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

INCOME TAX (TRADING AND OTHER INCOME) ACT

EXPLANATORY NOTES — VOLUME TWO

(SECTIONS 365 TO 886)

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Part 4: Savings and investment income

Overview

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

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

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

Structure of Chapters

3. The basic structure of each Chapter is:

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

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

Chapter 1: Introduction

Section 365: Overview of Part 4

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

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

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

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

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

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

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

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

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

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

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

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

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

17. *Subsection (4)* provides that an amount can be used in calculating a chargeable event gain under Chapter 9 of Part 4 (gains from contracts for life insurance etc.) although it may

also be used in calculating income under another provision in this Act. This is because the calculation of gains under Chapter 9 of this Part uses different principles from those used in other charges. However, section 527 of this Act ensures that the gain calculated under Chapter 9 is reduced by the amount charged elsewhere, to avoid a double charge on the same amount.

Section 367:Priority between Chapters within Part 4

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

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

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

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

Section 368: Territorial scope of Part 4 charges

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

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

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

25. The exact scope of section 18(1)(b) of ICTA and its relation to the rules in section 18(1)(a) of ICTA is not entirely clear. Section 18(1) of ICTA appeared in broadly its present form in the Income Tax Act 1853, borrowing wording from the Income Tax Act 1842. The 1842 Act is famously impenetrable but the provisions from which the words have been borrowed (sections 100 and 102) may be read as having territorial restrictions. It is difficult to believe that the 1853 provision that is now section 18(1)(b) of ICTA was not intended to share the same territorial restrictions as the provision that is now section 18(1)(a) of ICTA.

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

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

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

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

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

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

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

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

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

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

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

Clothes Group Ltd (2000), 72 TC 379[1] HL and a more detailed discussion of this topic may be found in the commentary on Chapter 1 of Part 8 of this Act.

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

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

Chapter 2: Interest

Overview

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

Section 369: Charge to tax on interest

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

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

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

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

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

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

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

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[1] STC [2000] 324

[2] STC [1975] 682.

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

46. For individuals, unless a particular charge specifies otherwise, interest arising from a source outside the United Kingdom is taxed under Schedule D Case IV if it arises from securities outside the United Kingdom but otherwise under Case V. This treatment is confirmed by Lord Manton's Trustees v Steele (1927), 11 TC 549 CA and Westminster Bank Executor and Trustee Co (Channel Islands) Ltd v National Bank of Greece SA (1970), 46 TC 472 HL.

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

Building Societies

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

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

Open-ended Investment Companies

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

Authorised Unit Trusts

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

Industrial and Provident Societies

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

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

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

Section 370: Income charged

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

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

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

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

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

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

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

62. The word "arising" has been the subject of a number of tax cases. "Arising" includes received and also credited to a bank account (Parkside Leasing v Smith (1984), 58 TC 282[3] HC). However, "arising" has a wider meaning than this. For example, it was held in Dunmore v McGowan (1978), 52 TC 307[4] CA, to include the "swelling of a person's assets", even where the person had no immediate right of access to the income. In view of the wide meaning given to "arising", and the fact that it is a term with which practitioners are familiar, the word has been retained.

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

Section 371: Person liable

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

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

66. The phrase "receiving or entitled to" has been considered at length by the courts, although no clear definition of it has emerged. In early cases the courts placed greater emphasis on the concept of receipt than on entitlement - see, for example, Dewar v Commissioners of Inland Revenue (1935), 19 TC 561 CA. Later, equal importance was attached to each part of the phrase - see, for example, Aplin v White (1973), 49 TC 93[5] HC.

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3 STC [1985] 63.
4 STC [1978] 217.
5 STC [1973] 322.

The most recent cases, such as MacPherson v Bond (1985), 58 TC 579[6] HC, and Peracha v Miley (1990), 63 TC 444[7] CA, have hinged on whether or not any benefit has accrued to the taxpayer.

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

Section 372: Building society dividends

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

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

Section 373: Open-ended investment company interest distributions

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

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

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

Section 374: Date when interest payments under section 373 made

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

Section 375: Interpretation of sections 373 and 374

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

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[6] STC [1985] 678.
[7] STC [1990] 512.

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

Section 376: Authorised unit trust interest distributions

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

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

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

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

Section 377: Date when interest payments under section 376 made

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

Section 378: Interpretation of sections 376 and 377

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

Section 379: Industrial and provident society payments

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

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

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

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

Section 380: Funding bonds

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

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

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

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

Section 381: Discounts

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

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

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

Introduction

Section 382: Contents of Chapter

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

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

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

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

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

Section 383: Charge to tax on dividends and other distributions

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

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

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

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

101. The charge to tax under Schedule F in the source legislation is also subject to section 171(2) of FA 1993 (Lloyd's underwriters: taxation of profits and allowance of losses) (see section 20(2) of ICTA). As with dealers, the tax charge in the source legislation is Schedule

D Case I and not Schedule F. But section 171(2) of FA 1993 additionally provides that the amount of the profits arising from assets in an ancillary trust fund is calculated under the relevant Schedule or Case. Again, section 383 does not explicitly rewrite the proviso in section 20(2) of ICTA but the effect of that section is replicated by section 366(1) of this Act (which gives charging priority to Chapter 2 of Part 2 of this Act). And section 2(4) of this Act ensures that the calculation can be made under this Chapter.

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

Section 384: Income charged

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

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

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

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

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

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

Section 385: Person liable

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

110. Under the source legislation there is no provision expressly stating who is liable for the tax charged. Although section 20(1) paragraph 1 of ICTA makes it clear that the charge to

tax encompasses all distributions of a UK resident company made in a tax year, and includes a reference to the recipient, it does not actually specify the person liable.

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

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

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

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

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

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

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

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

- the person to whom a distribution is made or to whom it is treated as made for the purposes of Part 6 of ICTA – sections 209(1) and (4), 254(12) and 418(2) of ICTA;

- the person receiving a distribution – sections 20(1)1, 231(1) and (4) and 209(4) of ICTA;
- the person entitled to the distribution – sections 20(1)2 and 231(4); and
- the person to whom the distribution, under any provision of the Tax Acts, is treated as belonging (where that person is not the recipient) – section 231(4) of ICTA.

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

Section 386: Open-ended investment company dividend distributions

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

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

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

Section 387: Date when dividends paid under section 386

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

Section 388: Interpretation of sections 386 and 387

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

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

Section 389: Authorised unit trust dividend distributions

126. This section and the two sections that follow provide investors, who are liable to income tax, with the information required to determine their taxable income from the authorised unit trust (AUT). The tax provisions relevant to the AUT are not in this Act. This

is because the AUT trustees are treated as a company liable to corporation tax under section 468(1)(a) of ICTA.

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

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

Section 390: Date when dividends paid under section 389

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

Section 391: Interpretation of sections 389 and 390

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

Shares in approved share incentive plans ("SIPs")

Overview

131. Section 392 and the following four sections are based on sections 251A to 251C of ICTA which are part of the legislation relating to SIPs. The SIPs legislation was originally contained in Schedule 8 to the FA 2000 (introduced by section 47 of FA 2000) and was rewritten in ITEPA. The majority of the SIP code is contained in Chapter 6 of Part 7 of and Schedule 2 to ITEPA.

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

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

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

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

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

137. If the trustees cannot reinvest the cash dividend either because the amount of the cash dividend is not sufficient to acquire a share or because there is an amount remaining after acquiring shares, the trustees may keep the cash dividend and carry it forward with a view to reinvestment at a later date (see paragraph 68(2) of Schedule 2 to ITEPA). In that case,

section 496 of ITEPA (rewritten as section 770(1)(b) of this Act) provides that the participant is not liable to income tax in respect of the amount of the cash dividend held by the trustees.

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

Section 392: SIP shares: introduction

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Section 396: Interpretation of sections 392 to 395

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

168. This section deals with the tax treatment of qualifying distributions received by persons not entitled to a tax credit (for example, because they are non-resident and do not fall within the definition of "eligible non-UK resident"). As mentioned in the commentary on

section 397(3), a person may be entitled to a tax credit whose value is nil. The person is nevertheless entitled to a tax credit and therefore this provision does not apply to such a person. It is based on section 233(1) and (1A) of ICTA.

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

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

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

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

Section 400: Non-qualifying distributions

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

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

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

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

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

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

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

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

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

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

Chapter 4: Dividends from non-UK resident companies

Overview

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

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

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

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

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

186. For the reasons explained in the overview, the expression "distribution" has not been adopted. It is possible that a non-UK resident company may make a distribution of income

which would not fall within Chapter 4 of Part 4 of this Act because it is not a "dividend". But if the distribution comprises income it will fall to be dealt with either under alternative specific charges (eg interest) or within "income not otherwise charged", the charge on which appears in Chapter 8 of Part 5 of this Act.

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

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

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

Section 403: Income charged

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

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

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

Section 404: Person liable

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

Section 405: SIP shares: introduction

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

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

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

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

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

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

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

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

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

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

Section 408: Reduction in tax due in cases within 407

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

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

Chapter 5: Stock dividends from UK resident companies

Overview

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

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

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

207. A bonus issue of redeemable shares, however, is a distribution (see section 209(2)(c) of ICTA). Without any special provision it would be charged to tax under the source legislation under Schedule F. However, there is a special provision – the charge to tax on

stock dividends under section 249 of ICTA. And, under section 230 of ICTA, anything that is a stock dividend:

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

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

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

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

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

Section 409: Charge to tax on stock dividend income

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

Section 410: When stock dividend income arises

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

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

Section 411: Income charged

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

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

Section 412: Cash equivalent of share capital

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

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

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

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

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

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

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

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

Section 413: Person liable

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

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

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

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

228. *Subsection (4)* deals with stock dividend income arising to personal representatives during the administration of a deceased person's estate. As personal representatives are not charged to tax under Chapter 5 of this Part they are not "persons liable". This means that they

are not treated as having paid income tax under section 414 but see further the commentary on section 680.

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

Section 414: Income tax treated as paid

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

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

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

233. *Subsections (3)* to *(5)* ensure that individual taxpayers cannot be given credit for income tax on more than the amount charged to income tax. So, for example, if the individual's total income is reduced by deductions (for example, personal allowances) such that the stock dividend income is only partially brought into charge to tax, credit will only be given for so much of the stock dividend income as is so taxed.

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

Chapter 6: Release of loan to participator in close company

Section 415: Charge to tax under Chapter 6

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

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

[8] STC [2004] 1245

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

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

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

Section 416: Income charged

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

Section 417: Person liable

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

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

243. There is no reference, here or in the source legislation, to the position where the burden of the debt has been passed to a third party. This is because it is not possible in law for a debtor to assign a debt. Any transfer of debt must be made by way of novation, which would involve the existing debtor being released from the debt and the new debtor taking on a new debt. In such a case, therefore, a charge to tax under section 421 of ICTA would arise on the release of the existing debtor. The interpretation is based on the cases of Collins v Addies and Greenfield v Bains (1992), 65 TC 190 CA[9].

Section 418: Relief where borrowers liable as settlors

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

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

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

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

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

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

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

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

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

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

251. So section 418:

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

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

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

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

Section 419: Loans and advances to persons who die

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

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

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

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

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

Section 421: Income tax treated as paid

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

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

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

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

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

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

Chapter 7: Purchased Life Annuity Payments

Overview

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

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

Section 422: Charge to tax on purchased life annuity payments

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

Section 423: Meaning of "purchased life annuity"

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

Section 424: Income charged

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

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

Section 425: Person liable

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

Section 426: Annuity payments received after deduction of tax

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

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

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

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

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

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

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

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

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

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

281. As there was no evidence that the payments were out of taxed income, it was a case within what is now section 349 of ICTA, rather than section 348 of ICTA. Deduction of tax was presumed to have occurred and Lord Simon’s dicta from Allchin v Corporation of South Shields were applied so that the requirement that the recipient must allow the deduction and treat the payer as acquitted of his liability had to be implied. It followed that the wife could not sue her husband for the tax because she would be met with the defence that he was

acquitted of his liability. Therefore the wife fell to be treated as the recipient of an amount that had borne tax. Collection of the tax was a matter between the payer and the Crown. The husband had become in effect an agent for the Crown, as the collector for the Crown of the tax due from (and in effect paid by) the wife. This is tantamount to the provision in section 348(1)(d) of ICTA.

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

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

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

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

Chapter 8: Profits from deeply discounted securities

Overview

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

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

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

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

Section 428: Income charged

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

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

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

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

Section 429: Person liable

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

Section 430: Meaning of "deeply discounted security"

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

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

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

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

Section 431: Excluded occasions of redemption

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

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

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

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

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

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

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

Section 432: Securities which are not deeply discounted securities

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

Section 433: Meaning of "excluded indexed security"

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

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

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

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

309. *Subsection (4)* defines "redemption period" for the purpose of this test. This definition differs from the one for the deeply discounted security test in section 430 to allow flexibility for the chargeable assets referred to in subsection (1) to be valued on dates other than, but

close to, the issue and redemption dates. Likewise, an index of the value of chargeable assets may not be computed for the actual issue and redemption dates and some approximation is required.

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

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

Section 434: Securities issued in separate tranches: preliminary

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

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

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

Section 435: Securities issued in separate tranches: basic rule

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

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

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

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

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

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

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

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

Section 437: Transactions which are disposals

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

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

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

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

Section 438: Timing of transfers and acquisitions

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

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

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

Section 439: Calculating the profit from disposals

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

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

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

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

Section 440: Market value disposals

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

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

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

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

Section 441: Market value acquisitions

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

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

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

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

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

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

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

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

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

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

Section 444: Meaning of "strip" in Chapter 8

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

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

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

Section 445: Strips of government securities: acquisitions and disposals

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

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

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

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

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

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

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

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

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

Section 446: Strips of government securities: relief for losses

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

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

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

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

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

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

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

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

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

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

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

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

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

Section 450: Market value of strips etc.

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

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

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

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

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

Section 452: Power to modify this Chapter for strips

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

Section 453: Application of sections 454 to 456

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Section 457: Trustees

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

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

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

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

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

392. *Subsection (5)* disapplies subsections (2) to (4) in the case of unauthorised unit trusts. Under section 469(2) of ICTA income arising to the trustees of unauthorised unit trusts is

regarded as income of the trustees and not as income of the unit holders and such income is chargeable at the basic rate.

Section 458: Non-UK resident trustees

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

Section 459: Transfer of assets abroad

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

Section 460: Minor definitions

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

Chapter 9: Gains from contracts for life insurance etc.

Overview

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

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

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

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

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

401. The income tax provisions in this Chapter for charging gains and the corporation tax provisions in ICTA apply independently to any policy or contract. In practice, the same event will occur, and the amount of the gain will be the same, under both sets of provisions. But a

charge to tax under one or other tax (sometimes to both taxes) only arises if someone is liable for the respective tax on the gain by virtue of sections 464 to 467 of this Act or section 547(1)(b) of ICTA. The corporation tax provisions do not include the equivalent of sections 530 to 537 (income tax treated as paid and top slicing relief) and 539 to 541 (relief for deficiencies).

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

- the policy must have a minimum term of ten years from the date it was made to the date it is due to end; and
- premiums of fairly even amounts must be payable at regular intervals in every year for at least ten years.

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

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

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

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

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

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

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

409. The Chapter is laid out as follows-

- charge to tax under Chapter 9 (sections 461 to 463)
- person liable etc. (sections 464 to 472)
- policies and contracts to which Chapter 9 applies (sections 473 to 483)

- when chargeable events occur: general (sections 484 to 490)
- calculating gains: general (sections 491 to 497)
- part surrenders and assignments: periodic calculations and excess events (sections 498 to 509)
- transaction-related calculations and part surrender or assignment events (sections 510 to 514)
- personal portfolio bonds (sections 515 to 526)
- reductions from gains (sections 527 to 529)
- income tax treated as paid and reliefs (sections 530 to 538)
- deficiencies (sections 539 to 541)
- supplementary (sections 542 to 546)

Section 461: Charge to tax under Chapter 9

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

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

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

Section 462: When gains arise from policies and contracts

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

Section 463: Income charged

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

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

Section 464: Person liable for tax: introduction

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

416. The source legislation does not preclude an overlap between the attribution of liability to one "person liable" and to another (say, both to an individual who placed a policy in trust and to the trustees who hold the legal rights in the policy). In practice, liability of a UK

resident individual normally prevails over other liability and the gain is not doubly charged to tax. See also the commentary on section 467 as it applies where the rights are held by trustees on charitable trusts (when liability falls on the trustees rather than the settlor).

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

Section 465: Person liable: individuals

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

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

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

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

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

Section 466: Person liable: personal representatives

423. This section sets out how a gain is charged to tax when the rights under the policy or contract are held by the personal representatives of a deceased person's estate. It is based on

sections 547 and 553 of ICTA. The term "personal representatives" is defined in section 878 of this Act.

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

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

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

Section 467: Person liable: UK resident trustees

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

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

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

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

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

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

Section 468: Non-UK resident trustees and foreign institutions

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

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

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

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

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

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

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

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

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

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

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

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

441. *Subsection (6)* applies the section to someone who has two or more interests in a policy or contract exactly as the section applies where two or more persons have such interests. For example, a person may hold one interest beneficially and the other as a trustee.

Each of those interests is treated separately. But there is an exception where all the material interests are held by that person only (that is, the interests are not shared) and are held in the same capacity. For example, one share may be beneficially owned by A, but held in a trust, and another share held by A absolutely. Both shares are held in the same capacity.

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

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

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

Section 471: Determination of shares etc.

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

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

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

Section 472: Trusts created by two or more persons

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

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

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

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

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

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

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

Section 474: Special rules: qualifying policies

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

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

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

Section 475: Special rules: personal portfolio bonds

456. This section is new.

Section 476: Special rules: foreign policies

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

458. The source legislation uses the terms "new non-resident policy", "overseas policy" and "new offshore capital redemption policy". The "new" in those terms indicates such

policies were issued on or after the commencement date for the legislation that introduced special rules. The terms used in this Chapter simply add "foreign" to the descriptions used for comparable UK policies and contracts.

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

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

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

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

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

Section 477: Special rules: certain older policies and contracts

463. This section is new.

Section 478: Exclusion of mortgage repayment policies

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

Section 479: Exclusion of pension policies

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

Section 480: Exclusion of excepted group life policies

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

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

Section 481: Excepted group life policies: conditions about benefits

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

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

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

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

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

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

Section 483: Exclusion of credit union group life policies

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

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

Section 484: When chargeable events occur

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

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

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

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

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

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

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

480. Broadly, there is no chargeable event if:

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

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

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

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

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

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

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

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

486. This section is based on section 545(1) of ICTA. The source legislation refers in part to "annual payments chargeable to tax under Schedule D". The income tax charge on such

income is rewritten in the Chapters listed in the section. The corporation tax charge on such income is still under Schedule D.

Section 487: Disregard of certain assignments

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

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

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

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

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

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

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

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

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

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

Calculating gains: general

Overview

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

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

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

Section 491: Calculating gains: general rules

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

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

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

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

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

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

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

Section 493: The value of a policy or contract

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Section 497: Disregard of trivial inducement benefits

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

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

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

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

Part surrenders and assignments: periodic calculations and excess events

Overview

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Section 500: Events treated as part surrenders

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

532. Note that an "event" within this section is not a "chargeable event", unless:

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

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

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

Section 501: Part surrenders: loans

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Section 505: Assignments etc. involving co-ownership

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

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

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

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

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

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

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

Section 507: Method for making periodic calculations under section 498

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

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

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

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

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

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

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

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

Section 508: The value of rights partially surrendered or assigned

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

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

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

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

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

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

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

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

Transaction-related calculations and part surrender or assignment events

Overview

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

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

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

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

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

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

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

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

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

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

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

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

Section 512: Available premium left for relevant transaction

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

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

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

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

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

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

581. Having thus deducted:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Section 516: Meaning of "personal portfolio bond"

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

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

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

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

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

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

Section 518: The index categories

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

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

Section 519: The index selection conditions

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

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

Section 520: The property categories

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

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

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

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

Section 521: The property selection conditions

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

Section 522: Method for making annual calculations under section 515

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

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

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

Section 523: The total amount of personal portfolio bond excesses

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

Section 524: The total amount of part surrender gains

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

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

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

Section 525: Chargeable events where annual calculations show gains

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

Section 526: Power to make regulations about personal portfolio bonds

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

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

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

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

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

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

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

623. Although the source legislation is in terms of an amount taxable under section 547(1) of ICTA and an "amount which is chargeable to tax" apart from that subsection, this section

reduces the gain otherwise chargeable by the "amount of the receipt or other credit item" taken into account in the other calculation. "Credit item" is not a defined term, but is used in, for example, section 4of this Act. See *Change 95* in Annex 1.

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

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

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

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

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

Section 529: Exceptions to section 528

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

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

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

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

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

Section 530: Income tax treated as paid etc.

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

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

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

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

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

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

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

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

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

Section 531: Exceptions to section 530

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

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

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

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

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

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

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

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

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

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

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

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

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

Section 533: Meaning of "comparable EEA tax charge"

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

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

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

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

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

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

Section 535: Top slicing relief

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

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

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

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

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

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

Section 536: Top slicing relieved liability: one chargeable event

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

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

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

666. *Subsections (2)* to *(8)* contain rules which modify how "N" is worked out. For example, where the gain is from a "calculation event", that is, a part surrender or assignment that gives rise to a gain, subsection (2) substitutes the number of years since the latest

"calculation event" which arose on that policy or contract. (But, where the policy is a "new policy" (see subsection (5)) in relation to a replaced policy, any calculation event which arose on the replaced policy is disregarded for the purposes of subsection (2), even though the life of the "new policy" is, under subsection (4), dated from the commencement of the earlier replaced policy.)

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

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

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

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

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

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

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

Section 538: Recovery of tax from trustees

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

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

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

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

Section 539: Relief for deficiencies

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

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

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

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

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

Section 540: When deficiencies arise: events following calculation events

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

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

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

Section 541: Calculation of deficiencies

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

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

Section 542: Replacement of qualifying policies

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

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

Section 543: Issue time of qualifying policy replacing foreign policy

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

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

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

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

Section 545: Minor definitions

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

690. The definitions of "charitable trust", "friendly society" and "non-charitable trust" are based on section 539 of ICTA.

691. The definition of "insurance company" is new for the purposes of this charge, although the Tax Acts provide a definition for other purposes. See *Change 99* in Annex 1. (There is no Chapter-wide definition of "insurer". Depending on the provision, that word may mean the insurer for the time being or the original insurer with whom the insurance or

contract was made. Where a definition is needed, it has been provided for the purposes of the section in question (for example, see section 501)).

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

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

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

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

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

Chapter 10: Distributions from unauthorised unit trusts

Section 547: Charge to tax under Chapter 10

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

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

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

Section 548: Income charged

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

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

Section 549: Person liable

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

Section 550: Income tax treated as paid

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

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

704. Under section 348(1)(d) of ICTA tax deducted from annual payments under section 348(1)(b) of ICTA is treated as paid by the recipient. Case law extends this to tax deducted under section 348(2) of ICTA and section 349 of ICTA. In allowing all tax deducted under sections 348 and 349 of ICTA to be treated as tax paid by the unit holder section 550 fills a gap otherwise filled by case law. For more detail see the commentary on section 426.

Chapter 11: Transactions in deposits

Overview

705. This Chapter charges profits from the disposal of deposit rights to tax. It is based on sections 56 and 56A of ICTA.

706. Until 2003, "deposit rights" generally took the form of a "certificate of deposit". A certificate of deposit is created when money has been deposited with a person who issues a certificate containing a promise to pay a certain amount, with or without interest, to whoever holds the certificate. Such certificates are transferable. There is a paperless version of this arrangement where no certificate is issued but someone is entitled to call for its issue.

707. What is now section 56 of ICTA was introduced by section 26 of FA 1973. The purpose of the legislation was to stop a tax avoidance device whereby certificates of deposit were sold just prior to maturity. The certificates were sold at a profit but, because the increase in value was not interest, the seller escaped tax under Schedule D Case III. Furthermore, because certificates of deposit do not constitute a debt on a security, the seller also escaped capital gains tax. Section 26 of FA 1973 stopped the avoidance by providing that, where the right to receive the amount stated in a certificate of deposit is disposed of, the gain arising is treated as an annual profit or gain charged to tax under Schedule D Case VI.

708. Under the source legislation, paperless deposit rights (that is, those deposit rights not evidenced by a paper certificate, where the holder is nevertheless entitled to call for the issue of a certificate) are dealt with by section 56A of ICTA. That provision was introduced by section 34 of and Schedule 8 to F(No 2)A 1992. It applies the charge under section 56 of ICTA.

709. Administration of the UK market in certificates of deposit and their paperless equivalents, and other forms of money market instrument, has become increasingly centralised and computerised. In 2001 the Treasury made regulations under section 207 of the Companies Act 1989 to facilitate the computerisation of the market (the Uncertificated Securities Regulations 2001 SI 2001/3755). The regulations introduced the concept of "units of a security to be evidenced otherwise than by a certificate and transferred otherwise than by a written instrument".

710. After a period of preparation, existing money market instruments, including certificates of deposit, migrated to a new, wholly computerised and uncertificated system in September 2003. It remains possible, in theory at least, for a paper certificate of deposit to be issued (and a paper version of other types of money market instrument). But conventionally it is now units of an "eligible debt security" that are issued.

711. The Treasury made regulations in June 2003, again under section 207 of the Companies Act 1989, amending SI 2001/3755 to cater for, among other things, "eligible debt securities" (the Uncertificated Securities (Amendment) (Eligible Debt Securities) Regulations 2003 SI 2003/1633 – the "2003 regulations"). That term is defined in regulation 3(h) as:

> (a) a security that satisfies the following conditions-
>
> (i) the security is constituted by an order, promise, engagement or acknowledgement to pay on demand, or at a determinable future time, a sum in money to, or to the order of, the holder of one or more units of the security; and
>
> (ii) the current terms of issue of the security provide that its units may only be held in uncertificated form and title to them may only be transferred by means of a relevant system;
>
> (b) an eligible Northern Ireland Treasury Bill; or
>
> (c) an eligible Treasury Bill.

712. The 2003 regulations also modify numerous provisions to cater for the new type of money market instrument where legislation applies to one or other type of migrated instrument. Some of the legislation is tax provisions, including section 56 of ICTA. Paragraph 6 of Schedule 2 to the 2003 regulations deals with certificates of deposit. In an enactment to which paragraph 3 applies:

> (a) a reference to a certificate of deposit includes a reference to uncertificated units of an eligible debt security where the issue of those units corresponds, in accordance with the current terms of issue of the security, to the issue of a certificate of deposit which is a certificate of deposit for the purposes of that enactment; and
>
> (b) a reference to an amount stated in a certificate of deposit includes a reference to a principal amount stated in, or determined in accordance with, the current terms of issue of an eligible debt security of the kind referred to in subparagraph (a).

713. Although the modification applied by the 2003 regulations does not amend the text of the statute in question, it has the same effect as an amendment. Section 552 therefore defines "deposit rights" to encompass all types of deposit, old and new.

714. While the vast majority of deposit rights in 2005-06 and later years will take the form of units of uncertificated eligible debt securities, there are likely to be a few extant old certificates of deposit (or the previous paperless equivalent) or new certificated deposits, and this Chapter applies to them.

715. A number of consequential amendments in Schedule 1 to this Act add, for income tax purposes, the modification applied by the 2003 regulations (see, for example, paragraph 148 which amends section 349 of ICTA). As regards the reference to "rights" in section 398 of ICTA (which modifies loss relief under sections 392 or 396 of ICTA in relation to the disposal of deposit rights), the modification applied by the 2003 regulations is provided, for income tax purposes, through the consequential amendment in that Schedule inserting a reference to this Chapter.

716. In so far as sections 56 and 56A of ICTA continue to apply after 2004-05 for corporation tax purposes (but see section 56(4A) and (4B) of ICTA), the modification is still provided by the 2003 regulations. For corporation tax purposes, the reference to "rights" in section 398 of ICTA is modified accordingly.

717. For the purposes of the exemptions provided by section 56(3)(b) and (c) of ICTA, which are not rewritten in this Act, the modification is also still provided by the 2003 regulations.

718. This Chapter does not rewrite section 56(3)(a) of ICTA, under which there is no charge in respect of a right to receive an amount stated in a certificate of deposit issued before 7 March 1973. As certificates of deposit are in practice issued for a maximum term of five years, section 56(3)(a) of ICTA is obsolescent, if not obsolete. Paragraph 92 of Schedule 2 to this Act provides a saving for extant pre-7 March 1973 certificates (if any).

Section 551: Charge to tax on profits from disposal of deposit rights

719. This section is based on sections 56 and 56A of ICTA.

720. As deposit rights consist of the right to receive interest and the right to the return of the principal amount, *subsection (2)* makes clear that receiving the principal amount is a disposal of rights for the purposes of the charge to tax but receiving interest is not. Such interest is taxable under Chapter 2 of this Part.

Section 552: Meaning of "deposit rights"

721. This section is based on sections 56 and 56A of ICTA, as modified by the 2003 regulations.

722. S*ubsection (2)* defines various terms. The definitions of terms in relation to "uncertificated eligible debt security units" are based initially on the modification provided by the 2003 regulations, although the definitions themselves are based individually on earlier regulations. The definition of a "certificate of deposit" is based on sections 56(5) and 56A(4) of ICTA. The definition of a "security" is based on section 56(5) of ICTA, which uses the definition in section 132 of TCGA. The definition of an "uncertificated right" is based on section 56A(1) of ICTA. Paragraph 93 of Schedule 2 to this Act preserves the commencement rule for this category, in so far as any pre-16 July 1992 arrangements are extant.

Section 553: Income charged

723. This section sets out the amount of income charged to tax. It is based on section 69 of ICTA.

Section 554: Person liable

724. This section states who is liable for any tax charged. It is based on section 59 of ICTA.

725. Section 56(2) of ICTA, as extended by section 56A(3)(a) of ICTA, sets out in rather elaborate terms the persons whose exercise of a deposit right results in the profits being charged to tax. But section 59 of ICTA achieves the same effect by simpler means, so those parts of sections 56 and 56A of ICTA are not rewritten.

Chapter 12: Disposals of futures and options involving guaranteed returns

Overview

726. This Chapter rewrites the provisions in Schedule 5AA to ICTA on guaranteed returns on transactions in futures and options. It taxes as income profits and gains on a disposal of a future or option which, but for this Chapter, would be taxed as chargeable gains.

Section 555: Charge to tax under Chapter 12

727. This section charges to tax profits and gains arising on a disposal of a future or option to which the Chapter applies. It is based on paragraph 1 of Schedule 5AA to ICTA.

728. The section refers to "profits and gains", as in the source legislation, since the profits arising may also be gains for the purposes of TCGA. There are provisions to ensure that a double charge under both this Chapter and TCGA does not arise. See new section 148A of TCGA (futures and options involving guaranteed returns) in paragraph 435 of Schedule 1 to this Act.

729. The word "disposal" (see section 562 (when disposals of futures or options occur: general)) replaces "transaction to which this Schedule applies" since a gain can only arise on a disposal, although not all transactions are necessarily disposals.

730. *Subsection (1)* refers to a disposal of a future or option rather than a disposal of futures or options as in paragraph 2(1) of Schedule 5AA to ICTA. A taxpayer is taxed on a disposal of a future or an option. A similar reference to a disposal of a future or option appears in sections 559 and 560 where the source legislation refers to a disposal of futures or options.

731. *Subsection (2)* provides that profits which, but for this Chapter, would be capital profits, may be charged under this Chapter.

732. Profits and gains from a trade, whether arising in the United Kingdom or abroad, are excluded and dealt with under Part 2 of this Act. See section 366(1) which gives the charge in Part 2 priority. That aside, the charge under this Chapter is on both UK and foreign profits and gains. See *Change 101* in Annex 1.

Section 556: Income charged

733. This section sets out the amount charged to tax on profits and gains that arise on the disposal of a future or option. It is based on paragraph 1 of Schedule 5AA to ICTA.

734. Schedule 5AA to ICTA provides no precise computational rules for computing the profit or gain arising on the future or option chargeable to tax. It refers only to the profits being "realised". This is rewritten by providing that the profits are the full amount of profits and gains arising when the disposal occurs. In most cases the quantum of profits will be the difference between the disposal proceeds and the acquisition cost of the future or option.

Section 557: Person liable

735. This section states who is liable for any tax charged. It is based on paragraph 1 of Schedule 5AA to ICTA.

Section 558: Meaning of "future", "option" etc.

736. This section explains what is meant by future and option for the purposes of this Chapter. It is based on paragraphs 4 and 4A of Schedule 5AA to ICTA.

