These notes refer to the Income Tax (Trading and Other Income) Act 2005 (c.5) which received Royal Assent on 24 March 2005

INCOME TAX (TRADING AND OTHER INCOME) ACT 2005

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 2: Trading income

Chapter 6: Trade Profits: Receipts

Overview

386. This Chapter contains provisions on how various receipts are to be treated in calculating the profits of a trade.

Section 95: Profession and vocations

387. This section makes it unnecessary to specify repeatedly that the rules in this Chapter (apart from section 105) apply to a profession or vocation as well as to a trade. The section is new.

Section 96: Capital receipts

388. This section corresponds to section 33 of this Act (capital expenditure) for capital receipts. It is new.

389. *Subsection (1)* sets out the general rule that items of a capital nature are not to be treated as receipts of a trade.

390. It is a long established principle that capital receipts are ignored in calculating the profits of a trade for income tax purposes. The principle that income tax applies only to receipts of a revenue nature is set out by Lord MacNaghten in Attorney General v London County Council (1900), 4 TC 265 HL:

"Income Tax, if I may be pardoned for saying so, is a tax on income. It is not meant to be a tax on anything else.

391. Decisions in subsequent cases on whether a receipt is in the nature of income or capital have taken as their starting point Lord MacNaghten's principle that only receipts of a revenue nature fall to be included in the computation of the profits of a trade. See, for example, the comments of Lord Dundas and Lord Ormidale in Glenboig Union Fireclay Co, Ltd v CIR (1922), 12 TC 427 HL on whether a sum received as compensation for not working certain seams:

"…"the sum under consideration was surely of the nature of capital not revenue….the compensation was paid for the loss of a capital asset…the sum can surely not be described as profits arising from the Appellant's trade or business. (Lord Dundas)

…the sum received as compensation…falls to be dealt with as capital….it seems to me to be impossible to predicate of the £15,000 that they were profits arising or accruing from the trade or business of the company. (Lord Ormidale)

392. And, after recalling Lord MacNaghten's dictum in the London County Council case, Lord Moncreiff commented in Trustees of Earl Haig v CIR (1939), 22 TC 725 CS as follows:

"I accordingly proceed on the assumption, (which moreover appears to me to be a sound assumption) that all profits from trade, being the profits dealt with in Case I, are profits which have an "income" and not a "capital" quality.

393. More recently, the principle that capital receipts are not subject to income tax was restated by Lord Templeman in Beauchamp v F W Woolworth (1989), 61 TC 542 HL[1]:

"[Section 1 ICTA 1988] … directs … that income tax shall be charged in respect of profits described in Schedule D set out in [section 18 ICTA 1988]. That section directs … that tax shall be charged in respect of the annual profits arising or accruing to any person … from any trade. … The expression 'annual profits' confirms that income tax is to be charged on profits of an income nature as opposed to capital profits …

394. The question of whether a receipt is of a capital or a revenue nature falls to be determined by reference to the nature of the trade. This principle was set out by Lord MacMillan in Van den Berghs Ltd v Clark (1935), 19 TC 390 HL after reviewing the early authorities on distinguishing between income and capital receipts:

"…the nature of a receipt may vary according to the nature of the trade. The price of the sale of a factory is ordinarily a capital receipt, but it may be an income receipt in the case of a person whose business it is to buy or sell factories.

395. *Subsection (2)* disapplies the general rule in subsection (1) where there is statutory provision for a capital sum to be taken into account as a receipt in calculating the profits of a trade. See, for example, section 106 of this Act (sums recovered under insurance policies etc.).

Section 97: Debts incurred and later released

396. If an amount owed by a trader is released, this section treats the amount released as a trading receipt. The section is based on section 94 of ICTA.

397. *Subsection (1)(c)* sets out the exception that applies if the debt is released as part of a "statutory insolvency arrangement" (defined in section 259 of this Act). This rule reflects the change to section 94 of ICTA made by section 144 of FA 1994.

