory it is still possible to claim the relief, given the passage of over 40 years and the effects of inflation it is almost certain no new claims will be made in or after the tax year 2005-06.

Paragraph 352(3): paragraph 18 of Schedule 30 to ICTA

3481. This amendment repeals paragraph 18 of Schedule 30 to ICTA.

3482. Paragraph 18 of Schedule 30 to ICTA is a transitional measure that applies to stock relief. Stock relief was available under different schemes from 1976 to 1984. It was given as a deduction in computing trade profits. Although FA 1984 abolished stock relief with effect from 12 March 1984 it allowed any unused relief to be carried forward and deducted in later years. The relief brought forward has to be used in the first tax year that has the capacity to absorb it. Paragraph 10 of Schedule 9 to FA 1981 provided that any unused relief brought forward which is not used in six years would be lost.

3483. It was necessary to preserve the transitional right to deducted unused relief brought forward when ICTA consolidated the earlier legislation in 1988. But this transitional measure is no longer required.