737. *Subsection (2)* reproduces the definition of "traded option" in section 144(8) of TCGA rather than relying on a cross-reference to that Act, as paragraph 4(6) of Schedule 5AA does. But the section does not employ the term "traded option". The distinction between a traded option and any other option is relevant only for paragraph 4(3) of Schedule 5AA to ICTA.

Section 562 (when disposals of futures or options occur: general), which rewrites that paragraph, applies the substance of the definition without using the term.

738. *Subsection (3)* has, for the sake of convenience, been introduced from TCGA.

Section 559: When disposals involve guaranteed returns

739. This section explains for the purposes of this Chapter when a disposal involves guaranteed returns. It is based on paragraph 2 of Schedule 5AA to ICTA.

740. *Subsection (1)* provides that where the conditions in *subsections (2)* to *(4)* are met a disposal will involve guaranteed returns. These conditions are that there must be at least one other related transaction, apart from the disposal giving rise to the charge, and that this, and the related transaction, are intended to produce a guaranteed return. (What is meant by "related transactions" is explained by section 566 (when transactions are related)). The guaranteed return should consist of the return from the disposal in question or a number of disposals of which the disposal in question is one.

741. *Subsection (5)* explains the phrase used in the first condition "two or more related transactions designed to produce a guaranteed return". A "main purpose test" is applied to the two or more related transactions. Considering them together, it must be reasonable to assume that their main purpose or one of their main purposes is to produce that guaranteed return.

742. *Subsection (6)* then explains what factors may be considered in making a "reasonable assumption". These are the same factors as in section 566 (when transactions are related).

Section 560: Production of guaranteed returns

743. This section explains, for the purposes of this Chapter, what is meant by producing a guaranteed return from a disposal of a future or option. It is based on paragraph 3 of Schedule 5AA to ICTA.

744. *Subsection (1)* gives the basic rule for ascertaining whether a guaranteed return is produced from a disposal of a future or option. A risk of fluctuations in the underlying subject matter (defined at *subsection (6)*) of the future or option must be eliminated or reduced so that the return on the disposal meets the two conditions in subsections (3) and (4).

745. *Subsection (2)* supplements the rule in subsection (1) where there is more than one disposal.

746. *Subsections (3)* and *(4)* provide two conditions that must be met for the basic rule to apply. Broadly, the return on the investment must be predictable and have more similarity to interest than to the risk expected on a future or option.

747. *Subsection (5)* extends the circumstances in which risks are treated as eliminated or reduced. A main reason for the choice must be the expectation that the value of an asset of that nature will be liable to only minimum fluctuation.

Section 561: The return from one or more disposals

748. In order to ascertain whether there is a guaranteed return for the purposes of this Chapter, section 559 (when disposals involve guaranteed returns) requires a consideration of "the return from one or more disposals". This section explains what is meant by "the return from one or more disposals". It is based on paragraph 5 of Schedule 5AA to ICTA.

749. *Subsection (1)* contains the basic rule. The charge under section 555 (charge to tax under Chapter 12) is on a profit or gain from an individual disposal. But, in deciding whether there is a guaranteed return, more than one disposal in the scheme or arrangement can be taken into account and the overall result of that disposal or those disposals considered, that is to say the profits or gains less losses on those disposals or on all but an insignificant part of them.

750. *Subsection (2*) provides that profits or gains or losses are to be treated as made by the same person, notwithstanding that they are realised by different persons, if they are made by persons who are associated with each other.

751. *Subsections (3)* to *(6)* explain when persons are associated with each other. (This is quite unconnected with the associated person test in section 227 of ICTA.) All disposals must be part of the same scheme or arrangements (defined in *subsection (7)*) and all must share in the net return of all the profits and losses incurred on those disposals in a sharing arrangement agreed for that scheme or arrangements.

752. The references in paragraph 5(3) of Schedule 5AA to ICTA to "associated companies" have not been reproduced. See *Change 102* in Annex 1.

Section 562: When disposal of futures or options occur: general

753. Tax is charged under this Chapter on the profits and gains arising from a disposal of a future or option. This section explains when there is a disposal. It is based on paragraph 4 of Schedule 5AA to ICTA.

754. *Subsection (1)* refers to the relevant sections of TCGA which decide whether and when a disposal occurs. Section 143(5) and (6) of TCGA treat as disposals futures contracts which are closed out by entering into another contract or which are settled by payment. Section 144 of TCGA treats as disposals grants and abandonments of options (but not the exercise of an option). Section 144A of TCGA provides that the exercise of an option which is settled by cash is treated as a disposal both in respect of the grantor of the option and the grantee. These last two sections also provide rules as to when a future or option in these circumstances has been disposed of.

755. The assumptions that apply in interpreting subsection (1) are set out in subsections (2) to (4).

756. *Subsection (2)* requires, for the removal of doubt, that all futures are to be considered as assets in applying the TCGA sections. (Options are already listed as chargeable assets in section 21(1) of TCGA.)

757. *Subsection (3)* requires section 143(5) and (6) of TCGA to be read without the words "in the course of dealing in commodity or financial futures" since the range of futures transactions covered by this Chapter extends beyond commodity and financial futures as defined in section 143 of TCGA.

758. *Subsection (4)*, by requiring references to a financial option in section 144 of TCGA to exclude only listed options, extends the provisions of that section to cover options that would otherwise be excluded under the definition in subsection 144(8) of TCGA. (Section 144 of TCGA provides for the grant and abandonment of options to be treated as disposals and for premiums to be included in the computation of the gain or loss.) These listed options are referred to as "traded options" in paragraph 4 of Schedule 5AA to ICTA. The context

demands that the listing should be at the time of disposal and this has been added for clarification.

759. *Subsection (5)* provides a cross-reference to sections 563 (timing of certain grants of options where related disposals occur later) and 564 (deemed disposal where futures run to delivery or options are exercised).

760. Section 563 provides timing rules for deemed disposals where futures run to delivery or option contracts are exercised. Section 564 provides that futures running to delivery and options exercised are treated as disposals for the purposes of this Chapter if they would not otherwise be.

761. This section does not rewrite paragraph 4(1) of Schedule 5AA to ICTA. That subparagraph explains that a disposal is a disposal of futures or options if it is the disposal of one or more futures or one or more options or both combined. Because a taxpayer is charged on a disposal of a future or option and more than one future or option may already be taken into account in ascertaining whether there is a guaranteed return (see section 561), it is considered that this sub-paragraph adds nothing but simply serves to confuse.

Section 563: Timing of certain grants of options where related disposals occur later

762. This section provides that certain grants of options are to be treated as having taken place after other transactions. The purpose is to allow loss relief arising on the grant of an option to be set against a later profit. The section is based on paragraph 4 of Schedule 5AA to ICTA.

763. *Subsection (1)* sets out the general rule. There are three conditions that must be satisfied for the rule to apply.

764. *Subsections (2)* to *(4)* set out these three conditions. There must be a number of related transactions designed to produce a guaranteed return of which one is the grant of an option. At least one of the other transactions should be entered into after the grant and should be a disposal that is not a grant of an option.

765. *Subsection (5)* then provides that the grant of the option is deemed to take place at the same time as the next one of the transactions referred to in subsection (4) takes place. As a result, a loss on the grant of an option will coincide with any profit arising on the later transaction. Because losses under Schedule 5AA to ICTA are allowable against Schedule D Case VI profits they may be carried forward against other Schedule D Case VI profits arising in a later year or set off against other Schedule D Case VI profits of the same year, but not carried back. Since the Schedule D Case VI set-off rule is rewritten, this section allows that later profit to be reduced by a loss which, but for this section, could arise in a later year than that profit.

766. *Subsection (6)* consequently requires that the two timing rules in sections 144(2) and 144A(2) of TCGA, should they apply, take precedence over the timing rule in this section. But in most cases the two rules will give the same result. (Sections 144(2) and 144A(2) of TCGA treat grants of options and transactions by the grantor to fulfil his obligations as a single transaction.) The purpose of this is to allow the sum received on the grant to fall within the same capital gains computation as arises when the option is exercised, etc. Where it applies for this Chapter, the timing rules in these two sections of TCGA will generally achieve the same results as this section. But the rules in sections 144(2) and 144A(2) of

TCGA will not always apply because certain transactions within this Chapter fall outside them.

Section 564: Deemed disposal where futures run to delivery or options are exercised

767. This section provides that futures which are allowed to run to delivery and option contracts which are exercised will be treated as disposals for the purposes of this Chapter if they would not otherwise be disposals under this Chapter. Paragraph 94 of Schedule 2 to this Act ensures that these transactions are not disposals if they took place before 6 February 1998. This section is based on paragraph 4A of Schedule 5AA to ICTA.

768. *Subsections (2)* and *(3)* provide the conditions that must apply for there to be a deemed disposal. There must be two or more related transactions (section 566 explains what is meant by a related transaction). One of these must be the creation or acquisition of a future or option and the other the running to delivery of that future or exercise of that option but which is not already a disposal for the purposes of this Chapter.

769. Under *subsection (4)* a disposal is deemed to have taken place the moment before the future runs to delivery or the option is exercised and that disposal is deemed to be a disposal provided for in a scheme or arrangements.

770. Both parties to the future or option are affected by the deemed disposal.

771. Under s*ubsection (5)* the person whose rights and entitlements have a value immediately before the option is deemed to dispose of that right or those rights for their market value. Thus the same disposal proceeds are deemed to arise as if the person had disposed of the contract to another and a profit or gain had arisen in those circumstances.

772. Under *subsections (6)* and *(7)* any other party to the future or option is deemed to have received nothing on the disposal but to have incurred costs equal to the amount the person would have been expected to pay in an arm's length transaction for the release of the person's obligations under the contract.

773. *Subsection (8)* requires that section 144(2) and (3) of TCGA should be disregarded in applying subsections (1) to (3). This is because under these two subsections of section 144 of TCGA (applicable as a result of section 562 (when disposals of futures or options occur: general)) the grant and exercise of an option are treated as a single transaction (to enable the premium to be set against the disposal proceeds). But, in order for this section to apply, subsections (1) to (3) require *two* related transactions, the creation of the future or option and its running to completion or being exercised, so those two transactions must not be taken to be a single transaction.

Section 565: Interpretation of section 564

774. This section provides explanations necessary to understand the previous section. It is based on paragraph 4A of Schedule 5AA to ICTA.

775. *Subsection (3)* defines "party" in relation to the future or option in terms of rights, entitlements, obligations and liabilities, ensuring that both "grantors" and "grantees" of both futures and options fall within the definition.

Section 566: When transactions are related

776. This section provides an explanation of what is meant by related transactions. The rules given in this section are necessary for the definition of what constitutes a guaranteed return in section 559, for the timing of disposals in section 563 and for applying the provisions on deemed disposals in section 564. This section is based on paragraph 6 of Schedule 5AA to ICTA.

Section 567: Losses

777. This section gives some rules on losses, when they arise and how they are relievable. It is based on paragraph 1 of Schedule 5AA to ICTA.

778. *Subsection (4)* gives a link to three sections which have been inserted into TCGA by paragraph 435 of Schedule 1 to this Act. They rewrite paragraph 4A(5) to (9) of Schedule 5AA to ICTA. The rules in these two new sections prevent gains which have been charged under this Chapter from being taxed again under TCGA and losses relieved under this Chapter from being relieved again under that Act. Because these rules are properly relevant to the capital gains regime they are rewritten as consequential amendments to TCGA.

Section 568: Special rule for certain income of trustees

779. This section provides, with some exceptions, that profits or gains arising to trustees under this Chapter are chargeable to tax at the rate applicable to trusts in section 686 of ICTA. It is based on paragraph 7 of Schedule 5AA to ICTA.

780. The reference in *subsection (4)* to a superannuation fund to which section 615(3) of ICTA applies has effect for the tax year 2006-07 onwards only. There is a transitional rule in paragraph 95 of Schedule 2 to this Act which gives the rules for 2005-06. Changes to the rules on superannuation funds in FA 2004 only apply from 2006-07.

781. *Subsection (6)* qualifies the meaning of "trustees" for the purposes of this section. Paragraph 7(3) of Schedule 5AA to ICTA simply refers to section 686 of ICTA but the definition in that section is rewritten in full here.

Section 569: Anti-avoidance: transfer of assets abroad

782. Sections 739 and 740 of ICTA provide rules to counter the avoidance of income tax by the transfer of assets abroad. They apply where income is payable to a person resident or domiciled outside the United Kingdom but which a person domiciled or resident within the United Kingdom has the power to enjoy. This section enables sections 739 and 740 of ICTA to apply to profits arising under this Chapter by ensuring that the profits or gains are treated as income payable to a person resident or domiciled outside the United Kingdom. It is based on paragraph 8 of Schedule 5AA to ICTA.

Chapter 13: Sales of foreign dividend coupons

Overview

783. This Chapter rewrites the charge to tax in section 18(3B) to (3E) of ICTA on the proceeds of the sale of coupons and warrants attached to foreign securities and shares, where the sale is made through a bank or to a dealer in coupons and both are in the United Kingdom.

Section 570: Charge to tax under Chapter 13

784. This section charges to tax income which is treated as arising from foreign holdings where a dividend coupon attached to the holding is (a) sold or otherwise realised by a bank in the United Kingdom or (b) sold to a coupon dealer in the United Kingdom by someone other than a bank or a coupon dealer. The term "foreign holdings" is defined in section 571. The section is based on section 18 of ICTA.

785. *Subsection (3)* sets out the first circumstance in which income is treated as arising from foreign holdings. This is where the UK office of a bank pays over the proceeds of a sale or realisation of dividend coupons or carries those proceeds to an account. Section 18(3B)(a) of ICTA refers simply to "a bank in the United Kingdom". See *Change 103* in Annex 1.

786. *Subsection (4)* sets out the second circumstance. This is where a person who is neither a bank nor another coupon dealer sells the dividend coupons to a coupon dealer in the United Kingdom. Section 18(3B)(b) of ICTA refers to "a dealer in coupons in the United Kingdom". See *Change 103* in Annex 1.

Section 571: Meaning of "foreign holdings" etc

787. This section gives the meaning of "foreign holdings" and "dividend coupons" and of words used within these definitions. It is based on section 18 of ICTA.

Section 572: Income charged

788. This section sets out the amount charged to tax on income arising from foreign holdings. It is based on section 65 of ICTA.

Section 573: Person liable

789. This section states who is liable for any tax charged. It is based on section 59 of ICTA.

Part 5: Miscellaneous income

Overview

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

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

- receipts from intellectual property (Chapter 2);
- films and sound recordings: non-trade businesses (Chapter 3);
- certain telecommunication rights: non-trading income (Chapter 4);
- settlements: amounts treated as income of settlor (Chapter 5);
- beneficiaries' income from estates in administration (Chapter 6);
- annual payments not otherwise charged (Chapter 7); and
- income not otherwise charged (Chapter 8).

Structure of Chapters

792. The basic structure of each Chapter is:

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

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

Part 5: Chapter 1: Introduction

Section 574: Overview of Part 5

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

Section 575: Provisions which must be given priority over Part 5

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

796. *Subsection (1)* ensures that if any amount falls within a charge in Part 5 of this Act and the charge on trade profits, Chapter 2 of Part 2 of this Act will charge that amount as a trade receipt.

797. It also reflects the decision to give effect to the Crown Option. See *Change 66* in Annex 1.

798. *Subsection (2)* ensures that if any amount falls within a charge in Part 5 of this Act and the charge on a UK property business, Chapter 3 of Part 3 of this Act will charge that amount as a receipt of a UK property business. This reflects the priority of Schedule A over Schedule D and is based on section 18(1)(b) of ICTA and Schedule D Cases III(a) and VI.

799. Particular types of income which, in the source legislation, are charged to tax under Schedule D Case III have been given separate charges to tax in Parts 4 and 5 of this Act. As the general annual payments charge in Chapter 7 of Part 5 of this Act takes effect only if an amount is not otherwise charged to income tax there can be no overlap between this charge and the ex-Case III charges in Part 4 of this Act.

800. *Subsection (3)*, therefore, provides a rule where there could potentially be an overlap between Chapters within Parts 4 and 5 of this Act. It ensures that the interest charge in Chapter 2 of Part 4 takes priority over any of the charges in Part 5 that are based on Schedule D Case VI. This maintains the priority in the source legislation of Case III over Case VI which charges amounts that do not fall under any other Case of Schedule D.

801. It also provides the priority between Chapter 3 of Part 4 of this Act (dividends etc. from UK resident companies) and Part 5 of this Act. This rewrites the effect of section 20(2) of ICTA which provides specifically for Schedule F to take priority over the other Schedules.

802. *Subsection (4)* ensures that if any amount falls within a charge in Part 5 and any of the charging provisions in ITEPA, ITEPA has priority. This reflects the priority of ITEPA over Schedule D and is based on section 18(1)(b) of ICTA and Schedule D Case VI.

803. The non-schedular charges rewritten in Part 5 of this Act in Chapter 5 (Settlements: amounts treated as income of the settlor) and section 656 (Beneficiaries' income from estates in administration: Income charged: UK estates) do not have the potential to overlap with Chapter 2 of Part 2 of this Act (trade profits) or Chapter 3 of Part 3 of this Act (UK property business) or any of the charges in Part 4 of this Act or ITEPA. There is therefore no need to exclude these charges from the priority rules.

Section 576: Priority between Chapters within Part 5

804. This section provides rules which determine which Chapter will take priority in the case of any overlaps in the charging provisions within Part 5 of this Act. It is new.

805. Usually, by their nature, the particular amounts charged in Part 5 of this Act can fall only within one Chapter so there is no need to make any special provision. In addition, as the general annual payments charge in Chapter 7 of Part 5 of this Act takes effect only if an amount is not otherwise charged to income tax there can be no overlap between this charge and the ex-Case III charges in Part 5 of this Act.

806. This section provides the one priority rule required for this Part. Where amounts fall within Chapter 2 (receipts from intellectual property) and Chapter 3 (films and sound recordings: non-trade businesses), Chapter 3 has priority. Although both charges are based on Schedule D Case VI, priority has been given to Chapter 3 to ensure that these amounts continue to benefit from the special deductions rules set out in sections 612 and 613 of that Chapter.

Section 577: Territorial scope of Part 5 charges

807. This section provides that income within Part 5 of this Act is only charged to tax if it is from a source in the United Kingdom or, if from a source outside the United Kingdom, it arises to a UK resident.

808. It is based on section 18(1) of ICTA.

809. The comments made in the commentary on section 368 of this Act on the absence of a charge to tax on income from outside the United Kingdom arising to non-residents apply here also. See in particular the specific comments on subsections (1), (2) and (3) of that section, the use of the term "source" and how it is proposed to include within that section income without a source.

810. *Subsection (4)* serves to exclude, for example, section 587 (charge to tax on income from sales of patent rights) from the scope of this rule since that section has its own rules on territorial scope.

Chapter 2: Receipts from intellectual property

Overview

811. This Chapter incorporates three charges to income tax in respect of intellectual property. The Chapter includes a charge to income tax on royalties and other receipts from intellectual property arising both within and outside the United Kingdom. In this context,

intellectual property includes patents, trade marks, registered designs and design rights, copyright, performer's rights or plant breeder's rights. The Chapter also charges to income tax capital sums arising from the disposal of know-how in certain circumstances and capital sums from the sale of patent rights.

812. The following are excluded from the scope of this Chapter:

- royalties or other receipts from intellectual property which form part of the profits of a trade (dealt with in Part 2 of this Act);
- capital sums from the disposal of know-how which are treated either as trading receipts or as a payment for goodwill (dealt with in Part 2 of this Act or in TCGA); or
- balancing charges for certain forms of intellectual property included in CAA.

813. Sections 536 (taxation of royalties where owner abroad), 537 (public lending right) and 537B (taxation of design royalties where owner abroad) of ICTA are not rewritten. These provisions all relate to deduction of tax at source under section 349(1) of ICTA.

Section 578: Contents of Chapter

814. This introductory section sets out the three income tax charges imposed by the Chapter. It is new.

815. *Subsection (2)* contains a signpost to section 727 of this Act which provides for a limited exemption from income tax for annual payments made by individuals. So payments of royalties which are made by individuals and arise in the United Kingdom will be outside the scope of this section if the conditions in section 727 are met. This subsection also contains a signpost to section 758 of this Act which contains another exemption for certain interest and royalty payments.

Section 579: Charge to tax on royalties and other income from intellectual property

816. This section charges to tax royalties and other income from intellectual property. It is based on section 18 of ICTA.

817. The section sets out a new provision creating a specific charge to tax on royalties and other income from intellectual property. The source legislation uses general principles to tax such income. In the source legislation, income from intellectual property is charged:

- as annual payments under Schedule D Case III;
- as profits of a trade under Schedule D Case I;
- as annual profits or gains under Schedule D Case VI; or
- as income arising from possessions out of the United Kingdom under Schedule D Case V.

The new charge covers income charged in the source legislation under the heads mentioned above, except that trading income derived from intellectual property is to be taxed not under section 579 but under Part 2 of this Act. The rules set out in the section are not intended to widen or restrict the scope of the charges under Schedule D in the source legislation.

818. The charge embraces royalties which are UK source annual payments (Schedule D Case III in the source legislation), overseas income from intellectual property (Schedule D

Case V in the source legislation) and casual profits of an income nature from the exploitation of intellectual property outside the course of a trade (Schedule D Case VI in the source legislation). The charges relating to capital sums arising from the disposal of know-how in certain circumstances and capital sums arising from the sale of patent rights are dealt with further on in this Chapter.

819. *Subsection (1)* contains the charge on royalties and other income from intellectual property. Royalties are mentioned specifically, even though they are covered by the words "income from intellectual property", since most of the income within the scope of this section is likely to be royalties. However, no attempt has been made to define the term "royalties". The source legislation does not do so. Although definitions have been suggested by the courts they are not appropriate to include here as the word "royalties" has only been used to assist the courts to determine whether a payment or receipt is of a revenue or capital nature.

820. *Subsection (2)* defines intellectual property for the purposes of this section. Intellectual property is an area of rapid change. Because of this, it is not possible to define intellectual property by way of an exhaustive list. Subsection (2)(b) therefore charges United Kingdom source royalties and other income from rights which correspond to or are similar to those listed in subsection (2)(a). Subsection (2)(c) covers rights under foreign law which correspond to or are similar to those listed in subsection (2)(a). Also within the scope of the charge is income from any information or technique not protected by a right within subsection (2)(a), (b) or (c) of this section. So subsection (2)(d) provides the flexibility to bring within the scope of the section income derived from new types of intellectual property as changes occur in this field.

Section 580: Income charged under section 579

821. This section sets out the amount charged to tax under section 579 in respect of royalties and other income from intellectual property. It is supplemented by the detailed calculation rules for certain income in section 582. The section is based on sections 64, 65, 68 and 69 of ICTA.

822. *Subsection (4)* contains a signpost to section 527 of ICTA (relating to the spreading of patent royalties etc. over several years). Section 527 of ICTA deals with relief in terms of a reduction in the income tax charge. It will be rewritten together with other similar relieving provisions.

Section 581: Person liable for tax under section 579

823. This section states who is liable for any tax charged under section 579 in respect of royalties and other income from intellectual property. It is based on section 59 of ICTA.

Section 582: Deductions in calculating certain income charged under section 579

824. This section sets out the rules for the deduction of certain expenses from income charged under section 579 other than annual payments (charged under Schedule D Case III in the source legislation) or foreign income charged on the remittance basis in accordance with section 832 of this Act. It applies to income charged under both Schedule D Case V and Case VI in the source legislation. It is new.

825. There is no express provision in the legislation for deductions of expenditure from Schedule D Case VI income, although it is implied by the word "profits" in section 69 of ICTA (Case VI assessments) and by section 392 of ICTA (Case VI losses). This view has

been upheld by the courts (see Curtis Brown v Jarvis (1929), 14 TC 744 HC). Expenditure admissible relating to income arising in the United Kingdom within the scope of the section would not cease to be admissible in respect of the same type of income arising outside the United Kingdom. However, under section 64 of ICTA (Case III assessments) no deduction is permitted from income within the Schedule D Case III charge so this section specifically does not apply to annual payments.

826. *Subsections (2) to (4)* contain general rules about the expenditure which may be deducted. The rules are broadly based on those for deduction of expenses in calculating trade profits. In particular subsection (2) allows only expenses wholly and exclusively incurred in generating income. The intention here is to allow expenses that would be available in computing profits under Schedule D Case V or VI, and not to widen or restrict the scope of deductible expenses.

827. *Subsection (6)* provides that the deduction of patent expenses under section 600 is additional to the relief due under this section. But where relief is given under section 582, no relief can then be given for the same expenditure as patent expenses – see subsection (5) of section 600.

Section 583: Charge to tax on income from disposals of know-how

828. Sections 583 to 586 all relate to consideration received for the disposal of know-how. Section 583 charges to tax the proceeds of certain disposals of know-how. It is based on section 531 of ICTA. Under the source legislation, income from disposals of know-how is charged to tax under Schedule D Case VI.

829. Section 531(6) of ICTA, which categorises a charge under section 531(4) of ICTA as "earned income", is repealed by this Act and replaced by new section 833(5A) of ICTA (see paragraph 338(5) of Schedule 1 to this Act). The concept of "earned income" in the context of know-how will now only be relevant for the purposes of section 282A of ICTA (jointly held property).

830. *Subsection (1)* imposes the tax charge. Subsection (1)(b) is based on section 531(8) of ICTA but the words "whether absolute or qualified" have been omitted since they are superfluous. The word "profits" has been used here as it more accurately describes the sum which, after deduction of certain expenditure, is chargeable to tax.

831. *Subsection (5)* defines "mineral deposits" for the purposes of this Chapter. This restores, for income tax purposes, a definition of "mineral deposits" that applied before CAA was enacted. See *Change 51* in Annex 1.

Section 584: Exceptions to charge under section 583

832. This section sets out the exceptions to the charge under section 583. It is based on section 531 of ICTA.

833. For the purposes of subsections (4) and (5) of the section, "control" is defined (through section 878(6) of this Act) by reference to section 840 of ICTA. The ICTA definition of "control" is identical in effect to that in section 574 of CAA. But as the relevance of "control" in this Act goes wider than this Chapter, the ICTA definition is used here.

Section 585: Income charged under section 583

834. This section sets out the amount charged to tax under section 583. It is based on sections 69 and 531 of ICTA. There is no exclusion for sums calculated under the remittance basis by section 832 of this Act because, under the source legislation, income from the disposal of know-how is charged under Schedule D Case VI (to which the remittance basis does not apply).

835. *Subsection (3)* ensures that expenditure may be deducted only once under this section and does not permit a deduction if relief has been obtained for the expenditure elsewhere (for example, as trading expenditure or by way of an allowance under CAA).

836. *Subsection (4)* contains a signpost to section 603 of this Act which deals with contributions to expenditure. This is necessary because section 532 of ICTA treats section 531 of ICTA as if it had been contained in CAA.

Section 586: Person liable for tax under section 583

837. This section states who is liable for any tax charged under section 583. It is based on section 531 of ICTA. The specific rules in section 531 of ICTA override the general "person chargeable" rule for Schedule D in section 59(1) of ICTA.

Section 587: Charge to tax on income from sales of patent rights

838. Sections 587 to 599 deal with sales of patent rights. Section 587 charges to tax capital sums from the sale of patent rights. It is based on section 524 of ICTA. The charge under this section applies equally to both traders and non-traders.

839. Section 529 of ICTA, which categorises certain income patent rights as "earned income", is repealed by this Act and replaced by new section 833(5B) to (5E) of ICTA (see paragraph 338(5) of Schedule 1 to this Act).

840. *Subsection (1)* taxes "profits" from sales of patent rights. The word "profits" has been used here as it more accurately describes the sum which, after deduction of certain expenditure, is chargeable to tax.

841. *Subsection (2)* contains a special rule providing that non-UK residents are taxed only on profits from the sale of UK patent rights. UK residents are taxed on profits from the sale of patent rights granted under the laws of the United Kingdom or any other country or territory.

842. *Subsection (3)* provides that tax is not charged where the seller is a non-UK resident company chargeable to corporation tax (for example, trading in the United Kingdom through a permanent establishment). Section 524(5) of ICTA sets out which persons are chargeable to income tax and which to corporation tax under section 524(3) of ICTA. This is necessary because sections 6 and 11 of ICTA, which generally deal with the income tax/corporation tax split, are drafted in terms of "income". Section 524(5) of ICTA explains how the split is to work in the case of the capital sums charged to tax under section 524(3) of ICTA. Subsection (3) of this section makes it clear that a non-UK resident company chargeable to corporation tax is not chargeable to income tax in respect of capital sums from the sale of patent rights.

Section 588: Income charged under section 587

843. This section sets out the amount charged to tax on profits from the sale of patent rights under section 587. It is subject to the spreading rules in section 590 to section 594. The section is based on section 524 of ICTA.

844. There is no exclusion for sums calculated under the remittance basis under section 832 of this Act because, under the source legislation, profits from the sale of patent rights are charged to tax under Schedule D Case VI (to which the remittance basis does not apply).

845. *Subsection (1)* provides that the profits are the proceeds of sale less the deductible costs. The reference to "net proceeds of the sale" in section 524(3) of ICTA implies that some deduction is available, but the source legislation does not further specify which amounts are deductible. The section makes it clearer what amounts may be deducted.

846. *Subsection (2)* defines deductible costs as the capital cost of the rights sold plus any incidental expenses of sale. The section makes it explicit that such expenses may be deducted. The types of expenses which may be allowed under this section are not listed. Incidental expenses which relate to both capital sale proceeds and other sums not chargeable to tax under section 587 are effectively apportioned under the rules about net proceeds of sale in section 606.

847. *Subsection (5)* contains a signpost to section 603 which deals with contributions to expenditure. This is necessary because section 532 of ICTA treats section 524 of ICTA as if it had been contained in CAA. There is also a signpost here to the special rules giving relief from tax on patent income in section 600.

Section 589: Person liable for tax under section 587

848. This section states who is liable for any tax charged under section 587. It is based on section 524 of ICTA. The specific rules in section 524 of ICTA override the general "person chargeable" rule for Schedule D in section 59(1) of ICTA.

Section 590: UK resident sellers: spreading rules

849. This section sets out the spreading rules where the person chargeable under section 587 is resident in the United Kingdom. It is based on section 524 of ICTA.

850. Section 524 of ICTA imposes a charge to tax where a person sells all or any part of any patent rights and the net proceeds of sale consist wholly or partly of a capital sum. There are separate charges for sellers who are resident in the United Kingdom (this section) and non-UK resident sellers of UK patent rights (sections 591 and 592).

851. For both UK residents and non-UK residents, tax is charged (depending on whether or not an election is made) either:

- in respect of the whole sum, for the tax year in which it is received, or
- on one sixth of the sum for that year and for each of the next five tax years.

852. A "sum" to which the above rules apply could be either the whole sale proceeds or an instalment of the proceeds. So, for instance, where a UK resident seller has not elected otherwise, any receipt of an instalment of sale proceeds charged under the source legislation (section 524(1) of ICTA) would trigger the start of a six year period over which the charge for that instalment would be spread.

853. In this Chapter, the way in which the rules on the timing of the tax charge apply to instalments is dealt with expressly.

854. *Subsection (3)* allows the person chargeable to elect to be taxed on the whole amount for the first tax year, subject to the time limit for the normal self-assessment filing date for the tax year concerned (see also subsection(6)).

855. *Subsection (6)* contains the time limit for elections under this section. The source legislation refers to "an officer of the Board" and the effect of this is maintained by section 878(4) of this Act which draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to "an officer of the Board".

Section 591: Non-UK resident sellers: election for spreading

856. This section sets out how non-UK residents are taxed on capital sums from the sale of patent rights where the sale proceeds are not received in instalments. It is based on sections 69 and 524 of ICTA.

857. *Subsection (1)* provides that the whole amount chargeable is taxed for the tax year in which the proceeds are received. This is subject to an election for spreading in subsection (2).

858. *Subsection (2)* enables the person chargeable to elect to be taxed over six tax years beginning with the tax year in which the proceeds of sale are received. This has been brought into line with section 590 which covers UK residents. Section 524(3) of ICTA provides that if a non-UK resident chargeable to tax makes an election, the proceeds received are *treated* as if they were chargeable to tax over six years and the liability is calculated *as though* the sum were spread over six years. But the effect is the same and there is no reason why the wording in these two sections should not be consistent. However, the source legislation would have been interpreted in this way so this clarification does not amount to a change in the law.

859. *Subsection (3)* sets out the time limit for making an election under subsection (2) to the Inland Revenue. The reference in section 524(4) of ICTA to "the Board" has not been reproduced. Section 878(4) of this Act draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to "an officer of the Board". See *Change 149* in Annex 1.