398. If the trader is no longer carrying on the trade when the debt is released, the amount released is charged to tax as a post-cessation receipt (see section 249 of this Act).

Section 98: Acquisition of trade: receipts from transferor's trade

399. This section sets out what happens if a successor to a trade receives a sum that arose from the trade when it was carried on by the predecessor. It is based on section 106(2) of ICTA.

400. If a sum arises from a trade that has ceased, the usual rule is that the sum is a post-cessation receipt (see Chapter 18 of Part 2 of this Act). But, if the right to receive the sum is transferred with the trade to a person who takes over the trade, this section applies instead.

1 STC [1987] 510

401. *Subsection (2)* treats the sum as a receipt of the successor's trade. It is not charged on the predecessor. The source legislation applies "for all purposes". This section applies for income tax purposes. Section 106(2) of ICTA (as amended by paragraph 85 of Schedule 1 to this Act) applies for corporation tax purposes. Section 37(1) of TCGA ensures that any sums received as a result of the transfer are not charged to capital gains tax.

402. *Subsection (3)* makes it clear that the sum is not treated as a post-cessation receipt.

403. Different rules apply if the right to receive sums is transferred to a person who does not take over the trade (see section 251 of this Act).

Section 99: Reverse premiums

404. This is the first of a group of five sections based on section 54 of and Schedule 6 to FA 1999. This legislation was introduced following the decision of the Privy Council in Commissioner of Inland Revenue v Wattie [1998], STC 1160. An inducement (a "reverse premium") paid to a tenant to take a lease of land is taxed as income in the hands of the tenant.

405. *Subsection (2)* introduces the term "the recipient", which is used throughout this group of sections.

406. *Subsection (3)* identifies the transaction which gives rise to a reverse premium.

407. *Subsection (4)* refers to an interest in land being "granted". This distinguishes such a transaction from one in which an interest is assigned. The general rule is that a charge to tax on a reverse premium arises on the grant of an interest in land but not on its assignment. But assignment can give rise to a charge if the assignor is connected with the grantor.

408. The meaning of "reverse premium" in this section is applied for the purpose of section 311 by subsection (6) of that section.

409. Paragraph 28 of Schedule 2 rewrites the transitional provision in section 54(2) of FA 1999. These sections do not apply to pre-1999 reverse premiums.

Section 100: Excluded cases

410. This section brings together the various exclusions from the charge on reverse premiums. It is based on paragraphs 5, 6 and 7 of Schedule 6 to FA 1999.

Section 101: Tax treatment of reverse premiums

411. This section treats a reverse premium as is a revenue receipt, rather than a capital item. It is based on paragraph 2 of Schedule 6 to FA 1999.

412. *Subsection (2)* is the rule for a trader. The reverse premium is treated as a receipt of the trade.

413. *Subsection (3)* is the rule for a non-trader. The reverse premium is treated as a receipt of a property business in accordance with section 311 of this Act.

414. If the transaction giving rise to the reverse premium is at arm's length there is no statutory timing rule; the normal accountancy treatment applies. If the transaction is not at arm's length, there is a timing rule in section 102.

Section 102: Arrangements not at arm's length

415. If a property transaction is not at arm's length there is a special timing rule. This section provides that the whole of the reverse premium is taxed when the property transaction is entered into. It is based on paragraph 3 of Schedule 6 to FA 1999.

416. *Subsection (1)* refers to “connected persons”. That expression is defined for the purpose of this section in section 103.

417. *Subsection (5)* deals with the case where the recipient enters into a property transaction for the purpose of a trade but the trade has not yet started. In that case, the reverse premium is brought into account when the trade starts.

Section 103: Connected persons and property arrangements

418. This section contains the definition of “connected persons” that applies for the group of sections on reverse premiums. It includes a cross-reference to section 878(5) of this Act, which relies on the definition of “connected persons” in section 839 of ICTA. The section is based on paragraph 8 of Schedule 6 to FA 1999.