860. Section 524(10) of ICTA is not rewritten. Section 524 of ICTA prescribes particular tax treatments with alternatives available by election. Section 524(10) of ICTA requires claims for relief under that provision to be made to the Board. The claim referred to in subsection (10) relates to capital sums received from the sale of patent rights to be spread over six years for the purposes of charging the sum to tax. As spreading is automatic for UK residents, the claim can only be relevant to non-UK residents. However, section 524(1) of ICTA refers to "a claim" and section 524(4) of ICTA, which deals with "spreading" rules for non-UK residents, refers to "the election". Section 524(10) of ICTA is, therefore, superfluous.

Section 592: Further provision about elections for spreading: instalments

861. This section sets out how non-UK residents are taxed on capital sums from the sale of patent rights where the sale proceeds are received in instalments. It is based on sections 69 and 524 of ICTA.

862. *Subsection (2)* sets out the rule for making an election for spreading where sale proceeds are received in instalments. This makes explicit in the section what was implicit in the source legislation.

863. *Subsection (3)* contains the time limit for making an election under subsection (2). The reference in section 524(4) of ICTA to “the Board” has not been reproduced. Section 878(4) of this Act draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to “an officer of the Board”. See *Change 149* in Annex 1.

Section 593: Death of seller

864. This section deals with the case where a seller of patent rights dies before the end of the six year spreading period under sections 590, 591 or 592. It is based on section 525 of ICTA.

865. *Subsection (2)* provides that personal representatives may elect for a reduction in the tax charged under subsection (1) based on “the lifetime tax years”. The term “personal representatives” is now defined in section 878(1) of this Act.

866. *Subsection (3)* defines “the lifetime tax years” for the purposes of subsection (2). The subsection also deals with sale proceeds which are received in instalments. This makes explicit in the section what was implicit in the source legislation.

867. *Subsection (4)* contains the time limit for making an election under subsection (2). The reference in section 525(2) of ICTA to “the inspector” has not been reproduced. Section 878(4) of this Act draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to “an officer of the Board”. See *Change 149* in Annex 1.

868. The time limit in section 525(2) of ICTA has been changed to fit in with the normal self-assessment filing date for the year in which the death occurs. See *Change 104* in Annex 1.

Section 594: Winding up of a body corporate

869. This section deals with a body corporate which is chargeable to income tax under section 587 where the body corporate commences to be wound up. It is based on section 525 of ICTA.

870. The section applies where, for example, a company not resident in the United Kingdom (and not trading in the United Kingdom through a permanent establishment) disposes of UK patent rights, makes an election for spreading under section 591 or section 592 and is subsequently wound up before the expiry of the six year spreading period.

871. *Subsection (2)* also deals with amounts arising to the corporate body in a fiduciary or representative capacity (for example, corporate trustees) which would have been chargeable to income tax for later tax years under section 590(2) or (4).

Section 595: Deduction of tax from payments to non-UK residents

872. This section contains rules relating to the deduction of tax from payments to non-UK residents where a charge arises under section 587 on profits from the sale of the whole or any part of any patent rights. It is based on section 524 of ICTA.

873. *Subsection (2)* provides that the capital costs in section 588 shall not affect the amount of income tax to be deducted under section 349(1) of ICTA and assessed under section 350 of ICTA. The reference in section 524(9) of ICTA to "section 349(1) and (3)" was clearly intended to read "sections 349(1) and 350". This has been corrected in the consequential amendment which inserts section 349ZA into ICTA (see paragraph 149 of Schedule 1 to this Act).

874. *Subsection (3)* provides that sections 349ZA and 350 of ICTA are not affected by any election under this Chapter for spreading provisions to apply. The reference to instalments makes explicit in the section what was implicit in the source legislation.

Section 596: Adjustments where tax has been deducted

875. This section contains rules relating to adjustments which may be necessary where tax has been deducted from payments to a non-UK resident under subsection (2) of section 595. It is based on section 524 of ICTA.

876. *Subsection (2)* provides that, where an election for spreading has been made, the necessary adjustments are to be made by treating one sixth of the sum deducted from the proceeds of sale or instalment as income tax paid for each of the six years. The reference to instalments makes explicit in the section what was implicit in the source legislation.

Section 597: Licences connected with patents

877. This section provides some definitions connected with patents which extend the meaning of patent rights for the purposes of section 587 to section 596 . The definitions relate to licences and are based on section 533 of ICTA.

Section 598: Rights to acquire future patent rights

878. This section deals with the sale of rights to acquire patent rights in the future, before the patent has been granted. It is based on section 533 of ICTA.

879. *Subsection (1)* provides that a sum paid to obtain an option to acquire future patent rights is to be treated as the purchase of patent rights in the hands of the payer and a sale of patent rights in the hands of the recipient. Any capital sum received is therefore chargeable under section 587 on the recipient and the payer may obtain relief for the expenditure under section 588 when the rights acquired are disposed of.

880. The section makes it more explicit than the source legislation that there is a deemed sale of patent rights where an option to acquire future patent rights is sold or granted and also clarifies the position regarding the costs of such options. However, the section does not change the law since the source legislation would have to be read in this way.

Section 599: Sums paid for Crown use etc. treated as paid under licence

881. This section provides that sums paid for Crown use, or by a government of a country outside the United Kingdom, in certain circumstances are to be treated as having been paid under a licence. It is based on section 533 of ICTA.

882. *Subsection (1)* sets out the conditions under which sums paid in respect of an invention which is the subject of a patent and used in the service of the Crown, or the government of a country outside the United Kingdom, are be treated as having been paid under a licence. The treatment of licences connected with patents is dealt with in section 597.

883. The reference in section 533(4) of ICTA to "sections 46 to 49 of the Patents Act 1949" has not been reproduced in this section. This is because patents granted under these provisions have ceased to have effect so it is unnecessary to reproduce this reference. The removal of this unnecessary material follows the line adopted in section 482 of CAA.

884. The words "used" and "use" in this section (which correspond with the relieving legislation in section 482 of CAA) are intended to be read widely and cover "make" and "sell".

Section 600: Relief for expenses: patent income

885. This section provides relief for certain expenditure in connection with patents. The section sets out the nature of the expenditure for which relief may be given under section 601. It is based on sections 526 and 528 of ICTA. The deduction is on the basis of expenses incurred. This relaxes any requirement in the source legislation that fees have to be paid before a deduction can be made.

886. *Subsection (2)* defines "inventor's expenses" for the purpose of this section. To the extent that relief is not given elsewhere (for example, as a deduction, where appropriate, in calculating trade profits) a claim may be made under this section for such expenses to be relieved against income from patents.

887. The word "net" in "the net amount of any expenses" in section 526(2) of ICTA has not been reproduced. This word is superfluous having regard to subsection (6) of the section which contains a signpost to section 603 (contributions to expenditure).

888. *Subsection (3)* defines "patent application and maintenance expenses" for the purposes of this section. Relief for such expenses is excluded from the scope of this section if the expenditure is incurred for the purposes of a trade carried on by the payer. This is because there is a similar provision in section 89 for trading expenses connected with patents.

889. *Subsection (5)* excludes from the scope of this section expenditure for which relief is given elsewhere. Section 526(2) of ICTA applies this rule only to expenditure incurred by the inventor and now covered by subsection (1)(a) of this section. Section 526(2) of ICTA provides that relief could not be given more than once for expenditure incurred in devising an invention for which a patent has been granted. There is no such explicit double deduction prohibition in section 526(1) of ICTA which deals with expenditure incurred in the grant, extension etc of a patent. To avoid any possible confusion, however, the section prevents a double allowance in respect of all relevant expenditure. This makes clear the implicit rule that the legislation does not enable such expenses to be relieved twice.

890. *Subsection (6)* contains a signpost to section 603 which deals with contributions to expenditure. This is necessary because section 532 of ICTA treats section 526 and 528 of ICTA as if those provisions had been contained in CAA.

Section 601: How relief is given under section 600

891. This section sets out how relief is to be given where a claim is made under section 600 for patent expenses to be set against patent income. It is based on sections 526, 528 and 533 of ICTA.

892. *Subsection (2)* allows relief for expenditure against patent income in the tax year in which the expenditure is incurred. However, if the expenses exceed the patent income in the tax year, the surplus expenses cannot be used to create a loss under this section.

893. *Subsection (3)* provides that the excess of eligible expenses over income in a tax year is carried forward and set off against patent income in the next tax year and so on until the expenses have been fully relieved. The carry forward to future years is automatic and no additional claim needs to be made.

894. *Subsection (5)* reproduces the ordering rule in section 528(3A) of ICTA. This requires the deduction or set-off of any capital allowances under section 479 of CAA in calculating "income from patents" for the purposes of subsection (4) of this section.

Section 602: Payments received after deduction of tax

895. This section deals with the position of an individual receiving royalties or other income within this Chapter from which tax has been deducted. It is based on sections 348 and 349 of ICTA. Under section 348(1)(b) of ICTA "a sum representing the amount of income tax thereon" may be deducted from certain annual payments.

896. The section reproduces the effect of section 348(1)(d) of ICTA, under which the sum is treated as income tax paid by the person to whom the payment is made. The payer is entitled, but not obliged, to deduct this sum representing tax, which is treated as tax paid by the recipient. The tax treated as paid by the recipient of the annual payment is taken into account, along with any other tax paid by deduction at source and any tax credits, in calculating the tax payable for the tax year.

897. In so far as this section covers payments which are not annual payments within section 348(1) of ICTA, the scope of the provision has been made more explicit. Section 348(1)(d) of ICTA applies, in terms, only to annual payments from which any deduction is made under section 348(1)(b) of ICTA, but case law effectively extends it to payments under sections 348(2) and 349 of ICTA. See commentary on section 426 of this Act.

Section 603: Contributions to expenditure

898. This section restricts expenditure allowable under section 585, section 588 and section 600 to the extent that the expenditure is met by a public body or someone other than the claimant. It is based on section 532 of ICTA and section 532 of CAA.

899. Section 532 of ICTA provides that sections 524, 526 and 531 of ICTA are to be treated as if those provisions had been contained in CAA.

900. *Subsection (3)* excludes this section from applying to incidental expenses incurred by the seller of patent rights (see section 588(2)(b)). This is because section 524 of ICTA only bites in the first place on the net proceeds of a sale.

Section 604: Contributions not made by public bodies nor eligible for tax relief

901. This section provides that contributions not made by public bodies may still be eligible as deductible expenditure in certain circumstances. The section is based on section 532 of ICTA and section 536 of CAA. It qualifies the general rule in section 603.

Section 605: Exchanges

902. This section provides an extended definition of sale to include exchange. It is based on section 532 of ICTA and section 572 of CAA.

903. Section 532 of ICTA provides that section 524 of ICTA (dealing with the sale of patent rights) and section 531 of ICTA (dealing with the disposal of know-how) are to be treated as if they had been contained in CAA.

Section 606: Apportionment where property sold together

904. This section provides for the apportionment of sale proceeds and expenditure on a just and reasonable basis where property within the scope of this Chapter is sold or disclosed together with other property. It is based on section 532 of ICTA and section 562 of CAA.

905. Section 532 of ICTA provides that section 524 of ICTA (dealing with the sale of patent rights) and section 531 of ICTA (dealing with the disposal of know-how) are to be treated as if they had been contained in CAA.

Section 607: Questions about apportionments affecting two or more persons

906. This section contains a signpost to section 563 of CAA which sets out the body of Commissioners responsible for determining any question about the way in which a sum is to be apportioned under section 606 where the relevant apportionment affects two or more persons. It is based on section 532 of ICTA and section 563 of CAA.

907. Section 532 provides that section 524 of ICTA (dealing with the sale of patent rights) and section 531 of ICTA (dealing with the disposal of know-how) are to be treated as if those provisions had been contained in CAA.

Section 608: Meaning of "capital sums" etc.

908. This section contains a signpost to section 4 of CAA which defines "capital expenditure" and "capital sums". It is based on section 532 of ICTA and section 4 of CAA.

909. Section 532 of ICTA provides that sections 524 to 529 and 531 to 533 of ICTA are to be treated as if those provisions had been contained in CAA.

Chapter 3: Films and sound recordings: non-trade businesses

Overview

910. This Chapter deals with income arising from the exploitation of films and sound recordings – and the special allocation rules available to the producers and acquirers of films and sound recordings – where the activities carried on do not amount to a trade.

911. The special allocation rules rewritten in Chapter 9 of Part 2 of this Act for trades apply also to businesses. So this Chapter is needed to cater for businesses which fall short of a trade.

912. There are no specific charging provisions for income from non-trade film and sound recordings businesses in ICTA. Such income is chargeable under Schedule D Case VI for UK sources and Schedule D Case V for foreign sources under the source legislation. The new charge has been carved out of a general charging provision and dealt with – together with the special allocation rules – in a separate charging Chapter. The new Chapter will apply to both UK source and foreign source businesses.

Section 609: Charge to tax on films and sound recordings businesses

913. This section charges to tax income from businesses involving the exploitation of films and sound recordings where the activities fall short of trading. It is based on section 18 of ICTA .

914. *Subsection (1)* imposes a charge on UK or foreign businesses involving the exploitation of films or sound recordings where the activities do not amount to a trade. Reclassifying the income according to its nature makes sense. The special allocation rules for films and sound recordings in sections 40A to 40D of F(No 2)A 1992 (and sections 41 to 43 of F(No 2)A 1992 for films) apply to both trades and businesses. The creation of a new charge and Chapter for this income provide a convenient link with the special allocation rules for films and sound recordings businesses (where the activities fall short of trading) which might otherwise be missed.

915. The new charge on income from non-trading film or sound recordings businesses has been carved out of the general sweep up charge (see section 687) of this Act and included in a separate Chapter together with a signpost to the special allocation rules for expenditure relating to such activities.

Section 610: Income charged

916. This section sets out the amount charged to tax under this Chapter. It is based on sections 65 and 68 of ICTA.

917. *Subsection (3)* provides that this section is subject to the special rules for foreign income in Part 8 of this Act. The special allocation rules for films and sound recordings can apply to businesses carried on outside the United Kingdom as well as to businesses carried on in the United Kingdom.

Section 611: Person liable

918. This section states who is liable for any tax charged under this Chapter. It is based on section 59 of ICTA.

Section 612: Calculation of income

919. This section contains calculation rules for income charged under section 609. It is new.

920. Where a particular type of income is carved out of what would otherwise be a general charge, this Act explicitly sets out the calculation rules applicable to that income. This approach has been extended to foreign source income charged under Schedule D Case V in the source legislation. This section sets out expenses that would, in practice, be deductible in calculating profits and does not widen or restrict the scope of deductible expenses.

921. There is no express provision in the legislation for deductions of expenditure from Schedule D Case VI income, although it is implied by the word "profits" in section 69 of ICTA (Case VI assessments) and by section 392 of ICTA (Case VI losses). This view has been upheld by the courts (see Curtis Brown v Jarvis (1929), 14 TC 744 HC). Expenditure admissible relating to income arising in the United Kingdom within the scope of the section would not cease to be admissible in respect of the same type of income arising outside the United Kingdom.

922. *Subsection (4)* precludes expenditure which would not have been allowed had a trade been carried on. So expenses precluded by Chapter 4 of Part 2 of this Act are not deductible here.

Section 613: Application of trading income rules to non-trade businesses

923. This section provides that Chapter 9 of Part 2 of this Act – the special allocation rules for trades – apply to non-trade businesses as those rules apply to trades (with certain modifications). It is new.

Chapter 4: Certain telecommunication rights: non-trading income

Overview

924. This Chapter imposes a charge on profits derived from certain telecommunication rights not held for trading purposes. It also sets out how the profits are to be calculated. The Chapter is based on Schedule D Cases III, V and VI of ICTA and Schedule 23 to FA 2000. The rights dealt with in the Chapter are certain telecommunications licences and capacity on telecommunications cable systems, known as indefeasible rights to use (IRU).

925. Schedule 23 to FA 2000 does not impose a charge to tax on the income derived from the rights. The main purpose of Schedule 23 to FA 2000 is to allow a taxpayer who acquires qualifying rights a revenue deduction for expenditure that would otherwise be treated as capital for tax purposes. It does this by providing that the income tax treatment follows the treatment in the accounts provided the accounts are prepared in accordance with generally accepted accounting practice. This rule applies not only to the acquisition but also to revaluations and disposals.

926. In most cases it is likely that the rights will be acquired for use in a trade. For this reason Schedule 23 to FA 2000 is rewritten as Chapter 10 of Part 2 of this Act. But the Schedule applies for all income tax purposes. This Chapter rewrites the charge if the assets are not acquired for the purposes of a trade.

927. The Chapter applies only to IRUs acquired on or after 21 March 2000. See the transitional rules in paragraphs 130 and 131 of Schedule 2 to this Act. No telecommunications licences to which this Chapter applies were acquired before that date.

Section 614: Charge to tax on certain telecommunication rights of a non-trader

928. This section charges to tax income from telecommunication rights arising to a non-trader. It is based on Schedule D Cases III, V and VI, section 18(1) and (3) of ICTA, and paragraph 1 of Schedule 23 to FA 2000.

929. If the rights are acquired for pure investment purposes and the licensor does not undertake to provide any extra services, ICTA charges the profits to tax under Schedule D Case III as an annual payment (or under Schedule D Case V in the unlikely event that the source is outside the United Kingdom).

930. If the licensor undertakes to provide services that do not amount to a trade, ICTA charges the profits under Schedule D Case VI (or under Schedule D Case V if the source is outside the United Kingdom).

Section 615: Income charged

931. This section sets out the amount charged to tax. It is based on sections 64, 65, 68 and 69 of ICTA and Schedule 23 to FA 2000.

Section 616: Person liable

932. This section states who is liable for any tax charged. It is based on section 59 of ICTA.

Section 617: Deductions in calculating certain income charged

933. This section sets out how to calculate the income charged to tax if the taxpayer provides services that do not amount to a trade. It is based on section 69 of ICTA and Schedule 23 to FA 2000.

934. In the source legislation this income would be charged under Schedule D Case VI (or under Schedule D Case V if the source is outside the United Kingdom). The rules set out in this section deal with two aspects of the calculation of this income. First, the general deduction rules that apply to income taxed under Schedule D Case VI. Second, the particular rules that apply to income from telecommunication rights.

935. There is no express provision in the legislation for deductions of expenditure from Schedule D Case VI income, although it is implied by the word "profits" in section 69 of ICTA (Case VI assessments) and by section 392 of ICTA (Case VI losses). This view has been upheld by the courts (see Curtis Brown v Jarvis (1929), 14 TC 744 HC). Expenditure admissible relating to income arising in the United Kingdom within the scope of the section would not cease to be admissible in respect of the same type of income arising outside the United Kingdom. However, under section 64 of ICTA (Case III assessments) no deduction is permitted from income within the Schedule D Case III charge so this section specifically does not apply to annual payments.

936. Schedule 23 to FA 2000 set out a particular set of rules that apply to income from telecommunication rights. Because they are most likely to apply to trading income this section merely cross-refers to the rewrite of those rules in sections 147 and 148 of this Act.

Section 618: Payments received after deduction of tax

937. This section deals with the position of an individual receiving income within this Chapter from which tax has been deducted. It is based on sections 348 and 349 of ICTA.

938. Under section 348(1)(b) of ICTA "a sum representing the amount of income tax thereon" may be deducted from certain annual payments. The section reproduces the effect of section 348(1)(d) of ICTA, under which the sum is treated as income tax paid by the person to whom the payment is made. The payer is entitled, but not obliged, to deduct this sum representing tax, which is treated as tax paid by the recipient. The tax treated as paid by the recipient of the annual payment is taken into account, along with any other tax paid by deduction at source and any tax credits, in calculating the tax payable for the tax year.

939. In so far as this section covers payments which are not annual payments within section 348(1) of ICTA, the scope of the provision has been made more explicit. Section 348(1)(d) of ICTA applies, in terms, only to annual payments from which any deduction is made under section 348(1)(b) of ICTA, but case law effectively extends it to payments under sections 348(2) and 349 of ICTA. See commentary on section 426 of this Act.

Chapter 5: Settlements: amounts treated as income of settlor

Overview

940. This Chapter rewrites the settlements legislation in Chapters 1A and 1B of Part 15 of ICTA. This legislation prevents the avoidance of tax where a person (the settlor) arranges for his or her income to be received by someone who is either chargeable to tax at a lower rate than the settlor, or not chargeable to tax at all. The legislation operates by treating the income as if it were the settlor's. The legislation operates where:

- the settlor retains an interest in property but the income from that property is received by another;
- payments from a settlement set up by the settlor are made to a minor child of the settlor; or
- payments are made to the settlor from the settlement in the form of capital rather than income.

Section 619: Charge to tax under Chapter 5

941. This section charges to tax payments, whether income or capital, which are deemed to be the income of the settlor under this Chapter. It also provides that the part which represents distributions attracts the dividend ordinary rate. It is based on sections 660C and 677 of ICTA.

942. *Subsection (1)* charges to tax the income and capital payments which are treated as the income of the settlor under this Chapter. It rewrites the charges under sections 660C and 677(7) of ICTA. Section 660C(1) of ICTA, which charges income treated as the settlor's because he or she retains an interest in the settlement or because of payments etc to a minor child, imposes a Schedule F charge on distributions and a charge under Schedule D Case VI on other income. Section 677(7) of ICTA, which charges capital payments treated as the settlor's income, imposes a Case VI charge on all such payments. The listing in this subsection of the amounts treated as income acts as an introduction to the Chapter and explains the nature of the charge under the Chapter.

943. *Subsection (3)* lists the income that is to be treated under *subsection (2)* as within section 1A(2)(b) of ICTA. The income is all distribution income or income treated as such. The effect of this provision is that this income is charged at the dividend ordinary rate (the Schedule F ordinary rate). The income within section 660C(1A), which this subsection rewrites, is included here as follows:

- (1A)(a) is rewritten at (3)(a);
- (1A)(b) is rewritten at (3)(b) and (e);
- (1A)(f) is rewritten at (3)(c); and
- (1A)(g) is rewritten at (3)(d).

944. Section 660C(1A)(c) to (e) has not been listed because it is unnecessary. The income within section 233(1), (1A) and (1B) of ICTA is already included within section 660C(1A)(a) as "income chargeable under Schedule F". Such income is included within subsection (3)(a) of this section since Chapter 3 of Part 4 of this Act rewrites the Schedule F charge.

945. Section 660C(1A)(b) of ICTA includes income to which section 1A of ICTA applies "by virtue of it being equivalent foreign income falling within subsection (3)(b) [of section 1A of ICTA] and chargeable under Case V of Schedule D". The "equivalent foreign income" within that subsection is dividends or other distributions of a non-UK resident company which would be chargeable under Schedule F if that company were resident in the UK. Because Chapter 4 of Part 4 of this Act charges foreign dividends and not foreign *distributions*, *subsection (4)* provides that any such foreign distributions falling outside that Chapter are included within section 619(3)(e) because they would, if the company were UK resident, fall within Chapter 3 of that Part. Chapter 3 of Part 4 of this Act rewrites the Schedule F charge on both dividends *and* distributions of a UK resident company.

Section 620: Meaning of "settlement" and "settlor"

946. This section explains the meaning of "settlement" and "settlor" for the purposes of this Chapter. It is placed in this part of the Chapter to help the reader by giving an early indication of the nature of the charge under this Chapter. It is based on sections 660G and 677 of ICTA.

Section 621: Income charged

947. This section sets out the amount charged to tax. It is based on sections 69, 660C and 677 of ICTA.

948. All the income and capital payments which are to be treated as the settlor's income are chargeable to tax.

949. The income to be treated as the settlor's income under section 624 is the income arising under the settlement. The meaning of income arising under a settlement is given in section 648. Subsection (1) of that section provides that income arising under a settlement includes income chargeable to income tax by deduction or otherwise and, in the case of income from outside the United Kingdom, income which would be chargeable if received by a UK resident. In consequence the appropriate measure of income chargeable and the tax year of charge are provided by the charging sections of other Chapters of this Act (or the appropriate sections of the Income Tax Acts).

950. Section 648(2) provides that where the settlor is non-domiciled etc and the settlement is entitled to income which would not be chargeable on the settlor if he or she made a claim for the remittance basis to apply, it is excluded from income arising under a settlement and is therefore not chargeable on the settlor.

951. The amount of income arising under a settlement which is treated as the settlor's income under section 629 and the year of charge are given in subsection (1) of that section.

952. The amount to be treated as the settlor's income under section 633 and the year of charge are given in subsection (1) of that section.

Section 622: Person liable

953. This states who is liable for any tax charged. It is based on sections 660A, 660B and 677 of ICTA.

954. Section 660A(1) of ICTA provides that income charged on the settlor is not treated as the income of any other person. Since that person could be a company, and outside the scope

of this Act, new section 660C(4) of ICTA (see paragraph 272(4) of Schedule 1 to this Act) ensures that a charge cannot be made on a company in respect of that income.

Section 623: Calculation of income

955. This section allows the settlor the same deductions and reliefs as if he had received as income the amount on which he is chargeable. As a result of this the settlor is charged to tax as if he had received the income arising under the settlement directly. It is based on sections 660C and 677 of ICTA. Section 660C(3) of ICTA is not rewritten in this Act.

Section 624: Income where settlor retains an interest

956. This is the first of the rules under which income is treated as the settlor's. Where the settlor retains an interest in settled property the income arising under the settlement is treated as the settlor's. The section is based on section 660A of ICTA.

Section 625: Settlor's retained interest

957. This section explains when a settlor is treated as having an interest in property for the purposes of section 624 and exceptions to this. It is based on section 660A of ICTA.

958. *Subsection (1)* explains what is meant by a settlor having an interest in property. The interests may also be those of the settlor's spouse.

959. *Subsections (2)* and *(3)* give occasions where a settlor does not have an interest in property. The exceptions cover instances when the settlor may by inadvertence or circumstances likely to be outside his or her control have an interest in property which he or she has settled or an interest in property derived from that property. These circumstances include bankruptcy, where the settlor may obtain an interest in property as a result of the bankruptcy of another person who has an interest in that property. This might occur where the beneficiary of a settlement, who is also the creditor of the settlor, becomes bankrupt and the debt is settled by a payment of settlement income from the bankrupt's estate.

960. The settlor is also excluded from having an interest in property as long as someone under the age of 25 years is alive during whose lifetime that property cannot be payable to the settlor other than in a bankruptcy or by assigning or charging the individual's interest in the property. While there is no requirement that the person under 25 years should have an interest in that property it may generally be expected that they will.

961. *Subsection (5)* provides the meaning of "related property" ("derived property" in section 660A(10) of ICTA). When this clause was drafted the House of Lords' decision in West v Trennery (2005), TL 3747[10] on the interpretation of "derived property" in section 77(8) of TCGA was not available. The definition of "derived property" in that section is the same as in section 660A(10) of ICTA. In consequence the section closely follows the source legislation.

Section 626: Exception for outright gifts between spouses

962. This section provides an exception to the rule in section 624 for an outright gift of property between spouses which gives rise to income. Such gifts are within the exclusion as

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long as the property gifted is more than simply a right to income and the right to income is a right to the whole of the income. The section is based on section 660A of ICTA.

Section 627: Exceptions for certain types of income

963. This section provides that section 624 does not apply to certain income between former parties to a marriage and to commercial and charitable payments and pension contributions. It is based on section 660A of ICTA.

964. *Subsection (1)* enables a person to make a settlement that benefits a former or separated spouse without that income being treated as income of the settlor.

965. *Subsection (3)(c)* refers to regulations made under the Welfare Reform and Pensions Act 1999 and its equivalent in Northern Ireland although section 660A(11)(c) of ICTA (inserted by paragraph 28 of Schedule 35 to FA 2004) simply refers to regulations made by the Secretary of State. See *Change 105* in Annex 1.

966. Subsection (3) applies for the tax year 2006-07 onwards and rewrites the changes to section 660A(11) of ICTA introduced by FA 2004. A transitional rule is found in paragraph 132 of Schedule 2 to this Act which gives the rules for "approved pension arrangements" for 2005-06. The FA 2004 changes to pension provisions only apply from 2006-07.

Section 628: Exception for gifts to charities

967. This section provides that certain charitable donations will not be treated as the settlor's income under section 624. It is based on section 44 of FA 2000.

968. Section 44 of FA 2000 applies to the charge under both sections 660A and 660B of ICTA (settlor-interested trusts and payments to a minor child of the settlor). Section 44 of FA 2000 is rewritten in two places in this Chapter, once as an exemption from the charge under section 624 and secondly as an exemption from the charge under section 629. (A payment may, for example, be made by trustees to a charity which benefits a minor child of the settlor.) *Subsection (3)(b)*, which includes within the sum paid to a charity sums for which the exemption in section 630 applies, covers the possibility, unlikely though it may be, of a trust changing its nature during a tax year whereby it is no longer a settlor-interested trust and thus one to which section 630 might apply. (A charge under that section will not apply if a charge under section 624 applies.) Any charitable payments exempted from a charge on the settlor under section 629 must be included to give the correct result.

Section 629: Income paid to unmarried minor children of settlor

969. This section provides the second charge under this Chapter. Income paid to or for the benefit of an unmarried minor child of the settlor or income which is treated as that child's income is charged as income of the settlor if it does not already fall within section 624. The section is based on section 660B of ICTA.

970. *Subsection (1)* sets out the basic rule. Subsection (1)(b) ensures that avoidance cannot arise by using a bare trust arrangement where a child is a beneficiary of the trust, although no income is paid to or for the child's benefit.

971. *Subsection (2)* provides that a charge under section 624 will always take precedence over a charge under this section.

972. See paragraph 133 of Schedule 2 to this Act for the application of this section in relation to income arising under a settlement made before 9 March 1999 or from funds provided before that date.

973. Section 660B(1) of ICTA provides that income charged on the settlor is not treated as the income of any other person. Since that person could be a company, and outside the scope of this Act, new section 660C(4) of ICTA (see paragraph 272(4) of Schedule 1 to this Act) ensures that a charge cannot be made on a company in respect of that income.

Section 630: Exceptions for gifts to charities

974. This section provides that certain charitable donations will not be treated as the settlor's income under section 629. This exemption might apply in the unusual circumstances of a charity benefiting the minor child of a settlor, that is to say that payments out of the settlement to the charity were paid to or applied for the benefit of the settlor's minor child. The section is based on section 44 of FA 2000.

975. See the commentary on subsection (3)(b) of section 628 as to how subsection (2)(b) of this section applies.

Section 631: Retained and accumulated income

976. This section applies the rule in section 629 where payments are made to or for the benefit of a minor child of the settlor out of a settlement under which income is retained or accumulated. It is based on section 660B of ICTA.

977. *Subsection (1)* provides the general rule. The payment must be made in connection with the settlement out of a trust under which income may be retained or accumulated. The distinction in trust law between "retained" and "accumulated" income (income the trustees have resolved to treat as capital) has been retained.

978. *Subsection (2)* provides that such payments are treated as payments of income even though out of capital as long as there is sufficient accumulated or retained income available to make the payment in question.

979. *Subsection (4)* sets out what is meant by available retained or accumulated income in subsection (2). Income that has arisen under the settlement must exceed the amounts set out in *subsection (5)*. These are amounts that have been paid out in expenses or already treated as the income of the settlor or another person, including a minor child of the settlor.

980. *Subsections (6)* and *(7)* provide the computation for income subject to income tax of a minor child of the settlor for the purposes of subsection (5)(d). One first computes a figure for the whole of the child's income from all sources less allowances and deductions and then compares that with the sums treated as the child's income under the settlement. If the income less allowances is sufficient to include the child's income from the settlement then that income is deemed to have been subject to tax, ie the settlement income is treated as the top slice of the child's income.

Section 632: Offshore income gains

981. This section provides that gains under the offshore funds legislation are deemed to be paid to a minor where they would have been considered as his or her income were it not for his or her minority. (Section 761(1) of ICTA provides that where there is a disposal in an

offshore trust the gain is treated as income of the person disposing of it.) The section is based on section 660B of ICTA.

Section 633: Capital sums paid to settlor by trustees of settlement

982. This section provides the third charge under this Chapter. It treats as income of the settlor capital sums paid or lent to the settlor by the trustees of the settlement where those payments are matched by undistributed income within the settlement. It is based on section 677 of ICTA.

983. *Subsection (1)* and *(2)* provide the basic rule that capital payments to the settlor are treated as his or her income where there is sufficient available income within the settlement up to the end of that tax year to cover that payment.

984. *Subsection (3)* deals with the situation where there is insufficient available income up to the end of the year in which the loan is made. One then takes into account the available income for the following year to the extent that it has not been treated as the settlor's income following a capital payment made in that year. If there is still insufficient available income one takes into account the available income for the year after that and so on.

985. *Subsection (4)* allows the rule in subsection (3) to run for up to 10 years subsequent to the capital payment.

Section 634: Meaning of "capital sum" and "sums paid to settlor"

986. This section provides the meaning of two terms used in section 633. It is based on section 677 of ICTA.

987. *Subsection (1)* explains what is meant by "capital sum". It includes sums paid as a loan, loans repaid or sums paid to the settlor or his or her spouse (see *subsection (7)*) in excess of the market value of goods or services. Settlors cannot therefore avoid tax by extracting income from a settlement in the form of a capital payment by the receiving of loans from the settlement, by the making of loans which are invested by the trustees and then receiving repayment of those loans, or by selling to the trustees of the settlement an item in excess of market value.

988. *Subsection (3)* excludes sums from being treated as capital sums which are broadly outside the control of the settlor (see commentary on section 625(2)).

989. *Subsection (5)* prevents a settlor from avoiding a charge under this section by arranging for the trustees to pay a capital sum to a third party from which the settlor may benefit.

Section 635: Amount of available income

990. This section explains what is meant by available income for the purposes of section 633. It is based on section 677 of ICTA.

991. *Subsections (2)* and *(3)* give the rules for ascertaining available income. It is the income arising under the settlement which has not been distributed, less sums which have already been taken into account under this rule as a capital payment in a previous year or which have been treated as the settlor's income under sections 624 or 629 or which represent an amount of tax paid on undistributed settlement income.

992. Section 677(2) of ICTA, on which subsection (3) is based, excludes from the measure of available income such income as has been treated as income of the settlor in tax years before 1995-96 under provisions which have been repealed. These paragraphs of section 677(2) of ICTA are rewritten in paragraph 134 of Schedule 2 to this Act.

Section 636: Calculation of undistributed income

993. This section explains for the purposes of section 635 what is meant by income arising under a settlement that has not been distributed. It is based on section 682 of ICTA.

994. *Subsection (1)* provides the basic rule with the detail in the remaining subsections. The amounts which may be set against the income arising are classified under three headings which are set out in *subsections (2), (4)* and *(6).*

Section 637: Qualifications to section 636

995. This section gives special provisions that apply to payments made by the trustees in section 636(2) to (6) and which would otherwise be available to reduce the undistributed income within the settlement. It is based on section 682 of ICTA.

996. *Subsection (1)* disapplies section 636(2) for payments of interest or payments to connected bodies corporate or other settlements. Such payments are not therefore to be treated as sums which have been distributed under that section.

997. The purpose of *subsections (2)* to *(7)* is to prevent certain payments of interest that would not be allowable against tax from reducing the undistributed income. Interest payments that are allowable for tax purposes will already have been allowed in arriving at the income arising under the settlement.

998. Disallowable interest payments should not be available to reduce the income treated as the settlor's income. Without special rules loan interest payable by the trustees, which would not be allowed for tax purposes, could reduce the undistributed income and hence the amount chargeable on the settlor.

999. Interest can only reduce the amount available for distribution to the extent that it represents an expense against income payments to persons other than the settlor. The formula in *subsection (5)* apportions the interest paid on these lines. The resulting sum represents the interest paid in respect of income payments made by the settlement to the settlor and that resulting figure is unavailable to set against the undistributed income.

1000. *Subsection (6)* removes from the computation interest that has been paid to the settlor or spouse of the settlor since tax will already have been borne on that interest and, but for this, double taxation would arise on those sums.

Section 638: Capital sums paid by way of loan or repayment of loan

1001. This section gives the rules that apply where the capital sums in section 633 are loans or repayments of loans. It is based on section 677 of ICTA.

1002. *Subsections (1)* provides that if a capital loan is repaid no part of it is treated as the settlor's income under section 633 for any year following the year of repayment.

1003. *Subsections (2)* and *(3)* provide that where a second loan is made to the settlor after repayment of the original loan, that loan is only treated as the settlor's income to the extent that it exceeds a previous loan which has been treated as the settlor's income. This is because no repayment of tax is made to the settlor in respect of the repayment of the first loan. He or she has effectively already paid tax on the new amount outstanding.

1004. *Subsections (4)* and *(5)* provide that, where a settlor has made a subsequent loan to the settlement following the repayment of an earlier loan, no part of the repayment on the first loan is treated as the settlor's income after the tax year in which the subsequent loan to the settlement is made, as long as it is not less than the amount of the first loan. The second loan here is treated as a repayment of the capital sum paid out of the settlement as repayment of the first loan.

Section 639: Loans to participators in close companies

1005. This section serves to avoid a double taxation charge as a result of the application of Chapter 6 of Part 4 of this Act. Under that Chapter loans made by a company to a participator and then written off are treated as income net of tax at the dividend ordinary rate on UK distributions. The rule is that where a charge potentially arises under both this section and under Chapter 6 of Part 4 of this Act this section will take precedence, but if a charge under Chapter 6 of Part 4 of this Act has already been made, then the charge under this Chapter on the settlor is reduced by a corresponding amount. See section 418 of this Act (relief where borrowers liable as settlors) which rewrites section 421(3) of ICTA. The section is based on section 677 of ICTA.

Section 640: Grossing-up of deemed income

1006. This section explains the grossing-up procedure for capital sums treated as the settlor's income and the tax allowed against the settlor's liability. It is based on section 677 of ICTA.

1007. S*ubsection (1)* provides that the settlor is taxed on the grossed up amount of the capital sum treated as his income. Section 877 of this Act explains how sums are grossed up.

1008. *Subsection (2)* then allows a set-off of tax against the settlor's tax liability with the result that only higher rates of tax are chargeable on the settlor. The amount that the settlor may set off against his liability is given in the following subsections.

1009. *Subsection (3)* explains the amount ("the deductible amount") that can be set against the settlor's liability. This is the lesser of the tax at which the capital sum is grossed up at for the tax year (the rate applicable for trusts) or the amount of tax the trustees are deemed to have paid on the available income (irrespective of the fact that the capital sum is grossed up at the rate applicable to trusts for the tax year in which the loan is treated as the settlor's income). This allows for the fact that where available income to cover the capital sum (see section 633(2)) arose in earlier years, that income may have been charged at different rates to those in the tax year in which the capital sum is treated as the settlor's income.

1010. *Subsections (4)* to *(7)* provide that, in order to ascertain the appropriate rates of tax for subsection (3)(c), the capital sum is matched against available income arising in earlier years before later years and the given rates of tax are applied for each tax year in which the available income representing the grossed-up sum arose. This includes a nil rate of tax where the available income would not have been subject to UK tax because the available income arose outside the United Kingdom to a non-UK resident. Subsection (6)(b) reflects the change in the rate applicable to trusts in FA 2004. The net effect of these subsections is that the credit available against the tax charge broadly represents the tax paid on the available income which represents the grossed-up capital sum. The nil rate applies in relation to any income in any tax year which falls within subsection (6)(a)(i) and (ii).

1011. Subsection (5) provides for grossing-up at the appropriate rate, that is to say the rates given in subsection (6), in order to ascertain the tax credit to set against the settlor's income (the "deductible amount"). This is a separate grossing-up exercise to that in subsection (1), which provides that the charge on the settlor's income is always on the amount grossed up at the rate applicable to trusts.

Section 641: Capital sum paid to settlor by body connected with settlement

1012. This section provides a variation on the preceding rule. It ensures that capital sums paid by a corporate body connected with the settlement are treated as income of the settlor where the payment of that capital sum can be identified with a payment made to the corporate body by the settlement. Thus payments of capital from the settlement to the settlor but dog-legged through a connected third party will not avoid a tax charge on the settlor. The section is based on section 678 of ICTA.

1013. Under *subsections (1)* and *(2)* where a capital sum is paid to the settlor by a body corporate connected with the settlement and an associated payment is made directly or indirectly to that body corporate by the trustees, the capital sum paid by the body corporate is treated, to the extent that it falls within the associated payment, as if it were paid directly by the trustees to the settlor and section 633 applies accordingly.

1014. Where an associated payment is made in the year following the year in which the payment is made by the corporate body to the settlor, the capital sum is treated as the settlor's income for that tax year and so on, up to the amount covered by the associated payment, for each subsequent year (*subsections (4)* to *(6)*).

1015. See the entry in paragraph 135 of Schedule 2 to this Act for the application of this section in respect of payments to the settlor made before 1995-96 by a body corporate connected with the settlement.

Section 642: Exception for certain loans or repayments of loans

1016. This section provides time limits for section 641. Where the capital sum paid to the settlor is repaid within 12 months or loans made to the settlor by a body corporate connected with the settlement are not outstanding for more than 12 months in five years, the capital sum is not treated as the settlor's income. The section is based on section 678 of ICTA.

Section 643: Interpretation of sections 641 and 642

1017. This section provides definitions of and further information on terms used in sections 641 and 642. It is based on section 678 of ICTA.

1018. *Subsection (1)* provides the same tests as section 633 in ascertaining whether a capital sum has been paid to a settlor.

1019. *Subsection (4)* widens the meaning of payments made by or to another body corporate. It enables sections 641 and 642 to apply where the body corporate making the payment to the settlor is a different body corporate to that receiving the payment from the trustees, whether directly or indirectly, but where both bodies corporate are associated.

Section 644: Application to settlements by two or more settlors

1020. This section explains how the provisions of this Chapter apply where there is more than one settlor. It is based on sections 660E and 682A of ICTA.

1021. The Chapter is written in terms of a single settlor and the rules in *subsections (2)* to *(5)* allow the property originating from each settlor to be considered in isolation.

Section 645: Property or income originating from settlor

1022. This section explains what is meant by property or income originating from a settlor for the purposes of section 644. It is based on sections 660E and 682A of ICTA.

1023. *Subsection (1)* rewrites section 660E(5) of ICTA. Section 660E(5) of ICTA provides under paragraph (c) that property originating from a settlor means property that represents property provided by the settlor and other property as, on a just apportionment, represents the property so provided. This is rewritten as "on a just and reasonable apportionment". See *Change 14* in Annex 1.

Section 646: Adjustments between settlor and trustees etc.

1024. This section enables a settlor to recover from the trustees or others tax which has been charged on him or her under sections 624 or 629 as well as requiring him to repay to the trustees any tax repayment which would not have arisen to him or her apart from the charge under these two sections. The section is based on section 660D of ICTA.

1025. *Subsection (1)* enables the settlor to recover from the trustees, or whoever else has received the settlement income, the tax payable by the settlor as a result of a charge under sections 624 or 629. Since the settlor has not in fact received the income it is considered inequitable that he or she should have to pay the additional tax. The net effect where such a recovery is made is that the trustees or beneficiary of the settlement effectively pay the tax on the income but at the settlor's highest tax rate.

1026. *Subsection (2)* enables the settlor to request a certificate of tax paid from the Inland Revenue which is conclusive, under *subsection (3)*, of the facts in it.

1027. Section 660D(1)(b) refers to "an officer of the Board". Similar references have been replaced in this Act by the term "Inland Revenue" to achieve a more consistent approach. This is not a change in the law since section 878(1) of this Act defines "the Inland Revenue" as "any officer of the Board of Inland Revenue".

1028. *Subsections (4)* and *(5)* require a repayment of tax to the trustees or other persons receiving the settlement income which a person would not have received but for a charge under sections 624 and 629. This is most likely to arise where the income charged on the settlor has had tax deducted at source and a repayment of tax is made to the settlor because there is a surplus of allowances or reliefs to set against that income. The repayment may be apportioned where the settlement income was received by more than one person.

1029. Section 660D(2) of ICTA refers to "a person" obtaining a repayment of income tax. This is rewritten here as "a settlor". The person referred to can only be the settlor and the use of "person" simply reflects the language of FA 1922, on which that section is based, which refers to the settlor as "a person making a disposition".

1030. *Subsection (8)* ensures that a charge on settlement income in respect of settlor-interested settlements and settlements in respect of minor children of the settlor may still be made on the trustees as recipients of the income.

Section 647: Power to obtain information

1031. This section allows the Inland Revenue to require parties to a settlement to provide them with information within a specified time limit. It is based on section 660F of ICTA.

1032. Section 660F refers to "an officer of the Board". Similar references have been replaced in this Act by the term "Inland Revenue" to achieve a more consistent approach. This is not a change in the law since section 878(1) of this Act defines "the Inland Revenue" as "any officer of the Board of Inland Revenue".

Section 648: Income arising under a settlement

1033. This section explains what is meant by income arising under a settlement. It is based on section 660G of ICTA.

1034. *Subsection (1)* includes all income chargeable to tax on a UK resident from sources within or outside the United Kingdom.

1035. *Subsections (2) to (5)* apply where the settlor is either not resident in the United Kingdom or not domiciled or not ordinarily resident here. In that case any foreign source income is excluded unless it is remitted to the United Kingdom and the settlor would be chargeable to tax in respect of it if it were his own income. In that case it is included in the income arising under a settlement in the year of remittance.

1036. The net effect of this section is to include all UK source income within income arising under a settlement but to exclude foreign source income if the settlor is non-UK resident. If the settlor would have been charged on an amount calculated by reference to section 832 (relevant foreign income charged on the remittance basis) had he or she been entitled to the income, then that foreign source income is charged only to the extent that it is remitted here.

Chapter 6: Beneficiaries' income from estates in administration

Overview

1037. This Chapter charges to income tax income paid or payable by personal representatives to residuary beneficiaries from estates in administration. The Chapter rewrites sections 695 to 698 and 699 to 702 of ICTA. Section 698A of ICTA (which deals with rates of tax) and section 700(4), (5) and (6) of ICTA (which deal with administrative matters) have not been rewritten in this Chapter. These provisions will be rewritten together with other provisions dealing, respectively, with rates of tax and administrative matters.

1038. Personal representatives are taxable only at the basic rate, lower rate or the dividend ordinary rate (Schedule F ordinary rate in the source legislation) on any income they receive during the administration period. When the income which arises to the personal representatives is paid to the residuary beneficiaries, it is treated as having borne tax at those rates. So this Chapter ensures that beneficiaries liable at the higher rate are chargeable at the higher rate or, as appropriate, the dividend upper rate (Schedule F upper rate in the source legislation), as well as allowing beneficiaries liable at the lower rate, or not liable to income tax, to reclaim some or all of the tax paid by the personal representatives.

Section 649: Charge to tax on estate income

1039. This section charges estate income to tax. It is based on sections 695, 696, 698 and 701 of ICTA.

1040. The approach of Part 16 of ICTA is to deem sums to have been paid as income for all tax purposes. In the case of UK estates, the income is not charged under a particular Schedule or Case and it is implicit that tax is charged on those sums. For foreign estates, a charge is imposed under Schedule D Case IV. This section applies to both UK and foreign estates. And it has now been made explicit that the charge to tax applies to all estate income which is treated as arising under the Chapter from a deceased person's estate.

1041. *Subsection (2)* provides a definition of "estate" and "estate income". It provides that the charge under this section applies to all estate income. This includes income from both UK and foreign estates.

1042. *Subsection (3)* ensures that estate income is treated as income for income tax purposes. Without the rules in this Chapter (and Part 16 of ICTA for corporate beneficiaries within the charge to corporation tax), payments by personal representatives to residuary beneficiaries would, in law, be payments of capital.

1043. *Subsection (4)* recognises that an estate may be divided into different parts with different residuary dispositions. Where, for instance, a proportion of an estate is subject to different dispositions from the remainder and each set of dispositions involves there being a residue, each part of the estate should be treated for the purposes of this Chapter as if they were separate estates. While this subsection applies where the testator has property abroad which he or she disposes of by a separate will, it can also apply to dispositions in the same will. For example, a testator could leave a limited interest in half his or her residuary estate to one child and half to the other with the capital comprising each half share to their respective issue. This would be treated, for the purposes of this Chapter, as two separate estates.

Section 650: Absolute, limited and discretionary interests

1044. This section defines the three types of interest in the whole or part of the residue of an estate. It is based on sections 698 and 701of ICTA.

1045. *Subsection (1)* defines an absolute interest in the whole or part of the residue of an estate. Subsection (1)(a) refers to the capital being properly payable to the person with the interest if the residue had been ascertained. This simply reflects the fact that the amount of any residue, and the income from it, can only be an estimate until the residue has been ascertained.

1046. *Subsection (2)* defines a limited interest in the whole or part of the residue of an estate. Subsection (2)(b) mirrors subsection (1)(a) of this section.

1047. *Subsection (3)* defines what is referred to as a "discretionary interest" in the whole or part of the residue of an estate for the purposes of this Chapter. The income has to be properly payable to the person with the discretionary interest "if the residue had been ascertained at the beginning of the administration period". Effectively, this imposes a working assumption that there will be sufficient income from the residue to make the discretionary payments when the residue has been ascertained.

1048. *Subsection (4)* covers the following four situations:

- income/capital properly payable directly to the person with the interest;
- income/capital properly payable to the person with the interest indirectly through a trustee or other person;
- income/capital properly payable for the benefit of the person with the interest to another person in that person's right, and that income/capital is paid directly to that other person; and
- income/capital properly payable for the benefit of the person with the interest to another person in that person's right, and that income/capital is paid indirectly through a trustee or other person.

1049. An amount is only treated as properly payable to a person if it is "properly payable to the person, or to another in the person's right, for the person's benefit". This makes it clear that, whether the amount is properly payable to the beneficiary or to another in the beneficiary's "right", it must still be payable for the beneficiary's benefit (eg where a payment is made to a person having a power of attorney for a beneficiary). An example of a situation in which this condition is not met is where the residuary beneficiary is in bankruptcy. The income/capital would not be properly payable to the residuary beneficiary but would be payable to the trustee in bankruptcy in his or her right. But any payments would not be made for the benefit of the trustee in bankruptcy as the trustee receives them in a fiduciary capacity.

1050. *Subsection (5)* deals with the situation where personal representatives would have an absolute or limited interest in the residue of another deceased person's estate if a right they have as personal representatives were vested in them for their own benefit. In these circumstances they are treated as having that interest. The term "personal representatives" is defined in section 878(1) of this Act.

1051. *Subsection (6)* makes it clear that for the purposes of subsection (4) it does not matter whether the payment is made directly to the beneficiary by the personal representatives or through a trustee or other person. For example, the payment may be made to the guardian of a child or to whoever is appointed to look after the finances of a mentally incapacitated adult.

Section 651: Meaning of "UK estate" and "foreign estate"

1052. This section defines "UK estate" and "foreign estate" for the purposes of this Chapter. It is based on sections 699A and 701 of ICTA. The definitions in this section underpin the whole of this Chapter.

1053. *Subsections (2), (3)* and *(5)* contain the conditions which determine whether an estate is a UK estate for a tax year. A "foreign estate" is an estate which is not a "UK estate" for the tax year.

Section 652: Estate income: absolute interests in residue

1054. This section sets out the basis on which estate income is treated as arising in a tax year in the case of absolute interests in residue. It is based on section 696 of ICTA.

1055. *Subsections (2)* and *(3)* set out the relevant conditions. A payment need not be made in the final tax year because the net amount of estate income in that year is always equal to the assumed income entitlement for that year. Under section 696(5) of ICTA, taxing a person with an absolute interest in a residuary estate depends on whether the person receives payments and, in the final year of administration, on a fictional payment under that section. The same effect is achieved in this section by determining the liability by considering the assumed income entitlement in all years. Assumed income entitlement is dealt with in section 665.

Section 653: Meaning of "the administration period" and "the final tax year"

1056. This section defines "the administration period" and "the final tax year". It is based on sections 695, 701 and 702 of ICTA.

1057. *Subsection (1)* defines "the administration period" for the purposes of this Chapter. The reference to "the period commencing on the death" in section 695(1) of ICTA suggests that the actual time of death could be important in determining whether income arose before or after death. In general, this will not be the case because income such as earnings, rent, interest and dividends does not arise at a particular time of the day. If such income arises on the date of death, it will be deemed to be income passing to the deceased immediately on the commencement of that day.

1058. But the administration period has not been defined in this Act as beginning the day after the date of death. This is because the possibility cannot be excluded that income will arise after the death, but on the same date, as a result of the efforts of the personal representatives and this should properly be regarded as income of the estate.

1059. *Subsection (2)* defines when the administration of the estate is completed for Scotland. A full definition for Scotland is required because the completion of the administration of an estate would otherwise have no meaning under Scottish law (although the definition has been updated by replacing the archaic expression "for behoof of"). In contrast, there are cases under English law which have established that the administration is complete when the residue of the estate is ascertained and is ready for distribution. Case law explains what this means in particular circumstances (see, for example, R v Special Commissioners ex parte Dr Barnardo's Homes (1921), 7 TC 646 HL, Daw v CIR (1928), 14 TC 58 HC and CIR v Sir Aubrey Smith (1930), 15 TC 661 CA).

1060. *Subsection (3)* defines "the final tax year" to avoid repeating the full meaning throughout the Chapter.

Section 654: Estate income: limited interests in residue

1061. This section deals with estate income relating to limited interests. It is based on section 695 of ICTA.

1062. The section sets out the basis on which estate income is treated as arising in a tax year for limited interests in residue. The section reflects the need to deal with tax years before the final tax year. Also, a limited interest might cease on the death of the beneficiary before the final tax year so that situation has to be provided for.

Section 655: Estate income: discretionary interests in residue

1063. This section deals with estate income relating to discretionary interests in residue. It is based on section 698 of ICTA.

1064. The section sets out the basis on which estate income is treated as arising in a tax year for discretionary interests in residue. Estate income is treated as arising if a payment is made in the tax year in exercise of the discretion in favour of the person with the discretionary interest.

Section 656: Income charged: UK estates

1065. This section sets out the amount charged to tax under section 649 for income from UK estates. It is based on sections 695, 696 and 698 of ICTA.

1066. As there are fundamental differences between the basis of charge for income from UK and foreign estates, the rules for foreign estates have been dealt with in a separate section (section 657).

1067. *Subsection (2)* provides that income from a UK estate is charged on the gross amount of the estate income arising in the tax year. This is the basic amount of the income grossed up at the applicable rate. "Basic amount" is a new term. This avoids confusion with the term "net amount" since it is the "net amount" which is actually charged to tax in the case of a foreign estate (except where section 680 (income treated as bearing income tax) applies).

Section 657: Income charged: foreign estates

1068. This section sets out the amount charged to tax under section 649 for income from foreign estates. It is based on sections 65, 68, 695, 696, 698 and 699A of ICTA.

1069. *Subsection (5)* provides that, so far as the income is not within section 680, the charge is on the basic amount of that income. Where the income is within section 680, the charge is on the gross amount of the income calculated in accordance with section 663.

Section 658: Special rules for foreign income

1070. This section is based on sections 695, 696 and 698 of ICTA. It indicates that estate income arising outside the United Kingdom may be subject to the special rules for foreign income in Part 8 of this Act.

1071. *Subsection (2)* provides that the special rules in Part 8 of this Act for "relevant foreign income" only apply to foreign estates. This preserves the effect of the source legislation under which those special rules only apply to income charged under Schedule D Cases IV or V. And under the source legislation, only income from foreign estates is charged under Schedule D Case IV.

Section 659: Person liable

1072. This section states who is liable for any tax charged under section 649. It is based on sections 695, 696 and 698 of ICTA.

1073. The person who is liable will very much depend on the nature of the interest held by the beneficiary. The various interests are set out in the section together with the person liable for each of those interests.

Section 660: Basic amount of estate income: absolute interests

1074. This section explains how to calculate the basic amount of estate income for absolute interests. It is based on section 696 of ICTA.

1075. For years before the final tax year, the basic amount is the total of all sums paid in the tax year in respect of the interest or the person's assumed income entitlement, whichever is the lower. Surplus payments are excluded because an absolute income beneficiary may receive sums which comprise both capital and income but the section taxes only the income element. For the final tax year, it is the person's assumed income entitlement for that year which is taxed.

1076. This section removes all the deeming of amounts to have been paid in Part 16 of ICTA. Instead, it looks at either amounts actually paid or the assumed income entitlement. It then catches all previously untaxed income due to the absolute interest holder by taxing the assumed income entitlement in the final year. This avoids the two stage process inherent in section 696(5) of ICTA.

1077. *Subsection (3)* introduces a new rule allowing excess estate deductions in the final tax year to be set off against the basic amount of estate income for that year. See *Change 106* in Annex 1.

Section 661: Basic amount of estate income: limited interests

1078. This section explains how to calculate the basic amount of estate income for limited interests. It is based on section 695 of ICTA.

1079. Essentially, the basic amount of estate income is all the sums referred to in section 654 falling within a particular tax year added together. It is impossible for there to be sums within both section 654(3)(c) and (4)(c) in the same tax year.

Section 662: Basic amount of estate income: discretionary interests

1080. This section identifies the basic amount of estate income relating to discretionary interests. It is based on sections 695 and 698 of ICTA.

Section 663: The applicable rate for grossing up basic amounts of estate income

1081. This section provides for basic amounts of estate income to be grossed up, as appropriate, for the purposes of the income charged sections (section 656for UK estates and section 657 for foreign estates) by reference to the rate at which tax is borne by the aggregate income of the estate. The aggregate income of the estate is defined in section 664. Section 663 is based on sections 699A and 701 of ICTA

Section 664: The aggregate income of the estate

1082. This section explains what is meant by the "aggregate income of the estate" for a tax year. It is an important definition of general application. Essentially, the aggregate income is all the taxable income of the personal representatives plus certain sums which are treated as having borne income tax at particular rates. The section is based on sections 249, 421, 547, 701 and 702 of ICTA.

1083. *Subsection (2)* defines the income and amounts within the aggregate income of the estate. Subsection (2)(a) brings in income chargeable to UK income tax. Subsection (2)(b) brings in foreign source income.

1084. *Subsection (4)* provides that the amount of income falling within subsection (2)(b) takes account of any deductions which would have been available if it had been subject to UK income tax. So subsection (4) brings foreign source income into line with UK source income.

1085. *Subsection (5)* provides that two types of income are excluded from the aggregate income of the estate. This subsection excludes income from property devolving on the deceased's personal representatives otherwise than as assets for payment of the deceased's debts. The subsection also excludes from the aggregate income of the estate income to which any person may become entitled under a specific disposition. This second exclusion is new to the definition of the aggregate income of the estate although it is similar to section 697(1)(b) of ICTA which deals with amounts which are deductible from the aggregate income in calculating the residuary income of the estate.

1086. It does not seem appropriate for income from specific dispositions or income from contingent interests to be treated as part of the aggregate income of the estate. See *Change 107* in Annex 1.

1087. Section 698(1) of ICTA deals with the position where the deceased person ("A"), whose estate is being administered by personal representatives, had an absolute or limited interest in the residue of the estate of another deceased person ("B"). Section 698(1) of ICTA deems the personal representatives to have the same interest as "A" "notwithstanding that that right is not vested in them for their own benefit". The substance of this is rewritten in section 650(5). Section 698(1) of ICTA also deems any income in respect of such an interest to be part of the aggregate income of A's estate. This part of the source legislation is not rewritten because such income will fall within the definition of the aggregate income of the estate anyway, once the personal representatives are deemed to have the interest, because it will be the income of the deceased's personal representatives as such. It is immaterial for this purpose that that right in relation to the estate of another deceased person "is not vested in them for their own benefit".

1088. It is not considered necessary to expand on the two types of excluded income mentioned in subsection (5) of this section (with the exception of *subsection (6)* of this section) since it will be clear when such income arises. Consequently, section 701(6) and (7) of ICTA are not rewritten.

Section 665: Assumed income entitlement

1089. This section explains the new concept of the "assumed income entitlement". It is based on section 696 of ICTA.

1090. The concept of "assumed income entitlement" has been introduced as a tool for calculating the basic amount of estate income for absolute interests. It is similar to the "aggregated income entitlement" in section 696 of ICTA but applies in a more straightforward way.

1091. *Subsection (1)* sets out the steps to be considered to determine whether a person has an assumed income entitlement for a tax year. The assumed income entitlement is the amount by which the absolute holder's share of residuary income (after, in the case of UK estates, deduction of tax at the applicable rate) for tax years up to and including the tax year in question exceeds the total of the basic amounts for which he is chargeable for all previous tax years. Thus, for example, if the beneficiary receives his share of the residuary income in each tax year up to the year in question, then the assumed income entitlement is the basic amount of his share of the residuary income for that year.

1092. Step 4 in subsection (1) deals also with situations where a corporate beneficiary liable to income tax was, at some earlier point during the administration period, chargeable to corporation tax. It also deals with other situations where a non-UK resident beneficiary becomes UK resident, when the estate is a foreign estate.

Section 666: The residuary income of the estate

1093. This section explains how the residuary income of the estate is calculated. Beneficiaries with absolute interests need to know the residuary income of the estate for a tax year in order to work out their assumed income entitlement. The section is based on section 697 of ICTA.

1094. *Subsection (2)* lists the "allowable estate deductions". This is a new label for the items which may be deducted from the aggregate income of the estate. Subsection (2)(a) refers to "all interest paid in that year by the personal representatives …". Section 697(1)(a) of ICTA refers to "the amount of any annual interest, annuity or other annual payment for that year which is a charge on residue …". The requirements that interest must be annual and also a charge on residue have not been reproduced. See *Change 108* in Annex 1.

1095. In practice, the Inland Revenue allow income from specific dispositions to be deducted from the aggregate income of the estate in calculating the residuary income of the estate in the year of assent and later years. But it is considered simpler for it merely to be excluded from what counts as the aggregate income and not be deducted from it. See *Change 107* in Annex 1.

1096. Subsection (2)(b) deals with annual payments. Because of the restricted meaning given to annual payments, much of the wide definition in section 701(6) and section 702(d) of ICTA is otiose. Any liabilities which are annual payments will now have to meet only the requirement that they are properly payable out of residue and this is also a requirement of section 701(6) of ICTA. Omitting the remainder of the definition removes unnecessary material. As a consequence of the change, section 701(7) of ICTA, which limits the meaning of "charges on residue" in relation to specific dispositions, does not need to be rewritten either.

1097. The section does not contain an ordering rule for allocating allowable estate deductions against different categories of income. It is not considered appropriate to state explicitly that the taxpayer may choose whichever allocation is most advantageous. This is implicit in the section.

Section 667: Shares of residuary income of estate

1098. This section is based on section 696 of ICTA. It explains the rules for determining the share of residuary income treated as arising from a person's absolute interest in the whole or part of the residue of an estate.

Section 668: Reduction in share of residuary income of estate

1099. This section provides that the share of the residuary income of the estate of a person with an absolute interest is reduced at the end of the administration period in certain circumstances. It is based on sections 4 and 697 of ICTA.

1100. This is beneficial to a person with an absolute interest because a lower share of the residuary income results in a lower (or no) assumed income entitlement. The section ensures that the beneficiary is not charged to tax on more income than he or she actually enjoys. The reduction may apply where, for example, the debts of the estate exceed the amount ultimately realised from the capital assets available for their payment and so part of the income received from the assets is also used, leaving only part available for the residuary beneficiary.

1101. *Subsection (2)* and *(3)* provide that if there is an excess within *subsection (1)*, that excess is available to reduce the person's share of the residuary income in the final tax year. If that share is reduced to nil then any remaining excess is available to reduce the share of the residuary income in the previous tax year and so on.

1102. *Subsection (5)* provides that, for the purposes of subsection (1)(b), a sum paid during the administration period is grossed up by reference to the basic rate for the tax year in which it was paid in the case of UK estates. And it provides that a sum payable at the end of the administration period is grossed up by reference to the basic rate for the final tax year in the case of UK estates. Section 4(1) of ICTA provides that any provision requiring, permitting or assuming the deduction of income tax shall be construed as referring to deduction or payment of income tax at the basic rate. This has been made explicit in subsection (5) itself.

Section 669: Reduction in residuary income: inheritance tax on accrued income

1103. This section deals with the case where an absolute interest holder is a higher rate taxpayer and income accruing before death has been taken into account both in calculating the residuary income and for inheritance tax purposes. The section is based on section 699 of ICTA.

1104. The overlap in the two tax charges may arise where income has accrued before death but is received after death. The section provides for a reduction in the residuary income in such circumstances.

1105. *Subsections (1)* and *(2)* explain the basic principle. The reduction applies when pre-death income (as defined) is taken into account both in calculating the residuary income of the estate for a tax year and in determining the value of the deceased's estate for inheritance tax purposes.

1106. *Subsection (4)* sets out a method statement for calculating the reduction in three steps. For liabilities to be deductible from pre-death income, they have to have affected both the value of the estate for inheritance tax purposes and the residuary income of the estate for the tax year. In the latter case, they might have been deducted in calculating the aggregate income of the estate or have been deducted from the aggregate income in calculating the residuary income.