Section 104: Distribution of assets of mutual concerns

419. This section deals with the consequences for a trader of receiving a distribution from a mutual concern that is a corporate body. It is based on section 491 of ICTA.

420. *Subsection (1)* sets out the circumstances in which a distribution may give rise to a tax charge. It refers to a distribution out of assets that “represent profits” of the concern. This is not quite the same as “assets of a body corporate, other than assets representing capital”, as identified in section 491(1) of ICTA. The difference is that the section excludes assets that represent capital gains of the concern. See *Change 27* in Annex 1.

421. *Subsection (2)* is the general rule: the distribution is treated as a receipt of the trade.

422. *Subsection (3)* deals with the case where the distribution is received after the trade has ceased. The section treats the distribution explicitly as a post-cessation receipt. See *Change 22* in Annex 1.

423. In the trading income Part the rules apply to the person carrying on a trade rather than to the trade itself. So section 113 of ICTA is not needed to treat a trade as ceasing when there is a change in the person carrying it on. That section is repealed (see paragraph 94 of Schedule 1 to this Act). Subsection (3) of this section reproduces the combined effect of section 491(3)(b) and (4) of ICTA.

424. *Subsection (4)* explains when money or money’s worth “represents assets” in subsection (1). “Money’s worth” includes consideration for the right to receive a distribution but excludes anything otherwise chargeable to tax.

425. *Subsection (5)* is a special rule that applies if the right to receive a distribution is transferred other than at arm’s length. Market value is substituted for the actual amount received.

426. The section omits the references to mutual insurance and industrial and provident societies in section 491(9) and (11) of ICTA. Those examples were intended to help readers but there is no comprehensive definition of “mutual business”. The subsections were intended to deal with particular doubts which were common when the provision was enacted in 1964. Those doubts do not exist today.

Section 105: Industrial development grants

427. This section deals with the treatment of certain grants under the Industrial Development Act 1982 or the corresponding provision in Northern Ireland. It is based on section 93 of ICTA.

428. This section does not rewrite the references in section 93(2) of ICTA to the Industry Act 1972, the Industries Development Act (Northern Ireland) 1966 and the Industries Development Act (Northern Ireland) 1971. These enactments were repealed or replaced in 1982 and there are no outstanding instalments under the old enactments.

429. Section 93(3) of ICTA disapplies section 93(1) of ICTA in the case of grants towards the payment of all or part of a corporation tax liability made under Article 7 of the Industrial Development (Northern Ireland) Order 1982. Persons liable to income tax do not, in general, receive grants for the payment of corporation tax. But such a grant could, in principle, be made under Article 7 of the 1982 Order to a partnership with an associated company.

430. Grants in respect of corporation tax liabilities can not be made under any of the enactments listed in *subsection (1)* of this section other than Article 7 of the Industrial Development (Northern Ireland) Order 1982. So *subsection (2)* of this section excludes *all* grants in respect of corporation tax liabilities.

Section 106: Sums recovered under insurance policies etc.

431. This section is based on section 74(1)(l) of ICTA.

432. Section 74(1)(l) of ICTA prohibits the deduction in computing a trader's profits of "any sum recoverable under an insurance or contract of indemnity". This is regardless of whether the sum is revenue or capital in nature.

433. Where a sum is recovered under an insurance policy or contract of indemnity in a year *other than* the year in which the event in respect of which it is received occurs, section 74(1)(l) of ICTA requires any deduction made in respect of that event to be adjusted to reflect the recovery.

434. This section provides instead that a capital sum recovered by a trader under an insurance policy or a contract of indemnity is brought into account as a receipt in calculating the profits of the trade to the extent that the loss or expense has been deducted in calculating those profits. This means the timing of the receipt will follow the accountancy treatment. See *Change 28* in Annex 1.

435. No special provision is needed for sums of a revenue nature.