1107. *Subsections (7)* and *(8)* are administrative provisions. They provide that the amount of inheritance tax chargeable and the value of the estate cannot be reopened once agreed or settled in proceedings. The reference to "the Board" in section 699 of ICTA has been replaced in this section by "the Inland Revenue" which is defined in section 878(1) of this Act. See *Change 149* in Annex 1.

1108. Section 699(6)(b) of ICTA, which provides that references to inheritance tax include references to capital transfer tax, is not rewritten; it is spent.

Section 670: Applicable rate for determining assumed income entitlement (UK estates)

1109. This section sets out the calculation of the applicable rate for the purposes of calculating income tax to be deducted from the residuary income in step 2 of section 665(1). The section is based on section 701 of ICTA.

Section 671: Successive absolute interests

1110. This section explains the position where two or more absolute interests in the residue of an estate are held successively by different people. It is based on sections 697 and 698 of ICTA.

1111. In each tax year in which a payment is made in respect of an absolute interest, it is necessary to calculate the beneficiary's assumed income entitlement. The assumed income entitlement works on a cumulative basis, so the share of the residuary income of the absolute interest holder and the basic amounts of previous tax years are taken into account. In order to give a true picture of the assumed income entitlement of someone who has an absolute interest in succession to another person, the position of the previous holder needs to be brought into the calculations. Otherwise, in certain circumstances, an element of the residuary income might escape taxation.

1112. *Subsections (1)* and *(2)* apply where successively there are different persons with absolute interests in the residue of an estate of a deceased person or in parts of such a residue. They apply primarily for situations where one absolute interest is succeeded by another. This might occur where, for example, an absolute interest holder dies or there is a deed varying the will so that the interest passes for income tax purposes to another beneficiary from the date of the deed etc.

1113. *Subsection (3)* contains an ordering rule to ensure that all determinations under subsection (2) or section 672(2) are made in relation to the person with the earlier interest before the person with the later interest. This subsection has been inserted to make explicit what is already implicit in the source legislation.

1114. *Subsection (4)* provides a special rule where there are two or more absolute interests in the final tax year. It is intended to ensure that it is the last absolute interest which is charged to tax on the assumed income entitlement, which will comprise all the residuary income, in the final year. This is because the last absolute interest holder will receive the capital of the residue (and also all outstanding income in respect of it).

1115. *Subsections (5)* and *(6)* contain special rules where section 668 (reduction in share of residuary income of estate) applies and there are successive absolute interests. These subsections provide that the calculation under section 668(1)(a) and (b) is to be made by reference to all the absolute interests taken together. Then, after applying the reduction to the last absolute interest under section 668(1) and (2), any remaining excess is applied to the previous absolute interest holders working backwards from the beginning of the last interest. See *Change 109* in Annex 1.

Section 672: Successive interests: assumed income entitlement of holder of absolute interest following limited interest

1116. This section (and section 673) explains the position of the absolute interest holder where successive limited and absolute interests in the residue of an estate are held by different people. It is based on section 698 of ICTA.

1117. The section only applies where the later interests arise or are created on the cessation of the previous interest otherwise than by death (the position of limited interests which cease on the death of the holder before the final tax year are dealt with in section 654(4)). All sums paid or remaining payable in respect of that interest after the tax year of death are treated as estate income arising in the tax year of death.

1118. Examples of situations, in relation to limited interests, that are covered by the section include:

- the disclaiming of a life interest which accelerates an existing interest under the will; and
- an interest which is only held until marriage or attaining a certain age.

1119. *Subsections (3)* and *(4)* contain the two rules introduced by *subsection (2).* They deal with the limited interest which ceases otherwise than on death. They also explain how such an interest is brought into the calculation of whether the person with the absolute interest has an assumed income entitlement and, if so, its amount. The assumed income entitlement works on a cumulative basis, so the share of the residuary income of the absolute interest holder and the basic amounts of previous years are taken into account.

Section 673: Successive interests: payments in respect of limited interests followed by absolute interests

1120. This section covers the position where the absolute interest holder is entitled to receive payments in respect of a preceding limited interest which has ceased otherwise than on death. It is based on section 698(1A) and (1B) of ICTA.

1121. *Subsection (2)* deals with such payments while the absolute interest holder still has the absolute interest. It provides that a payment made to the absolute interest holder in respect of the limited interest is treated as paid in respect of the absolute interest (and not the limited interest). Thus, such payments may form part of the basic amount of estate income in tax years before the final tax year.

1122. *Subsection (3)* deals with the position where the holder's absolute interest has itself ceased (but the administration period continues). The approach here is to treat any such sum paid in these circumstances as a payment in respect of the earlier limited interest. The result is that such payments are treated as estate income under the limited interests provisions. But *subsection (6)* provides that the payments are treated as paid or payable in respect of the absolute interest for the purposes of section 668 (reduction in share of residuary income of estate).

1123. The taxation of successive interests in the residue of an estate is dealt with in section 698(1A) to (2) of ICTA. Section 698(1B) of ICTA deals with the case where there were successive interests in an estate which ceased otherwise than on death and the earliest or one of the earlier interests was a limited interest (see section 698(1A) of ICTA).

1124. Section 698(1B)(a) of ICTA provides that Part 16 of ICTA applies as if all the interests were the same interest ("the deemed single interest"), so that none of them is to be treated as having ceased on being succeeded by any of the others. Section 698(1B)(b) of ICTA then determines who had the deemed single interest. It is either the person in respect of whose interest or previous interest the payment was made (section 698(1B)(b)(i) of ICTA) or a person who has or had an interest and is entitled to receive the payment (section 698(1B)(b)(ii) of ICTA). So a beneficiary who does not give up his or her entitlement to income which is unpaid at the time the interest ceases is taxable on the payment, rather than the person holding the successive interest at the time when the payment is made. However section 698(1B)(b) of ICTA is made subject to section 698(1B)(c) of ICTA. Section 698(1B)(c)(i) of ICTA provides that, so far as a later interest is an absolute interest, it is to be treated as having always existed and the earlier interest or interests as having never existed for the purposes of the provisions dealing with absolute interests in section 696(3A) to (5A) of ICTA.

1125. In rare circumstances the later absolute interest may itself have ceased at the time the payment is made. For example, A has a limited interest which is succeeded by absolute interests held first by B and then by C, and a payment is received by B in respect of A's earlier limited interest after B's own interest has ceased but before the end of the administration period. As a result of section 698(1B)(b)(ii) of ICTA, Part 16 of ICTA applies to the payment as if B had the deemed single interest. So section 696(3) of ICTA deems the sum to be paid to B as income in the year in which it is actually paid. That is a tax year in which C had the absolute interest. Under section 698(1B)(c)(i) of ICTA for the purposes of section 696(3A) to (5) of ICTA, Part 16 of ICTA is to apply as if the later interest of C had always existed and the earlier interests had never existed. Section 698(1B)(c)(ii) and (iii) of ICTA then provides that sums paid as income in respect of the earlier interests are deemed to be sums paid in respect of the later interest of C.

1126. The relationship between these particular provisions, where the later interest has itself ceased at the time the payment is made but the administration period continues, is difficult to work out. It would seem that the payment in the above example should be taxed on B because of section 696(3) of ICTA. The payment is then brought into account when the payments made in respect of C's interest are compared to his aggregated income entitlement (in making the final year calculation under section 696(5) of ICTA in respect of C's interest to determine whether any amount should be treated as having been paid to C immediately before the end of the administration period). So although section 698(1A) and (1B) of ICTA operate in a very convoluted way in the above circumstances, the end result appears to be that B, the person with the absolute interest who receives the payment, is taxed on it, but it does not affect B's aggregated income entitlement.

1127. In order to spell out how a payment made in these circumstances should be treated, section 673(3) and (4) provide that where such a payment is made, this Chapter applies as if the earlier limited interest had continued to subsist while the later absolute interest subsisted and had been held by the holder of the later absolute interest. The result is that payments to that holder are treated as estate income under the provisions about limited interests.

1128. Sums to which that holder is entitled that remain payable at the end of the administration period are treated in the same way. They will be basic amounts arising from the limited interest in the tax year in which the absolute interest ceases and are dealt with by sections 654 and 661. The effect of this on later absolute interests is then determined by the successive absolute interests provisions in section 671. Under subsection (6) of section 673, however, these sums are to be treated as paid or payable in respect of the absolute interest for the purposes of the provisions about the reduction in shares of residuary income under section 668.

Section 674: Successive interests: holders of limited interests

1129. This section explains the position of a limited interest holder where successive interests in the residue of an estate are held by different people and the earlier, or if there are more than two, the earliest of the interests is a limited interest. It is based on sections 695 and 698 of ICTA.

1130. The section only applies where the later interests arise or are created on the cessation of the previous interest otherwise than by death.

1131. *Subsections (3)* to *(5)* cover three sets of circumstances described as “cases” where the estate income in respect of successive limited interests is treated as arising. The cases are the equivalent for successive limited interests of the three cases for single limited interests in section 654. But the section recognises that there may be more than one limited interest in the chain of succession, so references are made to “one of the interests” and subsection (5) refers to “the last of the successive interests”.

1132. There is also an additional sub-paragraph in each case providing that a limited holder (as defined) is entitled to receive the payment. This reflects the fact that the person who receives the payment in these circumstances is not always the person in respect of whose interest the payment is made. For example, on disclaiming a life interest, a beneficiary may also disclaim any entitlement to income accrued in respect of that interest but not yet paid.

1133. The section does not make it explicit that a new chain of succession begins with the first limited interest (and a previous absolute interest is ignored) for the purposes of this provision. Nor does the section make it explicit that two limited interests which are preceded by a limited interest which ceased on the death of the beneficiary are covered by the section. These conclusions are implicit in the section.

Section 675: Basic amount of estate income: successive limited interests

1134. This section explains how to calculate the net amount of estate income for successive limited interests. It is based on sections 695 and 698 of ICTA.

1135. The section is the equivalent provision to section 661 for limited interests that are not successive. Essentially, the basic amount of estate income is all the sums referred to in section 674 falling within a particular tax year added together. It is impossible for there to be sums within both section 674(4)(c) and (5)(c) in the same tax year.

Section 676: Apportionments

1136. This section applies where successive interests apply to only part of the residue. In other words, the residuary estate is divided up and one or more of the successive interests provisions apply to a part or parts of that estate. It also applies where one of the interests covers the whole estate and the other interest covers part of it.

1137. In such circumstances, it is possible that a subsequent interest does not cover exactly the same part of the residuary estate as the interest which preceded it. For example, a limited interest holder may give up half his or her interest, thus accelerating the interest of the absolute interest holder. Only half the share of the residuary income and half the net amounts of the limited interest holder would be needed for the calculation of whether the absolute interest holder has an assumed income entitlement in accordance with section 672(2). The section provides for just and reasonable apportionments to be made in these circumstances.

1138. The section is new. See *Change 110* in Annex 1.

Section 677: Relief where UK income tax borne by foreign estate: absolute interests

1139. This section provides for relief if income, which has borne UK tax, arises to a person with an absolute interest in the residue of a foreign estate. It is based on section 696 of ICTA. The relief has been expressed as a formula to make it easier to compute.

1140. *Subsection (2)* contains the formula for calculating the relief where a claim is made. The labels in section 696(7)(a) and (b) of ICTA – "the deemed income" and "the aggregate income" respectively – were added as explanatory aids in the course of the 1988 consolidation. These labels are not retained.

Section 678: Relief where UK income tax borne by foreign estate: limited and discretionary interests

1141. This section provides for relief if income, which has borne UK tax, arises to a person with a limited or discretionary interest in the residue of a foreign estate. The section is based on sections 695 and 698 of ICTA. The relief has been expressed as a formula to make it easier to compute.

1142. *Subsection (2)* provides for a reduction to be made from the tax charged on the person following a claim for relief. The tax is to be reduced by an amount equal to the appropriate fraction of that tax. The fraction here (based on section 695(5) of ICTA) is slightly different to the fraction used for absolute interests (based on section 696(7) of ICTA). The labels in section 695(5)(a) and (b) of ICTA – "the deemed income" and "the aggregate income" respectively – were added as explanatory aids in the course of the 1988 consolidation. These labels are not retained.

1143. Section 695(6) of ICTA is not rewritten. The meaning of this provision, which was introduced when surtax was still charged, is now obscure and it is difficult to see how it could operate in the context of Self Assessment. See *Change 111* in Annex 1.

Section 679: Income from which basic amounts are treated as paid

1144. This section sets out the rules for determining from which part of the aggregate income of the estate a basic amount is treated as paid. It is based on sections 699A and 701 of ICTA.

1145. Personal representatives may receive such income from a number of sources. And different rates of tax apply to different types of income. Some of the income is taxed in the hands of the personal representatives at "the applicable rate" (the basic rate, the lower rate or the dividend ordinary rate; see section 680).

1146. The basic amounts of estate income do not always correlate precisely with the income received by the personal representatives. It is therefore necessary to attribute payments out of the residuary estate in the form of basic amounts to particular types of income received by the personal representatives.

1147. *Subsections (4)* to *(6)* deal with situations where some of the aggregate income of the estate is income treated under section 680 as bearing tax. In such circumstances, a third assumption is introduced. That third assumption is to be applied before the two assumptions referred to in *subsections (2)* and *(3).*

Section 680: Income treated as bearing income tax

1148. This section deals with income which is treated as bearing income tax. It is based on section 699A of ICTA.

1149. For certain types of income (for example, stock dividend income) the amounts treated as received by individuals are gross amounts on which they are treated as having paid tax at the dividend ordinary rate (the Schedule F ordinary rate in the source legislation) or the lower rate (as appropriate). They may then be chargeable to tax at the dividend upper rate or the higher rate on that income. Where such income forms part of the aggregate income of the estate (as a result of section 664(2)), this section treats the income as having borne tax at either the dividend ordinary rate or the lower rate (as appropriate) for certain provisions within the Chapter.

1150. *Subsection (1)* sets out the provisions within the Chapter affected by the section. The provisions in question all affect the aggregate income of the estate (see section 664).

1151. *Subsection (5)* provides that no repayment shall be made of any income tax which is treated as having been borne under section 656(3) or section 657(4) so far as the basic amount comes from sums within this section.

1152. Section 699A(1)(b) of ICTA is not rewritten in this Act. This provision provides that the sums to which section 699A(1)(a) of ICTA applies must be sums in respect of which the personal representatives are not directly assessable to UK income tax. Of the income referred to in section 699A(1)(a) of ICTA to which section 699A(1)(b) of ICTA applies, none appears to be directly assessable. So section 699A(1)(b) of ICTA serves no useful purpose.

1153. Section 699A(6) of ICTA is not rewritten in this Act. It deals with deduction of tax at source and will be rewritten together with the rewrite of sections 348 and 349 of ICTA. The purpose it achieves is served by the new subsection (4)(e) in the consequential amendment to section 348 of ICTA.

Section 681: Transfers of assets etc. treated as payments

1154. This section is concerned with the appropriation of assets by personal representatives to themselves, any other transfer of assets and the set off or release of a debt. The section is based on section 701 of ICTA.

1155. *Subsections (1)* and *(2)* provide that the relevant events are treated as payments when they occur.

1156. *Subsections (3)* and *(4)* provide that where the relevant events have not happened by the end of the administration period, amounts equal to the value of the assets or debt are treated as payable.

Section 682: Assessments, adjustments and claims after the administration period

1157. This section deals with adjustments after the end of the administration period. It is based on section 700 of ICTA.

1158. *Subsections (1)* and *(3)* deals with adjustments where the person previously appeared to be chargeable to either a greater or lesser amount.

1159. *Subsections (2)* and *(4)* make provision for all necessary adjustments and repayments to be made (and where a person has been allowed too much relief, for tax to be charged).

They also make provision for the person to be assessed and taxed (and where, for example, the beneficiary is a charity, for relief or additional relief to be allowed).

Chapter 7: Annual payments not otherwise charged

Overview

1160. The Chapter rewrites the part of section 18(3) Schedule D Case III (a) of ICTA which deals with annual payments and the parts of Schedule D Cases IV and V which deal with foreign annual payments.

1161. Under section 18(3) of ICTA there are no individual charges on income from different types of source within the Schedule D Case IV or V charge. The system of identifying and classifying income by Schedule and Case is replaced by individual charges on types of income, which previously would have fallen under a general Schedular/Case charge. In the context of income which would have previously been charged under Case IV or V, as appropriate, the charge is being fully integrated with the equivalent income arising from a UK source.

1162. This Chapter sets out the charge to income tax on any annual payments that are not charged to tax by any other provision of this Act or any other legislation. Annuity payments made under purchased life annuities and distributions from unauthorised unit trusts (which in the source legislation are treated as annual payments) are generally regarded as investment income. So the charge to tax for this income is in Part 4 of this Act. Royalties which are annual payments are generally regarded as income from intellectual property and are therefore taxed alongside other intellectual property income under Chapter 2 of Part 5 of this Act. Annual payments derived from telecommunication rights are also taxed under a separate Chapter, Chapter 4 of Part 5 of this Act. So, as the annual payments charge in Chapter 7 of Part 5 of this Act takes effect only if an amount is not otherwise charged to income tax, there is no overlap between the charge under this Chapter and the ex-Case III charges elsewhere in this Act.

1163. The charge to tax is in the penultimate Chapter of Part 5 of this Act to emphasise that it is a residual charge.

1164. The exemptions from the charge to income tax on annual payments are in Part 6 of this Act.

1165. The phrase "annual payment" is retained but not defined. The phrase is not defined in the source legislation. Instead it derives its meaning from an extensive body of case law. That case law illustrates that the phrase has a meaning for tax purposes far different from its natural one. Replacing that phrase risks breaking the link to case law without making the law any clearer or easier to understand. Because of the volume and complexity of the case law, defining "annual payment" comprehensively in this Act is impracticable and also risks changing the law.

1166. But it is possible to derive from the case law the main characteristics of an annual payment.

1167. For example, Jenkins L.J., in Commissioners of Inland Revenue v Whitworth Park Coal Company (1959), 38 TC 531 HL (at pages 548 to 550) regarded the following propositions as established:

(i) To come within the Rule as an "other annual payment" the payment in question must be ejusdem generis with the specific instances given in the shape of interest of money and annuities (Hill v Gregory 6 TC 39; Earl Howe v Commissioners of Inland Revenue 7 TC 289)…;

(ii) The payment in question must fall to be made under some binding legal obligation as distinct from a being a mere voluntary payment (Smith v Smith 1923)…;

(iii) The fact that the obligation to pay is imposed by an Order of the Court and does not arise by virtue of a contract does not exclude the payment from Rule 1(a) of Case III (Smith v Smith 1923; CIR v Corporation of London (as Conservators of Epping Forest) 34 TC 293) …;

(iv) The payment in question must possess the essential quality of recurrence implied by the description "annual" (Smith v Smith 1923) …;

(v) The payment in question must be in the nature of a "pure income" profit in the hands of the recipient (Earl Howe v CIR 7 TC 289).

1168. The value of the first proposition is not without doubt. Not only has Parliament changed the genus from that considered in Hill v Gregory and Earl Howe, but the Court of Appeal in R - v - Special Commissioners of Income Tax ex parte Shaftesbury Homes and Arethusa Training Ship (1922), 8 TC 367 CA, in construing "any yearly interest or other annual payment" held that the expression "other annual payment" could not be construed eiusdem generis with the expression "any yearly interest".

Section 683: Charge to tax on annual payments not otherwise charged

1169. This section is based on section 18(1) and (3) (Schedule D Case III (a) and Cases IV and V) of ICTA. *Subsection (1)* charges residual annual payments to tax.

1170. The charge to tax in the source legislation is in respect of "any annuity or other annual payment". The reference to "any annuity or other" is omitted because most annuities are not charged to tax under Chapter 7 of Part 5 of this Act but under Part 4 of this Act or ITEPA. Including a reference to annuities might therefore be misleading.

1171. Likewise the examples of annual payments in Schedule D Case III (a) are omitted on the basis that including these risks misleading the reader either by excluding a right which may give rise to an annual payment or by including rights which may not.

1172. The words "whether such payment is payable within or out of the United Kingdom" in Schedule D Case III (a) are also omitted. See the commentary on section 369 of this Act.

1173. The charge to tax in the source legislation excludes "any payment chargeable under Schedule A". It is not necessary to rewrite this as the priority rules (see section 575 (2)) ensure that property income is taxed under Part 3 of this Act and not under any other Part.

1174. *Subsection (2)* ensures that any exemption from other charges to income tax is not reversed by the charge under this Chapter. It protects an exemption, whether provided by Part 6 of this Act or other legislation.

1175. *Subsection (3)* rewrites "or whether the same is received and payable half-yearly or at any shorter or more distant periods".

Section 684: Income charged

1176. This section sets out the amount charged to tax, which is the full amount of the annual payments (*subsection (1)*). It is based on sections 64 and 65(1) of ICTA.

1177. The words "without any deduction" in section 64 of ICTA are omitted. It is unnecessary to reproduce this phrase because one of the defining characteristics of an annual payment is that the recipient may make no deductions for expenses from it. See also the commentary on section 370 of this Act.

1178. *Subsection (2)* makes subsection (1) subject to the rules in Part 8 of this Act. Part 8 sets out the special rules which apply to foreign income including allowable deductions from foreign income and the remittance basis (see further the commentary on Part 8).

1179. *Subsection (3)* signposts the tax provision in ICTA which deals with the position of a person who receives income from a discretionary trust.

Section 685: **Person liable**

1180. This section states who is liable for any tax charged and is based on section 59(1) of ICTA. The phrase "receiving or entitled to" is retained because it is generally understood and has been widely interpreted by the courts. See further the commentary on section 371 of this Act.

Section 686: Payments received after deduction of tax

1181. *Subsection (1)* confirms that if income tax has been deducted by the payer of the annual payment, the recipient is treated as having paid that income tax. It is based on sections 348(1) and 349(1) of ICTA. The gap otherwise filled by case law (see Allchin v Corporation of South Shields (1943), 25 TC 445 HL, particularly Viscount Simon LC on page 461, Stokes v Bennett, (1953) 34 TC 337 HC, and Grosvenor Place Estates Ltd v Roberts (1960), 39 TC 433 CA) has been expressly rewritten. See further the commentary on section 426 of this Act.

Chapter 8: Income not otherwise charged

Overview

1182. This Chapter charges to tax any income that is not charged by any other income tax provision, whether elsewhere in this Act or in any other part of the Tax Acts, including ITEPA. It is based on section 18 of ICTA.

1183. Schedule D is the residual Schedule into which income falls for income tax purposes if neither ITEPA nor another Schedule of ICTA applies to it. Section 18(1)(a) of ICTA charges "annual profits or gains arising or accruing… from any kind of property whatever…". Section 18(1)(b) of ICTA charges "…other annual profits or gains not charged under Schedule A or under ITEPA 2003 as employment income, pension income or social security income, and not specially exempted from tax". Schedule F (rewritten in Chapter 3 of Part 4 of this Act) has sole charging rights over the amounts within its scope. Tax is charged under Schedule D Case VI "in respect of annual profits or gains not falling under any other Case of Schedule D and not charged by virtue of Schedule A or by virtue of ITEPA 2003 as employment income, pension income or social security income".

1184. Case VI is itself the residual Case under Schedule D. Schedule D Case V includes an identical function for "relevant foreign income" (see the definition in section 830) of this Act. The scope of Case V is "tax in respect of income arising from possessions out of the United Kingdom not being employment income, pension income or social security income on which tax is charged under ITEPA 2003". Case law has established the comprehensive scope of Case V in relation to "income from possessions out of the United Kingdom" (see the commentary on the overview to Part 8 of this Act). So far as any amount is "income from possessions out of the United Kingdom", Case V is the "last resort" charging provision, not

Case VI. And a corollary of that rule is that income charged by Case VI (other than amounts which are directed to be taxed under Case VI) can only derive from a source in the United Kingdom.

1185. So far as is practicable, income charged by the source legislation under Schedule D Cases IV to VI is the subject of separate charges in this Act. See, for example:

- Chapter 4 of Part 4 of this Act, taken from Case V, which deals with dividends from non-UK resident companies;
- Chapter 3 of Part 5 of this Act, taken from Cases V and VI, which deals with films and sound recordings (non-trade businesses); and
- Chapter 4 of Part 5 of this Act, partly taken from Cases V and VI, which deals with certain telecommunication rights (non-trading income).

1186. This Chapter brings together the "sweep up" functions of Cases IV to VI. And it contains the charge to tax on two types of income where, in most cases, income will be wholly covered by relief. See section 688(2)(a) and (b).

1187. The charge under this Chapter is restricted to amounts that are "income" on first principles. That is, they are "annual profits or gains" under section 18(1) of ICTA, as that phrase has been interpreted by case law, and are not profits or gains of a capital nature (although some amounts of that nature have been treated as income charged to income tax, whether under a Case of Schedule D or otherwise). This is indicated by the use in section 687(1) of the words "from any source" and by the disapplication of the definition of "income" in section 878(1) of this Act by section 687(4). (For the significance of the reference to "any source", see the commentary on the overview to Part 8 of this Act on recent judicial remarks on "source".)

1188. Although some charges to income tax, whether in ICTA or elsewhere in the Tax Acts, are not rewritten in this Act or ITEPA, none of them overlaps with the charge under this Chapter. Nor is there any overlap with any other charges which themselves are limited to income not otherwise chargeable.

1189. Under the source legislation, Case VI losses may be set against Case VI profits or gains (see section 392 of ICTA). Paragraph 168 of Schedule 1 to this Act amends that section so that, in conjunction with section 836B to ICTA (inserted by that Schedule), where a loss arises in circumstances that, had there been income rather than a loss (other than relevant foreign income) the income would have been charged under this Chapter, the same loss relief applies. The only equivalent loss relief for relevant foreign income is under section 391 of ICTA. But this relief is restricted to losses from a trade, profession or vocation carried on wholly abroad. Any income from such a source would be charged under Part 2 of this Act. Section 391 of ICTA does not, therefore, apply to losses from a source where any income would be charged by this Chapter.

Section 687: Charge to tax on income not otherwise charged

1190. This section is based on section 18 of ICTA. Schedule D Cases IV and V charge tax in respect of *income*, whether from securities or possessions out of the United Kingdom. Schedule D Case VI charges tax in respect of *annual profits or gains*. The scope of all three cases is derived from section 18(1) of ICTA, which refers to "annual profits or gains". Case law does not indicate a difference, in the context of section 18 of ICTA, in the meaning of "annual profits and gains" and "income". The choice of term appears to be dictated (although not consistently) by the degree to which a calculation of profit or loss is relevant to the calculation of the income charged.

1191. The section uses *income* rather than *(annual) profits or gains*. There is nothing known which is "income" within the usual meaning of the term and therefore caught by this section but which would not be caught under Schedule D Cases V or VI.

1192. *Subsection (2)* ensures that section 683 (charge to tax on annual payments not otherwise charged) has the exclusive right to charge any annual payments not falling within any other charge.

1193. *Subsection (3)* protects an exemption, whether provided by Part 6 of this Act or other legislation.

1194. *Subsection (5)* lists some exemptions which apply particularly to this charge. Other exemptions may (exceptionally) apply: for example, see section 771 of this Act (relevant foreign income of consular officers and employees).

Section 688: Income charged

1195. This section is based on sections 65, 68 and 69 of ICTA. The rules in sections 65(1) and 68(1) of ICTA, for income chargeable under Schedule D Cases IV and V, and under section 69 of ICTA, for income chargeable under Schedule D Case VI, are broadly similar. But there is a difference in terms used (*income* in sections 65 and 68 of ICTA, *profits or gains* in section 69 of ICTA). For the reasons set out in the commentary on the preceding section, that difference has no significance here.

1196. As regards any income within this charge which is relevant foreign income (defined in section 830 of this Act), Part 8 of this Act applies. That Part rewrites the calculation rules in sections 65 and 68 of ICTA, for income charged under Schedule D Cases IV and V, setting out all the material differences between those rules and those in section 69 of ICTA for income charged under Schedule D Case VI. Chapter 4 of Part 8 of this Act contains rules that apply to income arising outside the United Kingdom, whether or not it is relevant foreign income.

1197. See also paragraph 159 of Schedule 2 to this Act. This paragraph provides that such case law guidance as there is on the calculation of income under this and other charges, as regards deductions allowed and not allowed, continues to apply. In respect of income that was formerly within Schedule D Case VI, this ensures that the guidance in, for example, Curtis Brown Ltd v Jarvis (1929), 14 TC 744 HC remains applicable. (The effect of that guidance is spelt out in the sections mentioned in that paragraph.)

1198. See also Chapter 2 of Part 10 of this Act for further rules that affect the calculation of income under this section.

Section 689: Person liable

1199. This section is based on section 59 of ICTA.

Part 6: Exempt income

Overview

1200. This Part groups all of the sections which provide exemption for income otherwise charged to income tax by this Act. A signpost in each charging section points the user to the main exemptions from that particular charge contained in this Part.

1201. For the most part each Chapter in this Part relates to a particular type of income but there are also Chapters that deal with exemptions relevant to certain types of annual payment and to miscellaneous other income.

1202. The exemptions, where relevant, apply to both United Kingdom and foreign income unless one of these kinds of income is expressly excluded in the section.

1203. The wording of the exemption sections follows the "no liability approach" adopted in ITEPA.

Chapter 1: Introduction

Section 690: Overview of Part 6

1204. This section lists the Chapters in this Part. These provide for exemption from income tax for:

- National savings income (Chapter 2);
- Income from individual investment plans (Chapter 3);
- SAYE interest (Chapter 4);
- Venture capital trust dividends (Chapter 5);
- Income from FOTRA securities (Chapter 6);
- Purchased life annuity payments (Chapter 7);
- Other annual payments (Chapter 8); and
- Other income (Chapter 9).

1205. *Subsection (3)* explains the purpose of Chapter 10 (general). This Chapter provides that any exemption in this Part, unless there is specific provision to the contrary, is disregarded for all income tax purposes.

1206. S*ubsection (4)* indicates that there are exemptions in other Acts relating to particular categories of person which could be relevant to the charges in this Act. For example see section 505 of ICTA which provides a general exemption for charities.

1207. *Subsection (5)* explains that the exemptions in this Act may apply, where relevant, to charges outside this Act.

Chapter 2: National savings income

Overview

1208. This Chapter deals with the exemptions from income tax relating to National Savings Bank ordinary account interest and income from savings certificates (including Ulster Savings Certificates).

Section 691: National Savings Bank ordinary account interest

1209. This section is based on section 325 of ICTA, which exempts from income tax the first £70 of interest on National Savings Bank ordinary account deposits arising in a tax year. The exemption, which is not available for interest on National Savings Bank investment account deposits, applies only to interest of individuals. Although the interest is exempt from income tax, certain returns of information may need to be made in respect of it (for example, information returns by the National Savings Bank under section 17 of TMA – see section 783(2) of this Act).

1210. It has not been possible to open a National Savings Bank ordinary account since 28 January 2004. And since 31 July 2004, existing ordinary account customers will not be able to transact on their accounts, unless it is to close the account or transfer into an Easy Access savings account. Even though the ordinary account has closed, any money which is left dormant in these accounts will continue to earn interest. The first £70 of interest for each tax year will still be tax free and customers will be able to come forward at any time to claim their money. So the tax exemption contained in this section will be needed for the foreseeable future.

1211. Two minor changes have been made to the wording of section 325 of ICTA. These are:

- to remove the reference to "total income" (which dates back to the days of surtax) as it is no longer relevant to this particular section; and
- to remove the reference to investment accounts and make it clearer that the exemption applies only to ordinary account interest.

1212. *Subsection (2)* makes it clear that a charge to income tax does apply where the interest exceeds £70 in a tax year. But the charge is only on the excess of the interest over £70 in the tax year.

Section 692: Income from savings certificates

1213. This section provides an exemption for income from savings certificates, provided that the holding of savings certificates is within specified limits. Income from any certificates purchased or held in excess of these limits is chargeable to tax. The section is based on section 46 of ICTA (excluding section 46(2) of ICTA which relates to Tax Reserve Certificates and is dealt with in section 750 of this Act).

1214. Most income from savings certificates would otherwise be taxable under the charge to tax on interest. However, income from certain savings certificates falls within the charge on profits from deeply discounted securities. This exemption therefore applies to income chargeable under both Chapters 2 and 8 of Part 4 of this Act.

1215. The detailed rules governing these certificates, including the maximum holding limits, are in regulations. The source legislation refers to the limits in terms of purchase by, or on behalf of, an individual. This could be confusing for situations such as joint ownership or inheritance, where special regulations apply. Also, the regulations are written in terms of a holding limit, but in practice this translates into a prohibition on purchasing in some situations.

1216. *Subsection (2)* avoids this confusion by using "acquisition" rather than purchase and by referring to the regulations as limiting a person's holding, in line with the way the regulations are written.

1217. Although section 46 of ICTA was simply written in terms of certificates, it is possible to purchase multiple certificates. The regulations say that a multiple certificate is to be treated as a number of unit certificates for the purposes of determining whether the holding limit has been exceeded. On a strict reading of section 46 of ICTA none of the income from a multiple certificate which is partially outside the permitted limit would be exempt. The section introduces the words "so far as" in subsection (2) to clarify that the exemption is available for the income from the permitted part of a multiple certificate. In practice section 46 of ICTA was applied in this way. See *Change 112* in Annex 1.

1218. *Subsection (3)* defines savings certificates. It is not possible to define savings certificates by reference to their characteristics; indeed, some savings certificates are not even called savings certificates. The only way of providing a completely accurate definition is by reference to the provisions under which the certificates are issued.

1219. *Subsection (4)* excludes Ulster Savings Certificates from the general definition of savings certificates, and then signposts the special rules for such certificates in section 693. Ulster Savings Certificates have been dealt with in a separate section, so that holders of other savings certificates do not have to work through material which is not relevant for their type of certificate.

Section 693: Income from Ulster Savings Certificates

1220. This section provides an exemption for income from Ulster Savings Certificates, for holdings within specified limits. Income from any certificates purchased or held in excess of these limits is chargeable to tax. The section is based on section 46 of ICTA, which also deals with savings certificates generally (see section 692).

1221. The basic provisions for Ulster Savings Certificates are the same as those for other types of savings certificate, but there are some additional rules. Although Ulster Savings Certificates have not been issued since March 1997, there are still holdings which have not been redeemed. Consequently it is necessary to rewrite this provision to ensure that interest continuing to be paid in respect of these holdings is exempt from income tax.

1222. *Subsections (2)* to *(4)* set out the residence conditions, one of which has to be satisfied in order for the income to qualify for exemption. Subsection (4) enacts ESC A34, which extends the exemption to a repayment made after the death of a holder who had been resident and ordinarily resident at the time the certificates were purchased. See *Change 113* in Annex 1.

1223. *Subsection (5)* uses "acquisition" rather than purchase and refers to a person's holding, in line with the way the regulations are written. In the case of Ulster Savings Certificates, the regulations which limit a person's holding are made by the Department of Finance and Personnel in Northern Ireland, rather than by the Treasury.

1224. Although section 46 of ICTA was simply written in terms of certificates, it is possible to purchase multiple certificates. The regulations say that a multiple certificate is to be treated as a number of unit certificates for the purposes of determining whether the holding limit has been exceeded. On a strict reading of section 46 of ICTA none of the income from a multiple certificate which is partially outside the permitted limit would be exempt. The section introduces the words "so far as" in subsection (5) to clarify that the exemption is available for the income from the permitted part of a multiple certificate. In practice section 46 of ICTA was applied in this way. See *Change 112* in Annex 1.

1225. *Subsection (6)* does not specify that the claim for exemption is to be made to the Board. Section 46(5) of ICTA requires such a claim to be made to the Board but it is not considered necessary for a claim to be made at this level. Section 878(4) of this Act draws attention to the rules in 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.

1226. *Subsection (7)* is based on section 832(1) of ICTA, which provides some general definitions. As these certificates are not mentioned elsewhere in this Act, it is more helpful to incorporate a definition in this section rather than have a general definition elsewhere which applies to the whole Act.

Chapter 3: Income from individual investment plans

Overview

1227. This Chapter gives the powers for regulations on individual investment plans – better known as PEPs and ISAs – to exempt income from tax. The regulations made so far are Personal Equity Plan Regulations (SI 1989/469) and Individual Savings Account Regulations (SI 1998/1870).

Section 694: Income from individual investment plans

1228. This section contains the general powers for the Treasury to make regulations providing for the income of individuals from certain types of investment plan to be exempt from income tax and defines the scope of the exemption. It is based on section 333 of ICTA.

Section 695: Investment plans

1229. This section contains the powers under which regulations may be made to provide rules about the form of the investment plans in which investments are held and about the investments which may be held in them. It is based on section 333 of ICTA.

1230. *Subsections (3)* and *(4)* provide for approval and registration by the Board of Inland Revenue respectively. References to "the Board of Inland Revenue" (rather than to the Inland Revenue) must remain as the power to make regulations is conferred on the Board under the Inland Revenue Regulation Act 1890 and not on the Inland Revenue or its officers.

Section 696: Plan managers

1231. This section contains the powers under which regulations may be made to provide rules for the investments to be held by plan managers on behalf of investors. It is based on section 333 of ICTA.

Section 697: Special requirements for certain foreign managers

1232. This section contains the powers under which regulations may be made to provide rules for foreign institutions to be plan managers if they fulfil certain requirements. It is based on section 333A of ICTA.

1233. *Subsection (2)* defines "foreign institution". Subsection (2)(c) includes non-UK resident insurance companies within the definition. Non-resident insurance companies are now included here rather than in a rewrite of section 333B(4) of ICTA, which provides for regulations to be made about non-resident insurance companies appointing United Kingdom tax representatives. See *Change 114* in Annex 1.

Section 698: Requirements for discharge of foreign institution's duties

1234. This section contains the requirements which have to be fulfilled for a "foreign institution" in section 697 to be a plan manager. It is based on section 333A of ICTA.

Section 699: Non-entitlement to exemption

1235. Under section 694(3) regulations may specify "the description of individuals who may invest" in a plan. This section contains the powers under which regulations may be made to provide rules for an investor in a plan ceasing to be entitled to the exemption from income tax. It is based on section 333 of ICTA.

Section 700: Information

1236. This section contains the powers under which regulations may be made to provide rules for documents and information to be provided within specified time limits to the Inland Revenue by the investor or the plan manager. It is based on section 333(4) of ICTA.

Section 701: General and supplementary powers

1237. This section contains some general powers under which regulations may be made to provide administrative rules. The regulations may specify how the exemption is to be claimed, either by the investor or by the plan manager on behalf of the investor. It is based on section 333 of ICTA.

Chapter 4: SAYE interest

Overview

1238. This Chapter rewrites the exemption for interest arising under certain contractual savings schemes, commonly known as SAYE schemes. The sections are based on section 326 of and Schedule 15A to ICTA and on Schedule 12 to FA 1995.

1239. An eligible employee who is granted options under a *SAYE option scheme* must agree to enter into a *linked savings arrangement* operated either by the National Savings Bank or by an authorised financial institution. Where the Treasury are satisfied that the arrangement is a linked savings arrangement, and meets any appropriate conditions, they certify it. Such an arrangement is called a "certified SAYE savings arrangement".

1240. For the meaning of "SAYE option scheme", see section 516 of and Schedule 3 to ITEPA.

1241. Under a linked savings arrangement, the employee agrees to save a specific amount each month, which may be between £5 and £250. At the end of the contract period (three, five or seven years) the contributions made will be repaid to the employee together with a bonus (based on the length of the contract and the level of contributions made). The employee may then use the money to exercise his or her share options under the SAYE option scheme. If the employee does not complete the contract, the contributions made are repaid together with interest (where this is due). In both cases, providing the institution operating the linked savings arrangement is authorised (where necessary), and the scheme complies with any Treasury requirements regarding certification, the bonus and interest payments are exempt from income tax.

1242. Exemption was also available for interest and bonuses paid under "ordinary" SAYE schemes, which are not share option linked, where the contract was entered into before 1 December 1994. But any contract entered into before that date will have run its course before 2005-06. The transitional provisions in paragraph 7(1) of Schedule 12 to FA 1995 have therefore not been rewritten in this Chapter.

1243. The exemption from tax is set out in section 702. The remainder of the Chapter defines terms and sets out the administrative requirements for linked savings arrangements and for providers of arrangements.

Section 702: Interest under certified SAYE savings arrangements

1244. This section is based on section 326 of ICTA. It introduces the key term "certified SAYE savings arrangement". The definition of that term in section 703 introduces both the various conditions to be met by the savings schemes (and the financial institutions who provide them) and the certification machinery.

1245. *Subsection (3)* qualifies the exemption by reference to:

- the rules in section 707 for authorisation of institutions providing arrangements; and
- a provision in FA 1988 in respect of building societies.

1246. Schedule 12 to FA 1988 contains provisions which apply when the business of a building society is transferred to a company in accordance with the Building Societies Act 1986 (that is, when a building society turns itself into a bank). Paragraph 7 of Schedule 12 to FA 1988 ensures that any interest payable after the transfer continues to be eligible for exemption, notwithstanding the fact that the transfer means the savings arrangement ceases to be a certified SAYE savings arrangement.

1247. *Subsection (4)* defines "interest" for the purposes of the Chapter. Although section 326(1) of ICTA refers to "any terminal bonus, or interest or other sum", in practice only bonuses and interest are payable under SAYE schemes.

1248. It is not clear why the source legislation refers to "other sum". The only other sums involved are contributions returned to the employee. But these are deposits - capital - being returned to an investor and are not themselves taxable. The words "other sum" add nothing to the provision (indeed, they might cause confusion) and are not rewritten.

1249. All bonuses are computed by reference to the level of contribution made by the employee and to the length of the savings contract. Despite the expression "terminal bonuses", a bonus is interest for tax purposes. A separate reference to the terminal bonus might put beyond doubt that the bonus is exempt from tax. But such a reference might also cast doubt on whether the bonus is in fact interest. That would in turn create uncertainty as to how the bonus would be taxed if the SAYE scheme should lose the status necessary for the income from it to qualify for the exemption in section 326 of ICTA. The section therefore simply uses "interest" throughout as including "bonus".

1250. Paragraphs 184(2) and 445(3) of Schedule 1 to this Act follow suit in amending section 477A(4) of ICTA (building societies: regulations for deduction of tax) and section

271(4) of TCGA (other miscellaneous exemptions), both of which refer to the source legislation for these sections.

Section 703: Meaning of "certified SAYE savings arrangement"

1251. This section is based on section 326 of and Schedule 15A to ICTA. It introduces the term "linked savings arrangement", defined in subsection (2). The source legislation refers to "contractual savings schemes" but this is only one of a number of names by which these arrangements are known. As any arrangement entered into since 1994 must be linked to a SAYE option scheme, "linked savings arrangement" reflects the present position.

1252. *Subsection (2)* introduces the various types of arrangement (set out in section 704) and the required link between the savings arrangement and the SAYE option scheme. Paragraphs 139 to 141 of Schedule 2 to this Act preserve the commencement rules for the amendments to this relief introduced by Schedule 12 to FA 1995. Those paragraphs affect what is or is not a certified SAYE savings arrangement.

1253. The definitions in *subsection (3)* are based on terms used and definitions provided by Schedule 15A to ICTA.

Section 704: Types of arrangements and providers

1254. This section sets out what types of arrangement may be linked savings arrangements. It provides definitions of each type of arrangement. These definitions are based on section 326 of and Schedule 15A to ICTA.

1255. *Subsection (1)* indicates that linked saving arrangements are either a "national savings arrangement" (defined in *subsection (2)*), or an "institutional arrangement", that is, one provided by a financial institution (defined in *subsections (3)* to *(6)*). The main distinction between a national savings arrangement and an institutional arrangement is that the provider of an institutional arrangement must be authorised (see section 707). The Treasury may also impose requirements on an institutional arrangement before they certify it under section 705.

Section 705: Certification of arrangements

1256. This section sets out the administrative provisions for the certification by the Treasury of linked savings arrangements. It also provides the powers for the Treasury to impose further requirements on an institutional arrangement. In practice, this means that arrangements must correspond to the Treasury model scheme for these arrangements. It is based on section 326 of and Schedule 15A to ICTA.

1257. In the source legislation, the power to impose further requirements is in respect of requirements "for the purposes of" section 326 of ICTA. But Schedule 15A to ICTA has "effect for the purposes of section 326" (paragraph 1 of that Schedule), so that the section must be read with the Schedule. This Chapter incorporates both the section and the Schedule, so this section applies the power in respect of requirements for the purposes of the Chapter.

Section 706: Withdrawal and variation of certifications and connected requirements

1258. This section is based on Schedule 15A to ICTA.

Section 707: Authorisation of providers

1259. This section is based on section 326 of and Schedule 15A to ICTA.

Section 708: Withdrawal and variation of authorisations

1260. This section is based on Schedule 15A to ICTA.

Chapter 5: Venture capital trust dividends

Overview

1261. This Chapter rewrites the provisions exempting from income tax dividends from Venture Capital Trusts ("VCTs"). The sections are based on section 332A of and Schedule 15B to ICTA.

1262. The VCT scheme is one of three venture capital schemes (the other two being the Enterprise Investment Scheme and the Corporate Venturing Scheme).

1263. The VCT scheme is aimed at encouraging individuals to invest indirectly in unquoted trading companies. VCTs are companies listed on the London Stock Exchange and are a special type of investment trust approved for the purpose of the VCT scheme by the Inland Revenue.

1264. The exemption from income tax on dividends is one of the benefits of investing in a VCT. Schedule 15B to ICTA sets out the tax relief available on the investment in a VCT and sections 151A and 151B of and Schedule 5C to TCGA give certain reliefs from capital gains tax.

Section 709: Venture capital trust dividends

1265. This section is based on paragraphs 7 and 8 of Schedule 15B to ICTA and sets out the conditions that have to be met in order for a VCT dividend to be exempt from income tax.

1266. Paragraph 7(3)(a) refers to " … a dividend (including a capital dividend) …". This is rewritten simply as "a dividend". Section 209(2) of ICTA, which sets out the meaning of "distribution", also refers to "any dividend paid by the company, including a capital dividend" (see section 209(2)(a) of ICTA). However, the charging provision in the source legislation (see section 20(1) paragraph 1 of ICTA) refers simply to "all dividends and other distributions … which are not specifically excluded from income tax … however they fall to be dealt with in the hands of the recipient". Likewise the rewritten charging provision charges to tax "dividends and other distributions …" (see section 383 of this Act). Given that the charging provision does not specifically refer to capital dividends and an investor is unlikely to know that he or she is receiving a capital dividend, the reference to capital dividends is omitted.

1267. The conditions for exemption relate first to the dividend (*subsection (2)*), then to the investor (*subsection (3)*) and then to the circumstances surrounding the investment (*subsections (4)* to *(7)*).

1268. The exemption applies only to dividends paid on ordinary shares acquired within the annual acquisition limit of £200,000 (see *subsection (4)*). The value applied is market value as defined in section 272 and 273 of TCGA (see *subsection (8)*).

1269. The condition contained in subsection (6) is based on paragraph 7(3)(a)(ia) of Schedule 15B to ICTA which was inserted by FA 1999. The condition applies only to acquisitions made on or after 9 March 1999 (see *subsection (1)(b)*). Subsection (7) confirms that shares not acquired for genuine commercial reasons are not treated as using part of the annual acquisition limit whether those shares were acquired before or after 8 March 1999. Prior to the FA 1999 amendments, such shares were not "relevant acquisitions". Following the FA 1999 amendments, dividends paid on such shares cannot qualify for exemption and therefore the shares are disregarded for the purposes of determining whether the annual acquisition limit has been exceeded.

Section 710: Treatment of shares where annual acquisition limit

exceeded

1270. This section is based on paragraph 8 of Schedule 15B to ICTA and provides an ordering rule to determine which shares are treated as within the annual acquisition limit (referred to as "exempt shares") if that limit is exceeded in a tax year.

1271. *Subsection (2)* provides the basic rule, that shares are treated as exempt shares if immediately after their acquisition the annual limit is not exceeded.

1272. *Subsection (4)* deals with the situation where the limit is exceeded on a day in which shares of different descriptions are acquired. In that case the appropriate proportion of shares of each description are treated as exempt shares.

Section 711: Identification of shares after disposals

1273. This section is based on paragraph 8 of Schedule 15B to ICTA and sets out the share identification rules for disposals of shares in a VCT.

1274. The first rule (*subsection (1)*) provides the assumption that non-VCT shares are disposed of before VCT shares.

1275. The second rule (*subsection (2)*) applies if the annual acquisition limit is exceeded and some shares are disposed of. Clearly an investor will want to know whether the shares falling within the annual acquisition limit are disposed of or whether the other shares (referred to as "excess shares") are disposed of. The section sets out the assumptions to apply. Shares acquired on an earlier day are treated as disposed of before shares acquired on a later day (see *subsection (3)*). If the shares are acquired on the same day, excess shares are treated as disposed of first (see *subsection (4)*).

1276. *Subsection (5)* is based on section 60 of TCGA, incorporating the rule relating to acquisitions and disposals by a person's nominee, and acquisitions and disposals between a person and his nominee.

Section 712: Identification of shares after reorganisations etc.

1277. This section deals with the identification of shares following a reorganisation etc, for example, where there has been a bonus issue of shares or where there has been an issue of shares falling within section 135 or 136 TCGA. It is based on paragraph 8(3) and (4) of Schedule 15B to ICTA and sets out three rules.

1278. The first rule (*subsection (2)*), is that any "new shares" acquired as a result of the reorganisation etc. are treated as satisfying the conditions for exempt shares set out in section 709(4) and, if relevant, section 709 (6), if the "old shares" satisfied those conditions. Dividends paid in respect of the new shares therefore qualify for the income tax exemption under this Chapter.

1279. The condition in section 709(6) relates to shares acquired on or after 9 March 1999. If the "old shares" were acquired before 9 March 1999 the new shares do not need to satisfy the condition in section 709(6). The source legislation refers only to the new shares being treated as satisfying the annual acquisition condition. See *Change 115* in Annex 1.

1280. The second rule (*subsection (3)*) is that if only a proportion of the "old shares" met the condition about the annual acquisition limit or the commercial reasons test then only the corresponding proportion of the "new shares" are treated as doing so. It follows that the remainder of the new shares are treated as not doing so. So dividends paid in respect of those shares would not qualify for the income tax exemption under this Chapter.

1281. The source legislation is silent as to whether "new shares" in excess of that corresponding proportion ("excess new shares") get another chance to qualify as exempt shares if any of the current year's annual acquisition limit remains available.

1282. For example, in the tax year in which the "new shares" are issued (say with a value of £150,000 of which £100,000 qualify under the corresponding proportion rule) further shares are acquired to a value of say £100,000. The issue is whether the £50,000 new shares which did not qualify under the corresponding proportion rule can be treated as falling within the annual acquisition limit because £100,000 of the current year's annual acquisition limit remains available.

1283. Paragraph 8(4)(a) of Schedule 15B to ICTA ensures that the excess new shares are disregarded in determining whether acquisitions, made during the same tax year as the excess new shares are issued, come within the annual acquisition limit. The position of the excess new shares is dealt with solely under paragraph 8(4)(b) of Schedule 15B to ICTA. That sets out the extent the new shares are to be treated as acquired within the permitted maximum by reference to the status of the shares from which they are derived, that is, the proportionate basis. If they do not qualify under that provision, they do not qualify at all.

1284. It is not thought to be the intention of the legislation that excess new shares should have a second chance of being treated as falling within the permitted maximum. So subsection (3) provides explicitly that the remaining new shares are not treated as meeting the conditions to qualify for the income tax exemption. This is implied but not expressly stated in the source legislation.

1285. The third rule (s*ubsection (4))* provides that the new shares are ignored in determining whether other shares acquired in the same tax year qualify for the income tax exemption.

Chapter 6: Income from FOTRA securities

Overview

1286. This Chapter provides for exemption from income tax in respect of United Kingdom government securities which are beneficially owned by persons who are not resident in the United Kingdom. Such securities are described as being "Free of Tax to Residents Abroad" or "FOTRA securities". The sections are based on section 154 of FA 1996 and section 161 of FA 1998.

1287. The beneficial owner of a FOTRA security may be entitled to an exemption from income tax in any of the following three situations:

- a person holding the security as an investment may be exempt from tax on the interest arising on the security;
- a dealer holding the security in circumstances where a profit on sale would be regarded as a trading receipt may be exempt from tax on the interest arising on the security; or
- a dealer holding the security in circumstances where a profit on sale would be regarded as a trading receipt may be exempt from tax on the profit arising from a purchase and sale of the security.

1288. It is not intended to rewrite section 22(1) of F(No 2)A 1931, section 60(1) of FA 1940 or section 154(1) of FA 1996. These provisions all concern the Treasury's powers to issue securities. The first two provisions were left untouched in the 1952, 1970 and 1988 consolidations. (Section 47 of Finance (No 2) Act 1915 was repealed in 1927, but in terms to the effect that the repeal did not affect income tax exemptions attaching to securities previously issued.)

Section 713: Introduction: securities free of tax to residents abroad ("FOTRA securities")

1289. This section sets out the scope of the Chapter. It is based on section 154(8) of FA 1996 and section 161 of FA 1998.

1290. *Subsection (2)* sets out the three different classes of FOTRA securities. Each class of FOTRA security has its own distinct rules.

1291. *Subsection (3)* to *(6)* define the term "the exemption condition" used in this Chapter. There are different definitions for each of the three classes of FOTRA securities in subsection (2).

Section 714: Exemption of profits from FOTRA securities

1292. This section sets out the conditions that must all be met if the exemption is to apply. It is based on section 154 of FA 1996. As the exemption can apply, in certain circumstances, to trading income as well as to interest (see overview to this Chapter), the general word "profits" has been used in *subsection (1)* rather than a more limited word such as "interest".

1293. *Subsection (6)* deals with two exceptions from the general exemption in subsection (1). These exceptions apply whatever the exemption condition relating to the FOTRA security provides.

Section 715: Interest from FOTRA securities held on trust

1294. This section reflects an Inland Revenue practice to regard the interest from a FOTRA security held in trust as exempt (and the beneficial ownership test in the exemption condition as satisfied) where none of the beneficiaries of the trust is ordinarily resident in the United Kingdom at the time when the interest arises. See *Change 116* in Annex 1. It is new. The section refers to "interest" and not "profits" because this reflects the Inland Revenue practice. It is not likely that trading profits or any other kind of income (apart from interest) could arise in respect of FOTRA securities held in trust.

Section 716: Restriction on deductions etc. relating to FOTRA securities

1295. This section prevents a deduction relating to a FOTRA security being taken into account for income tax purposes where the beneficial owner is exempt from tax. It is based on section 154(6) of FA 1996.

Chapter 7: Purchased life annuity payments

Overview

1296. This Chapter rewrites the purchased life annuity provisions in sections 656 to 658 of ICTA.

1297. 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).

1298. 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.

1299. 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.

1300. 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).

1301. 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.

1302. 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

1303. This section is based on section 656 of ICTA and sets out the extent of the exemption.

1304. *Subsection (1)* sets out the exemption and makes it clear that an annuity payment is only exempt to the extent provided in section 719.

1305. *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.

1306. 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.

1307. *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.

1308. 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

1309. 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.

1310. 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.

1311. 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.

1312. 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.

1313. 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

1314. 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.

1315. 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.

1316. *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.

1317. 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)*).

1318. 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".

1319. 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".

1320. 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.

1321. 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.

1322. 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.

1323. 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.

1324. 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

1325. 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.

1326. 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.

1327. 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.

1328. 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

1329. 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.

1330. 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.

1331. 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.

1332. 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

1333. 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.

1334. 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.

1335. *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

1336. 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.

1337. *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.

1338. 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.

1339. 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

1340. 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.

1341. *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

1342. 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.

1343. *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"

1344. This section defines "care provider" for the purposes of section 725(1). It is based on section 580C of ICTA.

1345. *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".

Chapter 8: Other Annual Payments

Overview

1346. This Chapter sets out the exemptions from income tax for income which would otherwise be taxable as annual payments.

Section 727: Certain annual payments by individuals

1347. This section is based on the parts of section 347A of ICTA which exempt from income tax annual payments made by individuals.

1348. See the commentary on Chapter 7 of Part 5 of this Act for an explanation of the phrase "annual payment".

1349. *Subsection (1)* gives the general exemption: annual payments made by individuals which would otherwise be taxable under Part 5 of this Act are exempt from income tax in the hands of the recipient. Section 347A of ICTA applies to annual payments which would otherwise be within the charge to tax under Schedule D Case III, that is, annual payments arising within the United Kingdom. This requirement is in subsection (1)(b).

1350. *Subsection (3)* is based on section 347A(3) of ICTA and applies the exemption to any payment made by an individual's personal representative if the exemption would have applied had the individual not died. "Personal representatives" is defined in section 878.

1351. In contrast with an English partnership, a Scottish partnership is a separate legal entity. *Subsection (4)* therefore defines "individual" as including a Scottish partnership so that the taxation treatment of English and Scottish partnerships is the same.

1352. Section 347A of ICTA applies to all payments falling due on or after 6 April 2000 and also to certain payments falling due before that date but on or after 16 March 1988. Although unlikely, it is possible for payments to fall due at a time when section 347A did not apply but to be paid after 6 April 2005. Paragraph 146 of Schedule 2 to this Act contains a transitional provision which determines whether the exemption in section 727 and the exemption in section 730 apply in these circumstances.

Section 728: Commercial payments

1353. This section provides an exception to the exemption in section 727. It is based on section 347A(2)(c) of ICTA and provides that annual payments made for commercial reasons in connection with the individual's trade, profession or vocation are not exempt from tax in the recipient's hands.

Section 729: Payments for non-taxable consideration

1354. This section also provides an exception to the exemption in section 727. It is based on section 347A(2)(d) of ICTA which provides that a payment to which section 125(1) of ICTA applies is not exempt from income tax.

1355. However, to work out whether this exception to the exemption applies, the reader has to work out whether section 125(1) of ICTA applies and this is not straightforward.

1356. Section 125(1) of ICTA applies to any payment which is an annuity or other annual payment (other than interest) taxable under Schedule D Case III and which is made in return for consideration which is not taxable in the payer's hands. But that section does not apply to:

(a) payments which (in the recipient's hands) are income within section 660A(8) or (9)(a) of ICTA (certain payments on divorce or separation);

(b) payments made to an individual in consideration of the surrender, assignment or release of an interest in settled property to or in favour of a person having a subsequent interest;

(c) any annuity granted in the ordinary course of a business of granting annuities; and

(d) any annuity charged on an interest in settled property and granted at any time before 30 March 1977 by an individual to a company whose business at that time consisted wholly or mainly in the acquisition of interests in settled property or which was at that time carrying on life assurance business in the United Kingdom.

1357. In other words, if the payment falls within paragraphs (a) to (d), it will not fall within section 125(1) of ICTA and the payment therefore falls within the exemption.

1358. Section 729 rewrites section 347A(2)(d) of ICTA by incorporating the relevant propositions of section 125(1) of ICTA rather than cross-referencing to that section and leaving the reader to work out if it applies. So, if the payment is made for non-taxable consideration (as defined in *subsection (2)*), the payment is exempt in the recipient's hands if either condition B or condition C is met. *Subsection (3)* is based on section 125(3)(a) of ICTA and *subsection (4)* is based on section 125(3)(b) of ICTA.

1359. Section 125(3)(c) of ICTA is not rewritten as an individual would not be authorised to grant annuities in the ordinary course of a business of granting annuities (and if an individual could do so, such a payment would fall within section 728).

1360. Subsections (3)(d) and (5) of section 125 of ICTA are not rewritten in section 729 but have been included in the transitionals Schedule (see paragraph 147 of Schedule 2 to this Act).

Section 730: Foreign maintenance payments

1361. This section is based on section 347A(4) of ICTA and exempts from income tax certain maintenance payments which arise outside the United Kingdom but which would be exempt from income tax if the payments had arisen in the United Kingdom.

1362. *Subsection (2)* explains what is meant by a maintenance payment. Section 347A(4) of ICTA defines a maintenance payment as a periodical payment "(not being an instalment of a lump sum)" and refers to the conditions in section 347B(5)(a) and (b) of ICTA. The words "(not being an instalment of a lump sum)" are not rewritten. The wording of the exemption makes them redundant. Additionally, section 347B(5) of ICTA was repealed by FA 1999 in relation to a payment falling due after 5 April 2000. But the conditions in *subsection (3)* and *(4)* are rewritten on the basis of the authority in A-G v Lamplough (1878), 3 Ex D 214.

Section 731: Periodical payments of personal injury damages

1363. This section provides an exemption from income tax for periodical payments in respect of damages for personal injury. It is based on sections 329AA and 329AB of ICTA as amended by section 100(2) of the Courts Act 2003.

1364. Section 329AA of ICTA exempts periodical payments awarded under the provisions listed in subsection (6) of that section. However, it was never intended to limit the scope of the exemption to particular provisions. The policy is that all periodical payments in respect of personal injury damages should be exempt. As the policy does not rely on the specific statutory references under which the damages are awarded, the statutory references are not rewritten. See *Change 121* in Annex 1.

1365. By omitting the specific statutory references, and particularly the reference to the Fatal Accidents Act 1976 and the Fatal Accidents (Northern Ireland) Order 1977, it would not be clear on the face of the legislation that references to personal injuries includes death from personal injury. *Subsection (4)* therefore makes this explicit. See *Change 121* in Annex 1.

Section 732: Compensation awards

1366. This section exempts from income tax annuity payments made under an annuity purchased to meet an award made by the Criminal Injuries Compensation Board. It is based on section 329AB of ICTA as amended by the Courts Act 2003.

1367. *Subsection (3)* includes in the definition of the "Criminal Injuries Compensation Scheme" the scheme established for Northern Ireland under the Criminal Injuries (Northern Ireland) Order 2002 SI 2002/796 (NI 1). See *Change 19* in Annex 1.

Section 733: Persons entitled to exemptions for personal injury payments etc.

1368. This section and the next one explain who is entitled to the exemption. It is based on sections 329AA and 329AB of ICTA as amended by the Courts Act 2003.

Section 734: Payments from trusts for injured persons

1369. This section extends the exemption to persons receiving payments from trustees on behalf of an individual entitled to the payments (for example, a child's parents). It is based in section 329AA(4) of ICTA. See *Change 122* in Annex 1.

1370. For the provisions which exempt interest on damages from income tax see section 751.

Section 735: Health and employment insurance payments

1371. This section provides an exemption from income tax for annual payments made under an insurance policy where certain requirements are met. It is based on section 580A of ICTA.

Section 736: Health and employment risks and benefits

1372. This section explains what constitutes a health or employment risk for the purposes of section 735. It is based on section 580A of ICTA.

1373. *Subsections (1)* and *(2)* define "health risk" and "employment risk" respectively. Subsection (2) treats a policy that insures against loss of office as an employment risk while section 580A(3)(b) of ICTA, on which it is based, does not. See *Change 123* in Annex 1.

1374. *Subsection (3)* expands on what is meant by "insurance against a risk". Benefits under this type of insurance are often not restricted to providing an indemnity against a particular liability. This subsection makes it clear that the exemption is also intended to cover benefits other than indemnities.

Section 737: Period for which payments may be made

1375. This section contains the first of the four conditions referred to in section 735(1)(c) and restricts the period for which benefits may be paid if the exemption is to apply. It must be satisfied by all health or employment insurance policies. The section is based on section 580A of ICTA.

1376. Under s*ubsections (1)* and *(2)* the policy may only provide for payments to be made during periods of ill-health or unemployment or while the insured's income is lower than it would otherwise have been. Periods which end in the insured's death and which immediately follow one of these periods are also included. Subsection (2)(b) treats a period throughout which the insured does not hold office as a period in respect of which payments may be made. Section 580A(4)(b) of ICTA, on which it is based, does not. See *Change 123* in Annex 1.

Section 738: Risk of significant loss

1377. This section contains the second of the four conditions referred to in section 735(1)(c) and this condition must be satisfied by all health or employment insurance policies. It is based on section 580A of ICTA.

1378. *Subsections (1)* and *(2)* require that the policy, taking into account investment returns on premiums, should involve the insurer in genuine commercial risk.

Section 739: Conditions to be met by policies also providing other benefits

1379. This section contains the third of the four conditions referred to in section 735(1)(c). It is aimed at preventing abuse of the exemption where an insurance policy covers other risks in addition to ill-health or loss of employment. This section is based on sections 580A and 580B of ICTA.

1380. *Subsections (2)* and *(3)* ensure that where other risks are ensured on the same policy the qualifying risks are not significantly different from what they would be if those other risks were not insured by that policy. Section 580B(2)(c) of ICTA refers to "benefits receivable by or in respect of any person" which reduce other benefits "payable to or in respect of that person". There does not appear to be any significance in the change from "benefits receivable" to "benefits payable" and this subsection refers to benefits "payable" throughout.

Section 740: Conditions to be met where policies are linked

1381. This section contains the last of the four conditions referred to in section 735(1)(c). It is aimed at preventing abuse of the exemption where a person is insured under more than one policy. The section is based on sections 580A and 580B of ICTA.

1382. *Subsections (2*) and *(3)* ensure that any difference in benefits payable for ill-health or loss of employment which arises simply because benefits under another policy are taken into account may be ignored. The source legislation, in section 580B(3)(d) of ICTA, refers to benefits "receivable by or in respect of any person" which reduce other benefits "payable to or in respect of that person". There does not appear to be any significance in the change from benefits "receivable" to benefits "payable". Subsection (3) refers to benefits "payable" throughout.

1383. Section 580B(4) of ICTA is not rewritten as it seems unnecessary to state that the terms of a policy include terms fixing the premium or otherwise in respect of insurance against risk.

Section 741: Aggregation of policies where employment ends for health reasons

1384. This section ensures that, where a person leaves employment but continues to receive benefits under a new separate policy derived from a policy entered into for the benefit of one or more employees, the exemption given by this Chapter continues to apply to payments under the new policy. The section is based on section 580A of ICTA.

Section 742: Meaning of "the insured"

1385. This section gives the meaning of "the insured" for this Chapter. It is based on section 580A of ICTA.

1386. Sections 580A and 580B of ICTA refer throughout to "the insured". During the Standing Committee debate on the Finance Bill which introduced these provisions, it was considered whether the exemption extended to cover insurance policies taken out by parents on behalf of their children. The written answer given by the Financial Secretary to the Treasury was that in such a case the child would be "the insured" to enable the exemption to apply. In practice the exemption has been treated as applying to payments under such policies. In the light of this, sub-paragraph (b) has been added to put the matter beyond doubt. See *Change 124* in Annex 1.

Section 743: Policies for the benefit of others who contribute to premiums

1387. This section provides that where one person takes out a health or employment insurance policy for the benefit of another, that other person may, in certain circumstances, be treated as the insured. It is based on section 580A of ICTA.

1388. Section 580A(7) of ICTA is drafted in terms of the benefits under the policy being apportioned. This section is drafted instead in terms of annual payments in order to be consistent with the other sections dealing with this exemption. This does not alter the effect of the provision.

Section 744: Payments to adopters: England and Wales

1389. This section and the following two sections ensure that certain financial support received by families who adopt are exempt from income tax. The sections are based on section 327A of ICTA which has been split between the different jurisdictions.

1390. Section 744 deals with payments made to adopters (and persons seeking to adopt) in England and Wales. *Paragraph (c)* exempts payments of allowances paid under regulations made under the Adoption Act 1976. The regulations cited in section 327A(1)(c) of ICTA, that is, the Adoption Allowance Regulations 1991, are not rewritten because if the regulations changed before this Act received Royal Assent the citation would be wrong.

Section 745: Payments to adopters: Scotland

1391. This section deals with payments made to adopters (and persons seeking to adopt) in Scotland.

Section 746: Payments to adopters: Northern Ireland

1392. This section deals with payments made to adopters (and persons seeking to adopt) in Northern Ireland.

1393. *Paragraph (c)* exempts payment of allowances under regulations under the Adoption (Northern Ireland) Order 1987. Again, the regulations cited in section 327A(1)(j) of ICTA, that is, the Adoption Allowance Regulations (Northern Ireland) 1996, are not rewritten.

Section 747: Power to amend sections 744 to 746

1394. This section gives the Treasury the power to amend sections 744 to 746 to take account of future changes in the description of financial support payments.

Section 748: Payments by persons liable to pool betting duty

1395. This section is based on section 126(3) of FA 1990 and section 121 of FA 1991. It gives an exemption from income tax for annual payments made by persons liable to pool betting duty provided the conditions mentioned in *subsection (1)* are satisfied (see the commentary on section 162 for the background to this relief).

1396. The exemption applies to payments made in consequence of a reduction in pool betting duty, whenever that reduction is made (see s*ubsection (2)*). Subsection (2) combines the conditions in FA 1990 and FA 1991. Although the source legislation is restricted to the 1990 and 1991 reductions in pool betting duty, the subsection applies to payments made "in consequence of" any reduction in the duty. See *Change 47* in Annex 1.

1397. *Subsections (3)* and *(4)* set out two further conditions either of which needs to be satisfied. The subsections do not specify that payments in consequence of the 1990 reduction in pool betting duty must be paid for football safety and comfort (see section 126(3) of FA 1990) or that payments in consequence of the 1991 reduction must be paid to the Foundation for Sport and the Arts (see section 121(3) of FA 1991). Instead each subsection applies to a payment in consequence of any reduction in pool betting duty. See *Change 46* in Annex 1.

Chapter 9: Other income

Overview

1398. This Chapter provides for exemption from income tax in respect of miscellaneous income. The income exempted under this Chapter is categorised as follows:

- interest only income;
- interest and royalty payments;
- income from occupation of commercial woodlands;
- housing grants;
- approved share incentive plan distributions;
- foreign income of consular officers and employees;
- income of non-UK residents of certain securities; and
- other income.

Section 749: Interest paid under repayment supplements

1399. This section provides an exemption from income tax for repayment supplement paid by the Inland Revenue. It is based on section 824(8) of ICTA.

Section 750: Interest from tax reserve certificates

1400. This section provides an exemption from income tax for interest from Tax Reserve Certificates ("TRCs") issued by the Treasury. It is based on section 46(2) of ICTA. (The remainder of section 46 concerns unrelated income from savings certificates, which is dealt with in Chapter 2 of Part 6 of this Act.)

1401. TRCs were introduced in 1941 as a mechanism for making payments of tax on account. Interest on TRCs is paid when the certificates are used to settle a tax liability. TRCs have not been issued since the mid-1970s, when they were replaced by Certificates of Tax Deposit. However, TRCs are still used from time to time to settle tax liabilities. In the light of this, it is not possible to regard section 46(2) of ICTA as obsolete for income tax purposes.

Section 751: Interest on damages for personal injury

1402. This section provides an exemption from income tax for interest on damages for personal injury or death. It is based on section 329 of ICTA.

1403. The source legislation deals with interest on damages awarded by reference to various enactments. *Subsection (1)* omits those statutory references. It was never intended to limit the scope of the exemption to particular enactments: the policy was to include any Act under which interest on damages for personal injury could be awarded. See *Change 121* in Annex 1.

1404. Section 329(1)(a) and (b) of ICTA limit the exemption to the interest included in a sum for which judgement is given. *Subsection (1)(a)* refers simply to "a sum awarded by a court". *Subsection (1)(b)* makes it clear that interest which may arise from the date of the award is not included in the exemption.

1405. *Subsection (1)(c)* gives statutory effect to ESC A30 (interest on damages for personal injuries (foreign court awards)). See *Change 125* in Annex 1.

1406. *Subsection (2)* is based on section 329(3) of ICTA and extends the exemption to interest in respect of payments in satisfaction of a cause of action.

Section 752: Interest under employees' share schemes

1407. This section contains an exemption from income tax in respect of interest relating to trustees of certain employees' share schemes. It is based on section 688 of ICTA.

1408. *Subsection (1)* applies the section where the trustees receive interest from a participant in the employees' share scheme and the scheme is set up to comply with certain statutory provisions. Section 688 of ICTA refers to the trustees receiving interest from "employees and directors" of the company. This reflects the wording of section 54(1) of the Companies Act 1948 (the relevant company law enactment when what became section 688 first came into force). However, the relevant company law enactment is now section 153(4)(b) of the Companies Act 1985. That provision refers to "the provision by a company, in good faith in the interests of the company, of financial assistance for the purposes of an employees' share scheme."

1409. Subsection (1) of the section brings the wording of this exemption into line with the corresponding company law enactment. See *Change 126* in Annex 1.

1410. *Subsection (2)* provides that the trustees will be exempt from tax charged under Chapter 2 of Part 4 of this Act on the interest they receive if the scheme requires the trustees to pay to the company an equivalent amount as interest. Section 688 of ICTA refers to an exemption from tax "under Case III of Schedule D". But the reference in the section to Chapter 2 of Part 4 of this Act will include foreign source interest. It would be possible for UK resident trustees to receive interest from non-UK resident employees etc. In such circumstances, it would be illogical to treat the foreign source interest as outside the scope of the exemption. See *Change 127* in Annex 1.

Section 753: Interest on repayment of student loan

1411. This section provides an exemption from tax for interest paid to borrowers of student loans in respect of refunds of over-repayments of such loans. It is based on section 331A of FA 1999.

Section 754: Redemption of funding bonds

1412. This section provides that, where the issue of funding bonds results in a charge to tax as interest under section 380 of this Act, any interest paid on the subsequent redemption of the funding bonds is exempt from tax. The exemption also applies where the deemed interest on the funding bond was charged to corporation tax but on redemption the bond was held by an income tax payer. The section is based on section 582 of ICTA.

Section 755: Interest on foreign currency securities etc. owned by non-UK residents

1413. This section is based on section 581 of ICTA. It provides an exemption from income tax for interest on certain foreign currency securities, or loans, beneficially owned by people who are not resident in the United Kingdom. The exemption is available only if the Treasury make an appropriate direction.

1414. Section 581(1)(a) of ICTA provides that, if a Treasury direction is made, interest on this type of security or loan is not subject to deduction of tax at source. This provision is not rewritten in this Chapter. It is rewritten as a new section 581A of ICTA (see paragraph 242 of Schedule 1 to this Act).

1415. The meaning of "foreign currency" in this section is dealt with separately in section 756.

1416. *Subsection (1)* sets out the interest within the scope of the exemption for the purposes of this section. Section 581 of ICTA originally applied only to securities issued by local authorities. It was later extended to cover securities issued by, or loans made to, statutory corporations by adding section 581(4) of ICTA.

1417. *Subsection (2)* sets out the conditions to be met if the exemption is to apply. The reference to "eventual repayment" in subsection (2)(b) of the section (and based on section 581(4) of ICTA) is relevant only for a loan with no immediate entitlement to repayment.

1418. *Subsection (3)* of the section is an anti-avoidance provision. Section 581(3) of ICTA is very widely drafted: "where any income of any person is by virtue of any provision of the Income Tax Acts to be deemed to be income of any other person, that income shall not be exempt ...". In fact, there are only two sets of provisions under which this type of income could be deemed to be income of another person. The relevant provisions are listed in subsection (3) of the section.

1419. *Subsection (4)* reflects the effect of the devolution settlements. See *Change* 19 in Annex 1.

Section 756: Which securities and loans are foreign currency ones for section 755

1420. This section defines "foreign currency securities" for the purposes of section 755. It is based on section 581 of ICTA. Although the basic proposition in *subsection (1)* is quite straightforward, there are four qualifications to this proposition, set out in *subsections (3)* to *(6)*.

1421. The source legislation, introduced during the exchange control era, refers to securities and loans "expressed in a currency other than sterling". However, there could be more than one interpretation of the word "expressed". In this context, the logical interpretation is that "expressed" means "repayable". This is in line with the exchange control definition of a foreign currency security, and with the reference to securities "expressed" in a particular currency in other contexts in the Tax Acts. This section is therefore drafted in terms of the currency used for repayment.

Section 757: Interest and royalty payments: introduction

1422. This section acts as a general introduction to sections 758 to 767. It is based on section 97 of FA 2004.

1423. Sections 757 to 767 rewrite most of Chapter 6 of Part 3 of FA 2004 which implements the European Union Interest and Royalties Directive (Council Directive 2003/49/EC of 3 June 2003).This directive provides for the elimination of source state taxation on interest and royalty payments between associated companies in different member States of the European Union.

1424. These sections therefore exempt from income tax certain interest and royalty payments made between associated companies where the beneficial owner is a company of another member State or a permanent establishment of such a company in a member State other than the United Kingdom. Although the person beneficially entitled to the income will be a company, the exemption is from income tax. This is because non-UK resident companies are only within the charge to corporation tax on such payments if they trade in the United Kingdom through a permanent establishment here and the interest or royalties are attributable to the permanent establishment.

1425. Income tax on interest and royalty payments would, apart from this exemption, be collected by deduction under section 349 of ICTA. Section 105(5) of FA 2004 introduced a new subsection (7) in section 349 of ICTA which provides that the latter section is subject to the exemption rewritten in these sections. The general disregard section in Chapter 10 of Part 6 of this Act ensures that, without a specific provision to the contrary, an amount that is exempt under Part 6 is disregarded for all other income tax purposes and this will include section 349 of ICTA. Section 349(7) of ICTA is not therefore amended to refer to the interest exemption but it continues to refer to section 101 of FA 2004 (dealing with the deduction of tax from royalty payments under section 349 of ICTA) which is not rewritten (see commentary on section 762).

Section 758: Exemption for certain interest and royalty payments

1426. This section gives the exemption and conditions for that exemption. Three conditions must be satisfied for the royalties exemption to apply and four for the interest exemption. The section is based on section 98 of FA 2004.

1427. *Subsection (1)* gives the exemption. Section 105(4) of FA 2004 inserts into section 18 of ICTA a subsection which makes the charge under that section subject to the exemption rewritten here. This is not rewritten as it is not considered necessary given the wording of subsection (1) of this section.

Section 759: The person making the payment

1428. The first condition in section 758 is that the payer of the interest or royalties is in the United Kingdom, whether as a UK permanent establishment of a company resident in another member State or a company resident in the United Kingdom (other than its permanent establishment outside the United Kingdom). The purpose of this section is to identify the payer (and thus ensure that the payer is in the United Kingdom) where the paying company has a permanent establishment in another territory. The criterion is where the payments are deductible against tax. If they are deductible against the profits of the permanent establishment in the territory where it is situated it is the permanent establishment that is treated as the payer. The section is based on section 99 of FA 2004.

Section 760: The person beneficially entitled to the payment

1429. The second condition in section 758 is that the person beneficially entitled to the income in respect of the payment is a European Union company other than such a company's permanent establishment in the United Kingdom or in a non-member State. The purpose of this section is to identify the beneficial owner where a European Union company has a permanent establishment in the United Kingdom or a non-member State and to ensure that the condition is satisfied. The section is based on section 99 of FA 2004.

Section 761: Meaning of "25% associates"

1430. The third condition in section 758 is that the payer and beneficial owner should be 25% associates. This section explains what is meant by a 25%. It is based on section 99 of FA 2004.

Section 762: Interest payments: exemption notices

1431. This section enables regulations about exemption notices to be made. These notices are required by the fourth and final condition in section 758 for the interest exemption. The section is based on section 100 of FA 2004.

1432. No exemption notice is required for royalty payments. Section 101 of FA 2004 is not rewritten in this Act as it relates to the deduction of tax. Section 102 of FA 2004 provides for claims for the repayment of tax deducted from interest or royalties paid. This section has not been rewritten.

Section 763: Special relationships

1433. This section provides that the exemption will not apply where the interest or royalties have not been paid between independent parties acting at arm's length. This is achieved by reference to a "special relationship" (a term used in double taxation treaties) between the payer and the beneficial owner of the income such that the payments will not be at arm's length. The section is based on section 103 of FA 2004.

1434. *Subsection (3)* provides that where a claim to relief under a double taxation treaty would provide greater relief from tax than is available under this exemption the company may chose to claim relief under the treaty.

Section 764: Application of ICTA provisions about special relationships

1435. This section ensures that the special relationships rule in section 763 is construed in the same way as similar rules in double taxation treaties. (Sections 808A and 808B of ICTA deal with the construction of the term "special relationship" in such treaties.) The section is based on section 103(2) to (4) of FA 2004.

Section 765: Anti-avoidance

1436. This section prevents exemption from tax being given if the purpose or one of the main purposes of the payments is to avoid tax. The wording is based on similar provisions in double taxation treaties. The section is based on section 104 of FA 2004.

1437. *Subsection (1)* applies to interest payments. Because it looks at the purposes of the person concerned with the creation or assignment of the debt, the section may apply where the interest payments are paid indirectly to a person not entitled to the exemption, for example where a payment is dog-legged through a European Union company to a non-European Union company.

Section 766: Interest and royalty payments: interpretation

1438. This section explains various terms used in the sections for this exemption. It is based on section 97 of FA 2004.

Section 767: Power to amend references to the Directive by Order

1439. This section allows the Treasury to amend the provisions for this exemption where that is appropriate for implementing any amendment to, or replacement of, the Directive adopted after 8 April 2004, the date when the clauses for Finance Bill 2004 were finalised. The section is based on section 97 of FA 2004.

1440. *Subsection (2)* enables references in section 101 of the FA 2004 to be amended where necessary as a result of amendments to the Directive. This is necessary as section 101 of that Act has not been rewritten (see commentary on section 762).

1441. Section 97(4) of FA 2004, which allows a first Treasury order to take effect before the making of the order, has not been rewritten as it would apply only if the Directive had been amended before Royal Assent to Finance Bill 2004 in a way that affected Chapter 6 of Part 3 of that Act.

Section 768: Commercial occupation of woodlands

1442. This section exempts income arising from the occupation of commercial woodlands from any charge as miscellaneous income. It is based on paragraph 3(2) of Schedule 6 to FA 1988.

1443. A consequence of this exemption is that no loss relief is available under section 392 of ICTA (losses from miscellaneous transactions). A requirement of that section is that any profit on the transaction would be liable to income tax.

1444. This section is complemented by sections 11 and 267 of this Act. The combined effect of these three sections is that income from the occupation of commercial woodlands is ignored for income tax purposes.

1445. The definition of "commercial woodlands" in *subsection (2)* is supplemented by the definition of "woodlands" in section 876 of this Act.

Section 769: Housing grants

1446. This section exempts from income tax grants paid under legislation intended to assist in providing, maintaining or improving housing. It is based on section 578 of ICTA.

1447. *Subsection (1)* reflects the effect of the devolution settlements. See *Change* 19 in Annex 1.

1448. *Subsection (2)* makes it clear that the expenditure need not be incurred by any particular person and that it may be current or future expenditure.

Section 770: Amounts applied by SIP trustees acquiring dividend shares or retained for reinvestment

1449. The commentary on the SIPs legislation in Chapter 3 of Part 4 of this Act explains the background to approved share incentive plans. This section is based on sections 493(1) and 496(1) of ITEPA. Without these exemptions a tax liability would arise under Chapter 3 of Part 4 of this Act (in respect of cash dividends paid by UK resident companies) or under Chapter 4 of Part 4 of this Act (in respect of cash dividends paid by non-UK resident companies). As the tax liability arises under this Act, the exemptions are rewritten in Part 6 of this Act rather than retained in ITEPA. Signposting provisions to this exemption are in sections 493 and 496 of ITEPA.

1450. The references to tax credits in subsection (2) of sections 493 and 496 of ITEPA are not rewritten in this section. The rewrite of section 231 of ICTA in this Act (see section 397) makes it unnecessary.

Section 771: Relevant foreign income of consular officers and employees

1451. This section exempts from income tax the relevant foreign income of consular officers and employees who satisfy particular conditions where an Order in Council has directed that the section should apply to give effect to a bilateral international convention with a foreign state. The provision is applicable only to a dozen or so conventions and it is unlikely that further Orders in Council will be made. The Consular Relations Act 1968 has made the use of such bilateral conventions unnecessary. "Relevant foreign income" is defined in section 830 of this Act. The section is based on section 322 of ICTA.

1452. *Subsection (1)* provides that the relevant foreign income of a consular officer or employee of a foreign state in the United Kingdom is exempt from tax if an Order in Council directs that the section applies to that state to give effect to a reciprocal arrangement and the individual concerned meets certain conditions. "Reciprocal arrangement" is the term used by section 302 of ITEPA which rewrites the employment income aspects of section 322 of ICTA. "Reciprocal arrangement" is defined in *subsection (5).*

1453. *Subsection (2)(b)* refers to "a British overseas territories citizen". This rewrites section 322(1)(a) of ICTA "a British Dependent Territories citizen". Section 2(3) of the British Overseas Territories Act 2002 requires any reference to a British Dependent Territories citizen be read as a reference to a British overseas territories citizen. The change of name has been incorporated into this section.

Section 772: Further provisions about Orders under section 771

1454. This section makes further provisions for Orders in Council under section 771. It is based on section 322 of ICTA.

Section 773: Income from Inter-American Development Bank securities

1455. This section provides an exemption from income tax, in certain circumstances, relating to income from a security issued by the Inter-American Development Bank. It is based on section 583 of ICTA.

1456. *Subsections (2)* to *(4)* set out the circumstances which must all apply if the income is to be exempt. The exemption applies in respect of any income from a security issued by the Bank (including dividends or interest).

Section 774: Income from securities issued by designated international organisations

1457. This section provides an exemption from income tax, in certain circumstances, relating to income from a security issued by designated international organisations. It is based on section 324 of ICTA.

1458. *Subsections (2)* to *(4)* set out the circumstances which must all apply if the income is to be exempt. The exemption applies in respect of any income from a security issued by the relevant designated organisation (including dividends or interest).

Section 775: Income towards reducing the national debt

1459. This section provides an exemption from income tax, in certain circumstances, in respect of income arising from property held in trust where the trust funds are to be used for the reduction of the national debt. It is based on section 514 of ICTA.

Section 776: Scholarship income

1460. This section is based on section 331 of ICTA.

1461. *Subsection (1)* sets out the exemption and *subsection (2)* points the way to section 215 of ITEPA. Section 215 of ITEPA provides that if the scholarship income is employment-related, the scholarship exemption applies only to the holder of the scholarship. But such income is also exempt from tax if the conditions set out in section 213 of ITEPA (scholarships provided by trust funds etc) are fulfilled.

Section 777: VAT repayment supplements

1462. This section exempts VAT repayment supplement from tax. It is based on section 827(2) of ICTA. The supplement does not have the character of interest. So the exemption is in this Chapter rather than with the exemptions for interest.

Section 778: Incentives to use electronic communications

1463. This section exempts from tax incentives provided under regulations to make use of electronic communications. It is based in section 143 of FA 2000.

Section 779: Gains on commodity and financial futures

1464. This section is based on section 128 of ICTA. That section was introduced as section 72 of FA 1985. It was part of changes which removed gains on commodity and financial futures from the scope of income tax or corporation tax under Schedule D (unless chargeable as trade profits) and charged them instead as capital gains under section 143 of TCGA. This is an unusual instance of an item which is naturally income being charged instead as a capital profit (most "deeming" legislation is designed to tax capital profits as income).

1465. Section 80 of FA 1997 reversed the FA 1985 change to the extent of gains charged to tax thereafter under Schedule 5AA to ICTA (guaranteed returns on transactions in futures and options, rewritten in Chapter 12 of Part 4 of this Act).

1466. The only Cases of Schedule D which could apply to the gains covered by section 128 of ICTA, where the gain is income on first principles (and disregarding the exemption the section provides), are Schedule D Cases V and VI. As the relevant charging function of those Cases is rewritten in Chapter 8 of Part 5 of this Act, the section is expressed as an exemption from the charge under that Chapter.

1467. Together with the "priority sections" (sections 575 and 576), which award priority to a charge under Part 2 or under Chapter 12 of Part 4 of this Act, expressing the exemption in that way ensures that any gains not falling within that Part or Chapter are not charged to income tax. That leaves the way clear for gains covered by this exemption to be taxed under section 143 of TCGA.

1468. The section imports the definitions provided by section 143 of TCGA.

Section 780: Disabled person's vehicle maintenance grant

1469. This section is based on section 327 of ICTA and exempts from income tax grants made in respect of a disabled person's vehicle.

Section 781: Payments under New Deal 50plus

1470. This section is based on section 84 of FA 2000 and exempts from income tax certain payments made to a person participating in the New Deal 50plus scheme.

Section 782: Payments under employment zone programme

1471. This section is based on section 85 of FA 2000 and exempts from income tax payments made to a person participating in an employment zone programme.

Chapter 10: General

Section 783: General disregard of exempt income for income tax purposes

1472. This section confirms that income covered by exemptions in this Part, unless specific rules are provided, is exempt for all purposes of the Income Tax Acts (including information returns and the operation of sections 348 and 349 of ICTA).

1473. The source legislation employs a variety of expressions concerning exemptions which may suggest that particular exemptions might be more narrowly expressed than others. But even where apparently more narrow wording is employed the implications of such wording are mitigated by regulations or practice.

1474. *Subsection (2)* is based on section 325. It provides that the full amount of NSB interest (exempt and non-exempt interest) is to be included in information returns.

1475. *Subsection (3)* provides that specific provisions override this section: an example is the provision of information under the SIP code in paragraph 93 of Schedule 2 to ITEPA.

Part 7: Income charged under this Act: rent-a-room and foster-care relief

Chapter 1: Rent-a-room relief

Overview

1476. The sections in this Part are based on section 59 of and Schedule 10 to F(No 2)A 1992. These provisions are entitled "Furnished Accommodation" in the source legislation but are commonly known as "rent-a-room", the name adopted in this Act.

1477. "Rent-a-room" gives relief in one of two forms for householders who provide furnished accommodation in their homes for lodgers. One form is complete tax exemption for the rent, provided it does not exceed a certain level - the "full relief" form. If the rent does exceed that level the rent-a-room profit is taxable. But taxpayers can choose to have the profit calculated by deducting a fixed amount as expenses, rather than their actual expenses, if that is advantageous - the "alternative method of calculation" form of the relief.

1478. References to "profits or gains" in the source legislation which relate only to income are rewritten in this Chapter omitting the reference to "gains". This continues the tidying up of such references started in section 46(3) of and Schedule 7 to FA 1998.

Section 784: Overview of Chapter 1

1479. This section introduces the relief. It is new.

1480. *Subsection (2)* introduces the key factor in determining the form of relief available: the level of gross receipts.

1481. *Subsection (3)* introduces the full form of the relief where gross receipts are modest.

1482. *Subsection (4)* introduces the alternative method of calculation form of the relief where gross receipts are larger.

Section 785: Person who qualifies for relief

1483. This section states the basic conditions that an individual must satisfy to obtain the relief. It is based on paragraph 2 of Schedule 10 to F(No 2)A 1992.

1484. *Subsection (1)(a)* is a general condition that is satisfied only if the taxpayer claiming rent-a-room relief satisfies the more detailed conditions in respect of the letting.

1485. *Subsection (1)(b)* helps in restricting the relief to the simpler cases for which it is intended. In referring to the income types to which rent-a-room relief is relevant it avoids reference to a "source" – the term used in paragraph 2(3) of Schedule 10 to F(No 2)A 1992 – because what is meant by a "source" in this context may not always be clear. So in rewriting references to a "source", subsection (1)(b) refers to trades, lettings or agreements.

1486. Paragraph 2(3) of Schedule 10 to F(No 2)A 1992 disqualifies an individual from relief if the income from any source from which his or her rent-a-room income is derived also includes income that is not rent-a-room income. "Source" is not defined.

1487. The source of the income arising from a trade is the trade itself.

1488. When Schedule 10 to F(No 2)A 1992 was enacted, relief was available on income from furnished lettings if the income fell within Schedule D Case VI (rather than Schedule A). The source of such income was considered to be the letting in question. FA 1995 brought income from furnished lettings in the United Kingdom within Schedule A and consequentially amended Schedule 10 to F(No 2)A 1992 to make relief available on such income. The amendment was not intended to be read as changing the source of the income for the purposes of that Schedule. For a Schedule A business to be a "source" for this purpose could have capricious results: running a separate business of letting commercial property would disqualify an individual from rent-a-room relief on Schedule A income for letting a room in his or her house (but rent-a-room relief could still be available to a person who ran both a bed-and-breakfast business at home and a separate commercial trade).

1489. As regards amounts incidental to the letting, and within Schedule D Case VI, on which rent-a-room relief might be available (for example, receipts for goods or services such as meals or laundry) the source of the income is the agreement to provide the goods or services in question.

1490. So subsection (1)(b) refers to whatever is the appropriate source for each kind of income for which rent-a-room relief is available.

1491. Section 785, unlike the provision in paragraph 2(1) of Schedule 10 to F(No 2)A 1992, does not impose the condition that to be within rent-a-room, *all* the letting income (or income related to a letting) must be trade or UK property business income. Specifically, it allows rent-a-room relief to apply where certain income related to a letting is received that would, in the source legislation, be within Schedule D Case VI. The existence of any such amounts would, under the source legislation, disqualify the taxpayer from rent-a-room relief in respect of all his or her income. See *Change 128* in Annex 1.

1492. The approach in subsection (1)(b) also removes a potential disqualification from rent-a-room relief in particular circumstances. See *Change 129* in Annex 1.

Section 786: Meaning of "rent-a-room receipts"

1493. This section defines "rent-a-room receipts". It is based on paragraphs 2, 4 and 8 of Schedule 10 to F(No 2)A 1992.

1494. *Subsection (1)(a)* makes explicit what is merely implicit in the source legislation: that the let accommodation must be in the United Kingdom to be within rent-a-room. This approach also removes a disqualification from rent-a-room relief that can arise in respect of a let United Kingdom residence when exceptionally the individual also lets an overseas residence at the same time. See *Change 129* in Annex 1.

1495. *Subsection (1)(b)* refers to an "income period". The period for which receipts must satisfy certain conditions is identified in the source legislation as the "basis period". "Basis period" was appropriate to Schedule D Case I income but less so when applied to Schedule A income where it was potentially confusing. The use of "income period" in the rewritten section makes it possible to avoid using "basis period" for property income and income charged under Chapter 8 of Part 5 of this Act: the conditions have to be satisfied by reference to the events of an "income period". That is, for trade profits, the basis period (see *subsection (3)*). But for property income and income charged under Chapter 8 of Part 5 of this Act it is the tax year or, if letting begins or ends during the tax year, the date of, respectively, the beginning and the end of the letting (see *subsection (4)*).

1496. One incidental consequence of this approach is the way in which it works in conjunction with the requirement in *subsection (1)(c)*. It makes explicit the period during which the "only or main residence" requirement must be met in the years when a letting begins or ends and the income is taxable as property income (in the source legislation it was not clear what was meant by "basis period" in these cases). Now it is explicit that the period is concurrent with the period of the letting and does not extend to the whole of the tax year.

1497. *Subsection (1)(d)* ensures that when the relief is in respect of income chargeable under the trading or property income Parts of this Act, it continues to apply only to amounts to which it applies under the source legislation, that is, to rent-a-room lettings which give rise to trade or property business profits. This provision is necessary because the charges under the trading income and property income Parts of this Act go wider than purely trade and property business profits and include (for example) post-cessation receipts.

1498. Subsection (1)(d) also extends rent-a-room relief to income from the provision of the incidental services mentioned in subsection (1)(a) that would, in the source legislation, be charged under Schedule D Case VI and excluded from rent-a-room. See *Change 128* in Annex 1.

Section 787: Meaning of "residence"

1499. This section is based on paragraph 7 of Schedule 10 to F(No 2)A 1992.

1500. *Subsection (1)(b)* refers to a "caravan or houseboat". There is an Act-wide definition of "caravan": see the commentary on section 875 of this Act and *Change* 148 in Annex 1.

1501. There is also an Act-wide definition of "houseboat": see the commentary on section 878(1) of this Act and *Change* 150 in Annex 1.

Section 788: Meaning of "total rent-a-room amount"

1502. This section introduces and defines a key rent-a-room term: "total rent-a-room amount". It is based on paragraphs 9 and 11 of Schedule 10 to F(No 2)A 1992.

1503. The term "total rent-a-room amount" is new. It sets out how the amount of income to be compared with the limit is calculated. The level of an individual's "total rent-a-room amount" determines which form of rent-a-room relief the individual is entitled to: the full relief or the alternative method of calculation.

1504. *Subsection (1)(b)* includes any relevant balancing charges in the "total rent-a-room amount" to remove an anomaly in the source legislation. See *Change 130* in Annex 1.

Section 789: The individual's limit

1505. This section determines the individual's rent-a-room limit for the tax year. The "limit" is the maximum amount of rent-a-room income that is exempt from tax. It is based on paragraphs 5 and 6 of Schedule 10 to F(No 2)A 1992.

1506. *Subsection (1)* signposts to the section which sets out the full conditions that must be met to qualify for the full "basic amount".

Section 790: Exclusive receipts condition

1507. This section states the detail of the conditions that must be met to qualify for the full "basic amount". It is based on paragraph 5 of Schedule 10 to F(No 2)A 1992.

1508. *Subsection (1)(a)* makes it clear that a third party letting of *any* kind in the same residence triggers the halving rule. That in turn reflects the policy in the source legislation that only the "simplest" cases should get the full value of the relief.

1509. The source legislation refers to a "basis period". The approach of section 786 (described in the commentary on that section) is reflected in section 790 where reference to basis periods is avoided.

Section 791: Full rent-a-room relief: introduction

1510. This section introduces the sections that provide for full relief. It is based on paragraph 9 of Schedule 10 to F(No 2)A 1992.

Section 792: Full rent-a-room relief: trading income

1511. This section provides for full relief when the rent-a-room income is trading income. It is based on paragraph 9 of Schedule 10 to F(No 2)A 1992.

1512. This section is simpler than the two sections that immediately follow it. That is because for both of the latter the rent-a-room income element may have to be separately identified from non rent-a-room income taxable under the same Part of this Act. That is not the case for rent-a-room income that is trading income. If receipts of a single trade include both rent-a-room and non rent-a-room income none of that income is eligible for relief (paragraph 2(3) of Schedule 10 to F(No 2)A 1992 rewritten as section 785(1)). So a trade qualifies for rent-a-room relief only if its income consists wholly of rent-a-room income.

1513. A person carrying on a trade is normally eligible for capital allowances or liable to balancing charges under CAA. The effect of *subsection (2)* is that neither are taken into account when full relief is due under section 792. Saying that the profits and losses are nil achieves that because capital allowances and balancing charges are taken into account in calculating those profits and losses.

Section 793: Full rent-a-room relief: property income

1514. This section provides for full relief when the rent-a-room income is property income. It is based on paragraph 9 of Schedule 10 to F(No 2)A 1992.

1515. *Subsection (3)* states explicitly what is merely implicit in the source legislation. That is, in calculating the profits of a property business, no capital allowances or balancing charges are to be made in respect of rent-a-room related assets.

1516. This form of the rule is needed because the rent-a-room letting may be part of a property business comprising other lettings. Tax under Part 3 of this Act is charged on the profits of a UK property business, which may include activities other than rent-a-room lettings. Section 793 cannot treat the profits of the whole UK property business as nil, but instead expressly excludes all amounts relating to rent-a-room activities from the calculation of the profits of the UK property business. Those amounts include capital allowances and balancing charges which relate to rent-a-room lettings and, accordingly, section 793(3) excludes them.

Section 794: Full rent-a-room relief: income chargeable under Chapter 8 of Part 5

1517. This section provides for full relief when the rent-a-room income includes income charged under Chapter 8 of Part 5 of this Act. It is new.

1518. *Subsection (1)* reflects the change referred to in the last paragraph of the commentary on section 786. The extension of rent-a-room relief to certain income charged under Schedule D Case VI in the source legislation requires the rule in this section to relieve such income when the relevant conditions are met. See *Change 128* in Annex 1.

1519. There is no equivalent in this section of section 793(3). Such a provision is not needed for rent-a-room income charged under Chapter 8 of Part 5 of this Act because there is no statutory provision for capital allowances for that type of income.

Section 795: Alternative calculation of profits: introduction

1520. This section introduces the sections that provide for the second form of the relief – the alternative method of calculating profits. It is based on paragraph 11 of Schedule 10 to F(No 2)A 1992.

1521. *Paragraphs (a)* to *(c)* state the three conditions that must be met. See *Change 130* in Annex 1.

Section 796: Alternative calculation of profits: trading income

1522. This section sets out the basis of calculation when the rent-a-room income is wholly or partly trading income and it exceeds the rent-a-room limit. It is based on paragraph 11 of Schedule 10 to F(No 2)A 1992.

1523. *Subsection (2)(a)* makes explicit what is merely implicit in the source legislation: the retention of any balancing charge where the alternative method of calculation applies. As in exemption cases, there is no entitlement to capital allowances if the taxpayer elects for the alternative method of calculation (paragraph 11(6) of Schedule 10 to F(No 2)A 1992). But - and this differs from exemption cases - any balancing charge remains. In the source legislation the retention of the balancing charge is merely implicit in paragraph 11(6) of Schedule 10 to F(No 2)A 1992: it is simply not mentioned as part of the disapplication of the allowance under section 55 of CAA.

1524. *Subsection (3)(b)* gives a formula for calculating the correct deduction when the rent-a-room income consists of trading income and another type of income. In these circumstances the total rent-a-room deduction is apportioned between the rent-a-room income types.

Section 797: Alternative calculation of profits: property income

1525. This section sets out the basis of calculation when the rent-a-room income is wholly or partly property income and it exceeds the rent-a-room limit. It is based on paragraph 11 of Schedule 10 to F(No 2)A 1992.

1526. S*ubsection (3)(b)* makes explicit what is merely implicit in the source legislation: the capital allowances adjustments that are required. Like section 796(2)(a), subsection (3)(b) refers explicitly to the retention of any balancing charge where the alternative method of calculation applies. But subsection (3)(b) also refers to an allowance. That is required because this section deals with profits that may represent only part of the overall profits of a property business. So to give proper effect to the rent-a-room adjustment it needs to state explicitly what is to be included in, and excluded from, the overall calculation of the profits of that business.

Section 798: Alternative calculation of profits: income chargeable under Chapter 8 of Part 5

1527. This section sets out the basis of calculation when the rent-a-room income is income that is taxed under Chapter 8 of Part 5 of this Act and it exceeds the rent-a-room limit. It is new.

1528. *Subsection (1)* reflects the extension of rent-a-room relief to certain income that is, in the source legislation, charged under Schedule D Case VI. See *Change 128* in Annex 1. It gives a deduction rule for income charged under Chapter 8 of Part 5 of this Act that reflects similar rules for trading and property income in, respectively, section 796 and section 797.

1529. *Subsection (3)* provides for an apportionment of the available rent-a-room deduction between income charged under Chapter 8 of Part 5 of this Act and other income. It does not address the case where an individual's rent-a-room income consists wholly of income charged under Chapter 8 of Part 5 of this Act. That is because such income can, in the rent-a-room context, exist only in company with other (normally property business) rent-a-room letting income.

1530. There is no reference to any capital allowances adjustments because there is no statutory provision for capital allowances for income within Chapter 8 of Part 5 of this Act.

Section 799: Election not to apply full relief

1531. This section allows a taxpayer to opt out of full relief (it may not always be beneficial, for example, if he or she has losses to use). It is based on paragraph 10 of Schedule 10 to F(No 2)A 1992.

1532. It follows the approach of the source legislation in making the exemption automatic unless the taxpayer opts out. That is because, in the type of small case to which the exemption will most frequently apply, the likelihood is that it will be beneficial.

1533. *Subsection (3)* converts references, in the source legislation, to the Board of Inland Revenue and to an officer of the Board of Inland Revenue into references to the Inland Revenue. See *Change* 149 in Annex 1.

1534. Subsection (3) expresses the time limit by reference to the normal Self Assessment rules.

Section 800: Election for alternative method of calculating profits

1535. This section provides a rule that allows a taxpayer to choose the alternative method of calculation if he or she qualifies. It is based on paragraph 12 of Schedule 10 to F(No 2)A 1992.

1536. This section follows the approach of the source legislation in making an election necessary in order to benefit from the alternative method of calculation. That is because this form of the relief is likely to apply to larger, more complex cases. Whether or not the relief is beneficial in these cases will depend on the particular circumstances.

1537. *Subsection (5)* converts references, in the source legislation, to the Board of Inland Revenue and to an officer of the Board of Inland Revenue into references to the Inland Revenue. See *Change* 149 in Annex 1.

1538. Subsection (5)(a) expresses the time limit by reference to the normal Self Assessment rules.

Section 801: Time limit on adjustment of assessment

1539. This section allows adjustments to be made to assessments within a certain time to give effect to rent-a-room elections or withdrawals of elections. It is based on paragraphs 10 and 12 of Schedule 10 to F(No 2)A 1992.

1540. *Subsection (2)* expresses the time limit by reference to the normal Self Assessment rules.

Section 802: Minor definitions

1541. This section provides interpretation for terms not defined elsewhere. It is based on paragraphs 9 and 11 of Schedule 10 to F(No 2)A 1992 and paragraph 86 of Schedule 2 to CAA.

Chapter 2: Foster-care relief

Overview

1542. The sections in this Chapter are based on section 176 of and Schedule 36 to FA 2003. These provisions are entitled “Foster carers” in the source legislation.

1543. They give relief in one of two forms for individuals who provide foster care. One form is complete tax exemption for their foster-care income provided their gross receipts do not exceed a certain level - the “full” form of relief. If gross receipts do exceed that level the income is taxable. But taxpayers can choose to have it calculated by deducting a fixed amount as expenses, rather than their actual expenses, if that is advantageous - the “alternative method of calculation” form of the relief.

1544. Foster-care relief shares certain features with rent-a-room relief (see Chapter 1 of this Part) on which the source legislation was modelled.

Section 803: Overview of Chapter 2

1545. This section introduces the relief. It is based on paragraph 1 of Schedule 36 to FA 2003.

1546. *Subsection (2)* introduces the key factor in determining the form of relief available: the level of gross foster-care receipts, that is receipts before any deductions for expenses.

1547. *Subsection (3)* introduces the full form of the relief where gross receipts are modest: they are simply not charged to tax.

1548. *Subsection (4)* introduces the alternative method of calculation form of the relief where gross receipts are larger.

1549. Not all taxpayers prepare accounts to 5 April. *Subsection (5)* alerts the reader to the fact that special rules apply in that case.

1550. The nature of the activity requires a rather different approach to capital allowances than that in rent-a-room. *Subsection (5)(b)* introduces the special provisions.

Section 804: Person who qualifies for relief

1551. This section states the basic condition that an individual must satisfy to obtain the relief. It is based on paragraph 2 of Schedule 36 to FA 2003.

1552. *Subsection (1)* is a general condition that is satisfied only if the taxpayer claiming foster-care relief satisfies the more detailed conditions in the sections that follow.

1553. *Subsection (1)(b)* refers to an “arrangement” as well as a trade. This covers cases where the foster care does not amount to a trade and where any profits from it would be taxed, in the source legislation, under Schedule D Case VI as profits from the contractual provision of services.

1554. Subsection (1)(b) prevents relief in cases where the foster care that would otherwise qualify for relief is combined with activities that would not. In so doing it limits the relief to the simpler cases.

Section 805: Meaning of “foster-care receipts”

1555. This section defines “foster-care receipts”. It is based on paragraph 3 of Schedule 36 to FA 2003.

Section 806: Meaning of providing foster care

1556. This section explains what is meant by references in this Chapter to the provision of foster care. It is based on paragraph 4 of Schedule 36 to FA 2003.

1557. Foster care is regulated by a number of non-tax laws. These are cited in the source legislation as a part of the qualifying conditions to benefit from the relief: an individual will qualify only if he or she is a foster carer by virtue of those non-tax laws.

1558. *Subsections (3)* and *(4)* list the relevant non-tax tax laws. They do not reproduce the references in paragraph 4(3)(a) and (b)(i) of Schedule 36 to FA 2003 to the particular provision of the regulations at 9 April 2003. Those references are of no substantive effect and if the regulations are altered the references will not be helpful.

Section 807: Calculation of “total foster-care receipts”

1559. This section clarifies the meaning of a key term, “total foster-care receipts”. It is based on paragraph 5 of Schedule 36 to FA 2003.

1560. “Total foster-care receipts” is a key term because the level of an individual’s “total foster-care receipts” determines which form of relief the individual is entitled to: full relief or the alternative method of calculation.

Section 808: The individual’s limit

1561. This section defines the individual’s “limit” for the tax year. It is based on paragraphs 7 and 9 of Schedule 36 to FA 2003.

1562. This section is the first of a group of four sections which explain how to work out an individual’s limit for a tax year. The “limit” is the maximum amount of foster-care income that is not charged to tax. It is the amount with which the taxpayer’s “total foster-care receipts” are compared to determine which type of relief is due.

1563. *Subsection (1)* introduces the two elements that make up the limit. One is a fixed amount (apportioned between foster carers in a single residence) and the other varies according to the number and ages of the children fostered.

Section 809: Share of fixed amount: residence used by more than one foster carer

1564. This section reduces the fixed amount when a residence is used by more than one foster carer. It is based on paragraph 7 of Schedule 36 to FA 2003.

1565. *Subsection (2)* apportions the fixed amount equally between each foster carer in the same residence.

1566. *Subsections (3)* and *(4)* define "residence". The definition refers to a "caravan or houseboat". There is an Act-wide definition of "caravan": see the commentary on section 875 of this Act and *Change 148* in Annex 1.

1567. There is also an Act-wide definition of "houseboat": see the commentary on section 878(1) of this Act and *Change 150* in Annex 1.

Section 810: Share of fixed amount: income period not a year

1568. This section reduces the fixed amount when the foster-care period is for less than a year. It is based on paragraph 7 of Schedule 36 to FA 2003.

1569. *Subsection (2)* makes it clear that the reduction applies to an individual's *share* of the fixed amount if section 809 applies because there is more than one foster carer in the same residence.

Section 811: The amount per child

1570. This section determines the variable component in calculating the individual's "limit" for the tax year: "the amount per child". It is based on paragraphs 8 and 9 of Schedule 36 to FA 2003.

1571. The amount per child for a tax year depends on the duration of the foster care and the age of the child fostered.

1572. The duration of the foster care is measured in weeks. *Subsections (4)* to *(6)* give rules that identify relevant weeks.

Section 812: Full foster-care relief: introduction

1573. This section provides for the full form of the relief when the individual's foster-care receipts do not exceed his or her limit. It is based on paragraph 10 of Schedule 36 to FA 2003.

1574. The reference to the limit is in terms that make it clear that foster-care receipts that equal the individual's limit are within the full relief.

1575. The majority of foster carers who are trading prepare accounts to 5 April. There are special rules for those who do not, which are located later in the Chapter. *Paragraph (c)* excludes such cases from the main full relief provisions and signposts the reader to the other relevant provisions.

Section 813: Full foster-care relief: trading income

1576. This section authorises the full form of the relief when the foster-care income is trading income. It is based on paragraph 10 of Schedule 36 to FA 2003.

Section 814: Full foster-care relief: income chargeable under Chapter 8 of Part 5.

1577. This section authorises the full form of the relief when the income derives from foster care that does not amount to a trade. It is based on paragraph 10 of Schedule 36 to FA 2003.

1578. *Subsection (2)* limits the effect of the relief to the foster-care income and associated expenses.

Section 815: Alternative calculation of profits: introduction

1579. This section is the first of five sections that provide for the alternative form of the relief. It is based on paragraph 11 of Schedule 36 to FA 2003.

1580. The alternative calculation form of the relief applies when the individual's foster-care receipts exceed his or her limit.

1581. Unlike the full form of the relief the alternative calculation form applies only if the individual elects for it.

1582. As in the case of the full form of the relief (see the commentary on section 812) there are special rules for those who do not prepare trading accounts to 5 April. These are located later in the Chapter.

Section 816: Alternative calculation of profits: trading income

1583. This section sets out the basis of calculation when the foster-care income is trading income and it exceeds the individual's limit. It is based on paragraph 12 of Schedule 36 to FA 2003.

Section 817: Alternative calculation of profits: income chargeable under Chapter 8 of Part 5

1584. This section sets out the basis of calculation when the income is from foster care that does not amount to trading and it exceeds the individual's limit. It is based on paragraph 13 of Schedule 36 to FA 2003.

Section 818: Election for alternative method of calculating profits

1585. This section provides for a foster carer to elect for the alternative form of the relief. It is based on paragraph 14 of Schedule 36 to FA 2003.

1586. This section also provides explicitly for a procedure to withdraw an election within the stated time limit. The absence of such a procedure in the source legislation for foster-care relief is in contrast to the source legislation for rent-a-room on which the former is otherwise closely modelled. It was not considered necessary in the source foster-care relief legislation because, unlike the rent-a-room relief election, a foster-care relief election is made only for one year. It was implicit in the year by year approach that the foster-care election could be withdrawn within the Self Assessment time limits by, for example, an amendment to a return. This Part puts these similar reliefs side by side and a contrast in approach might wrongly suggest a different intended legal effect. To make the position clear this section provides explicitly for the withdrawal of an election.

1587. *Subsection (2)* makes it clear that the election applies only to the year for which it is made.

1588. *Subsection (3)* converts references, in the source legislation, to the Board of Inland Revenue into references to the Inland Revenue. See *Change* 149 in Annex 1.

Section 819: Adjustment of assessment

1589. This section provides for an election for the alternative form of relief to be made following an adjustment to an individual's return of foster-care profit. It is based on paragraph 14 of Schedule 36 to FA 2003.

1590. Without this section an individual might be prevented from electing for the alternative form of relief if his or her return of foster-care profits were adjusted after the normal election time limit in section 818.

1591. *Subsection (3)* makes it clear that the election applies only to the year for which it is made.

1592. *Subsections (3)* and *(4)* follow the approach described in the commentary on section 818 in providing for the withdrawal of an election under this section.

Section 820: Periods of account not ending on 5th April

1593. This section is the first of four sections that deal with cases where the foster-care activities amount to a trade and accounts are prepared to a date other than 5 April. It is based on paragraph 15 of Schedule 36 to FA 2003.

1594. The rules that apply to this sort of case have been extracted from the main body of the rules and grouped together in a place of less prominence as they are believed to apply only to a minority of foster carers.

Section 821: Meaning of "relevant limit"

1595. This section introduces and defines the term "relevant limit". It is based on paragraph 15 of Schedule 36 to FA 2003.

1596. For cases where the foster-care activities amount to a trade and accounts are prepared to a date other than 5 April, the amount with which the individual's total foster-care receipts are compared to determine what form of relief is available is the individual's "relevant limit" (and not, as normally, "the limit"). The calculation of the relevant limit reflects the fact that the basis period of the trade will not coincide with the periods (tax years) for which the "fixed amount" and the "amount per child" are determined. This section give rules to link the "fixed amount" and the "amount per child" for tax years to basis periods.

Section 822: Full relief

1597. This section provides for full relief in "accounting date other than 5 April" cases. It is based on paragraph 15 of Schedule 36 to FA 2003.

1598. It achieves the same effect for these cases as section 812 and section 813 together achieve for other cases.

Section 823: Alternative method of calculating profits

1599. This section provides for the alternative form of relief in "accounting date other than 5 April" cases. It is based on paragraphs 14 and 15 of Schedule 36 to FA 2003.

1600. It achieves the same effect for these cases as section 815 and section 816 together achieve for other cases.

1601. *Subsection (3)* applies the election and adjustment of assessment provisions in section 818 and section 819. In so doing it imports (through section 818(3) and section 819(4)) the conversion of references, in the source legislation, to the Board of Inland Revenue into a reference to the Inland Revenue. See *Change 149* in Annex 1. It expresses the time limits by reference to the Self Assessment rules.

Section 824: Capital allowances: introduction

1602. This section is the first of four sections that deal with the capital allowances aspects of foster-care relief. It is based on paragraphs 16 and 20 of Schedule 36 to FA 2003.

1603. The section introduces key terms and links the language of this Chapter with that of CAA: the language and concepts have to link directly with those of CAA. The "chargeable period" mentioned in *subsection (2)(a)* is an example. In CAA "chargeable period" does not necessarily mean, for individuals, "tax year". It can mean (for trades) "period of account" (section 6(1) of CAA). *Subsection (3)* provides the link so that the provisions work properly.

1604. The overall effect of the four capital allowances sections is that, in tax years when either form of foster-care relief applies, capital allowances and balancing charges are not relevant.

1605. Unlike paragraph 16 of Schedule 36 to FA 2003, the capital allowances sections in this Chapter make no reference to the rules that apply when the foster care does not amount to a trade and the foster-care receipts are chargeable under Schedule D Case VI. That is because an arrangement to provide foster care is not a qualifying activity within section 15(1) of CAA and therefore the question of capital allowances and balancing charges cannot arise.

1606. Dropping these references will have no practical effect because entitlement to an allowance or liability to a balancing charge does not arise from Schedule 36 to FA 2003 but from CAA. The references in Schedule 36 to FA 2003 are, however, potentially confusing and removing them makes the rewritten legislation clearer.

Section 825: Carried forward unrelieved qualifying expenditure

1607. This section provides for the temporary suspension of allowances and charges in respect of pool expenditure during tax years when foster-care relief applies. It is based on paragraph 17 of Schedule 36 to FA 2003.

1608. *Subsection (3)* deals with the transition from a year when foster-care relief does not apply to a year when it does.

1609. *Subsection (4)* deals with the transition from a year when foster-care relief does apply to a year when it does not.

Section 826: Excluded capital expenditure

1610. This section prevents an allowance for capital expenditure incurred at a time when foster-care relief applies. It is based on paragraph 18 of Schedule 36 to FA 2003.

Section 827: Excluded capital expenditure: subsequent treatment of asset

1611. This section provides for an allowance, when foster-care relief ceases to apply, in respect of capital expenditure incurred at a time when foster-care relief did apply (and for which therefore no allowance was due in accordance with section 826). It is based on paragraph 19 of Schedule 36 to FA 2003.

Section 828: Overlap profit

1612. This section preserves entitlement to overlap relief when the foster-care activities are a trade. It is based on paragraphs 10 and 15 of Schedule 36 to FA 2003.

1613. *Subsection (2)(a)* allows relief for overlap profit against foster-care profits calculated under the rules in this Part. That may include relief for overlap profit that was created before the introduction of foster-care relief. If foster-care profits are treated as nil (because full foster-care relief under section 813 or section 822 applies) the overlap relief can create a loss.

1614. *Subsection (2)(b)* allows the creation of overlap profit when the foster-care alternative basis of calculation applies (no overlap profit can be created when full foster-care relief applies). The overlap profit is calculated by reference to the profit after the foster-care rules have applied.

Part 8: Foreign income: special rules

Overview

1615. This Part contains rules that may affect the calculation of income charged under this Act or under Parts 9 or 10 of ITEPA.

1616. In the source legislation for this Act, income arising outside the United Kingdom is charged to income tax mainly under Schedule D Cases IV and V (section 18 of ICTA sets out the Cases of Schedule D). But some foreign income may be taxed under Schedule D Case VI or under a non-schedular charge if the provision covers both U K and non-UK income. And profits made by the foreign branch of a UK trade, profession or vocation are charged under Schedule D Cases I and II, and are not foreign income (see sections 6(1) (trade profits: territorial scope of charge to tax) and 7(5) (trade profits: income charged)).

1617. The term “foreign income” has not been used in the Tax Acts (other than as part of the obsolescent term “foreign income dividends”), and it does not have any clear or defined meaning. Chapter 1 of this Part of this Act introduces the label “relevant foreign income” to describe the income and other amounts charged to income tax in this Act that are charged under Schedule D Cases IV or V in the source legislation. That income is charged in this Act alongside the equivalent UK income (with the exception of dividends from non-UK resident companies (Chapter 4 of Part 4 of this Act)).

1618. A number of special rules apply to relevant foreign income. Rather than repeat the rules in every place where they apply, the rules are rewritten in this Part. The “income charged” sections for any charge that includes relevant foreign income incorporates the rules by making the main calculation rule in that section subject to this Part. For example, see section 7(4) (trade profits: income charged).

1619. Chapter 4 of this Part of this Act has a potentially wider application than Chapters 2 or 3 of this Part, as it can apply to all income arising outside the United Kingdom rather than just relevant foreign income.

1620. There are a number of charges under Parts 9 (pension income) and 10 (social security income) of ITEPA that, before being rewritten in ITEPA, were charges under Schedule D Case V. See sections 573, 609 to 611, 629, 633 and 678 of ITEPA. The amount of income charged under those provisions is calculated by reference to certain rules in ICTA, some of which are rewritten in this Part. Schedule 1 to this Act amends the ITEPA provisions for calculating income under those charges to provide an "income charged" rule and to deem the income in question to be relevant foreign income for the application of rules in this Part of this Act (see paragraphs 606 to 609 and 613 of that Schedule).

1621. Unless the remittance basis applies (see Chapter 2 of this Part of this Act), or the income arises from a trade, profession or vocation (see section 7 (trade profits: income charged)), the amount of relevant foreign income charged for a tax year is the income arising in the year. This rule is based on section 65(1) of ICTA and forms part of the basis of each "income charged" provision in this Act for relevant foreign income. See, for example, section 403 (dividends from non-UK resident companies). Where a charge includes both relevant foreign income and equivalent UK income the same rule serves for both. See, for example, section 370 (interest: income charged).

1622. The "income charged" provisions do not rewrite the words "whether the income has been or will be received in the United Kingdom" from section 65(1) of ICTA.

1623. Before FA 1914, the remittance basis was the only basis of assessment for income within Schedule D Cases IV and V. It applied to all UK residents and not just to those persons who were non-UK domiciled, or were both not ordinarily resident in the United Kingdom and were either Commonwealth or Irish citizens (as necessary for a claim under section 65(4) of ICTA). FA 1914 took certain Schedule D Cases IV and V income out of the remittance basis and that income was taxed thereafter on the arising basis.

1624. The words "whether the income has been or will be received in the United Kingdom" were included in the 1914 legislation to emphasise that income within Schedule D Cases IV and V was now chargeable to tax, whether or not the income had been remitted to the United Kingdom. That emphasis is no longer needed.

1625. In the source legislation the basis for charging income arising in the Republic of Ireland is provided as follows:

- income from trades, professions or vocations: section 68(3) and (4) of ICTA;
- income from property: section 65A of ICTA;
- other Schedule D Case IV or V income: section 68(1) of ICTA; and
- pension income: Part 9 of ITEPA, but the rules in section 68 of ICTA apply.

1626. Parts 2 and 3 of this Act integrate the rules in sections 68(3) and (4) and 65A of ICTA in respect of trade profits and property business income arising in the Republic of Ireland with the rules for other such income.

1627. The wording of section 68(1) of ICTA is identical in all material respects to section 65(1) of ICTA. The "income charged" provisions for relevant foreign income charged on the arising basis, in Parts 4 and 5 of this Act, are based on both sections 65(1) and 68(1) of ICTA. Likewise, the deductions provided by Chapter 3 of this Part are based on both sections 65 and 68 of ICTA.

1628. See also Chapter 2 of Part 10 of this Act for further rules that may affect the calculation of income arising outside the United Kingdom charged on the arising basis.

Chapter 1: Introduction

Overview

1629. This Chapter sets out the content of Part 8 and provides a definition of "relevant foreign income" for this Act.

Section 829: Overview of Part 8

1630. This section is new.

Section 830: Meaning of "relevant foreign income"

1631. This section is based on section 18 of ICTA. The main provisions in this Act which apply to relevant foreign income (apart from numerous charges to tax and "income charged" sections) are:

- section 771: exemption for relevant foreign income of consular officials and employees;
- Chapter 2 of this Part: relevant foreign income charged on remittance basis; and
- Chapter 3 of this Part: relevant foreign income charged on arising basis: deductions and reliefs.

1632. To be "relevant foreign income", income must arise from a source outside the United Kingdom, and be chargeable under one of the provisions listed in *subsection (2)*. (See also the definition of "income" in section 878(1), by virtue of which "income" includes amounts treated as income. A number of the provisions listed in subsection (2) include such income; for example, see Chapter 8 of Part 4 of this Act.)

1633. The definition is based on words in section 18(3) of ICTA:

- "tax in respect of income arising from securities out of the United Kingdom" (Schedule D Case IV); and
- "tax in respect of income arising from possessions out of the United Kingdom" (Schedule D Case V).

1634. Section 18(1) and (3) of ICTA require that, for an amount to fall within the charge under those Cases, as opposed to another charging provision, it has to be (a) income, (b) which arises from, (c) securities or possessions, (d) out of the United Kingdom and (e) is not charged in priority under another Schedule of ICTA or under ITEPA.

1635. Case law establishes that "securities" are a sub-set of "possessions". The definition of "relevant foreign income" does not maintain any distinction between income which, in the source legislation, is within Schedule D Case IV and income which is within Schedule D Case V.

1636. The definition uses "source" rather than "possessions" (the expression in Schedule D Case V). "Possessions", in the context of Schedule D Cases IV and V, appeared in the first income tax Act of 1799 when the word carried associations with, in particular, colonial property that it no longer has. The definition employs the more widely used term "source".

1637. The meaning of "possessions" in Schedule D Case V has been interpreted by case law. It covers any and every source of income arising outside the United Kingdom. Income charged to tax under Schedule D Cases IV and V by virtue only of section 18(3) of ICTA (that is, excluding amounts treated as income by another provision in the source legislation and charged under Schedule D Case IV or V) has an identifiable source.

1638. In Colquhoun v Brooks (1889), 2 TC 490 HL (where the subject was how to tax a partner's share of a foreign trade), Lord Macnaghten dealt with the meaning of "possessions" in terms of a source of income (page 508):

> Turning now to the "fifth case," I ask why are not the Respondent's profits and gains from his Melbourne business within the "fifth case"? What is the meaning of the term "possessions" in that case? The word "possessions" is not a technical word. It seems to me that it is the widest and most comprehensive word that could be used. Why, for instance, should not possessions in Ireland mean everything, every source of income that the person chargeable has in Ireland, whatever it may be? Why should not "profits from possessions out of Great Britain," which is to be found in Schedule G., No. XI., and recalls the expression "income out of Great Britain" in the Act of 1799, mean profits from every source of income abroad? I use the expression "source of income" because it is as a source of income that the Act contemplates and deals with property and everything else that a person chargeable under the Act may have, and the Act itself, in section 52, uses the expressions "sources chargeable under the Act" and "all the sources contained in the said several schedules" as describing everything in respect of which the tax is imposed.

1639. There were at that time no income tax charges on amounts treated as income. But the scope of Schedule D Cases IV and V has since been extended by provisions which charge to income tax, within one or other of the Cases, a profit or gain which would not otherwise be income arising from a security or from possessions within section 18(3) of ICTA. That is, on first principles it would be a capital profit or receipt. Such chargeable amounts could not therefore be said to derive from a "source" in the traditional sense. In Walker v Centaur Clothes Group Ltd (2000), 72 TC 379 HL[11], Lord Hoffmann commented (page 416):

> Income tax is traditionally a source-based annual tax, liability depending upon the existence of a source of income falling under one of the Schedules during the year of assessment (see *Brown* (*Surveyor of Taxes*) *v National Provident Institution* [1921] 2 AC 222, 8 TC 57).
>
> If the income tax had retained that ancient simplicity, it would be true to say that income could not be within the charge to tax unless there was a source within the charge and a person could not be within the charge unless he had a source of income within the charge. But that would be because of the nature of the income tax and not anything in the language of the definition.
>
> It is, however, no longer true to say that liability to income tax depends upon the existence during the year of assessment of a source within the charge. There are cases (such as post-cessation receipts) when liability depends upon the existence of income defined by reference to a source which does not exist within the year of assessment. Or liability may depend upon an event, such as a balancing charge on the sale of an asset which has attracted a capital allowance, or the receipt of a capital sum from a particular kind of transaction, which is deemed to be taxable income received in that year of assessment or sometimes spread over several years of assessment.

1640. Although the definition uses "income which arises from a source" in respect of all income within the definition, specific rules have been added, in view of Lord Hoffmann's remarks, in sections 428(3) (deeply discounted securities) and 658(2) (beneficiaries' income from estates in administration), to attribute a foreign source to the income in question to ensure that there is no doubt that the definition applies to these provisions.

1641. Subsection (2) lists by Chapter or section the provisions in this Act that charge income and other amounts which the source legislation charges under Schedule D Cases IV or V. Where a Chapter contains more than one charge and only one of those charges applies

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to relevant foreign income, the section applying that charge has been specified – for example, see section 579 (charge to tax on royalties and other income from intellectual property). Chapter 2 of Part 4 of this Act has been included in full because, if any interest from a registered industrial and provident society is foreign interest, although it is not charged under Cases IV and V in the source legislation, it is treated by the Act as relevant foreign income. See *Change 131* in Annex 1.

1642. *Subsection (3)* eliminates income that would otherwise be within the definition of "relevant foreign income" because it is charged under one or other of the provisions listed in subsection (2) in accordance with section 844. In the source legislation, such income is charged under Schedule D Case VI. This subsection is based on section 584(4) of ICTA.

Chapter 2: Relevant foreign income charged on remittance basis

Overview

1643. This Chapter provides an alternative to the arising basis for calculating the charge on relevant foreign income where a claim is made by an eligible claimant. It is based on section 65 of ICTA. The well-known term "remittance basis" is used in the Chapter heading and section headings but not in the sections themselves.

1644. The term is also used in section 878(2) (other definitions). The definition in that section applies for the purpose of the expression "a person to whom the remittance basis applies" (see, for example, sections 357 (charge to tax on overseas property income) and 857 (partners to whom the remittance basis may apply)).

1645. The Chapter includes a relief for "delayed remittances", based on section 585 of ICTA.

Section 831: Claims for relevant foreign income to be charged on the remittance basis

1646. This section is based on sections 65 and 68 of ICTA. If a claim is made under this section neither Chapter 3 nor Chapter 4 of this Part applies to the claimant's income for that year. (Those Chapters deal respectively with relevant foreign income charged on the arising basis (deductions and reliefs) and with unremittable income.)

1647. A claim under this section is for the remittance basis to be applied for a tax year rather than (as in the source legislation) a claim for a purely personal status from which the remittance basis flows for that year.

1648. A claim is made for a particular tax year. The claim is an annual claim. In the source legislation, a claim has to be made to the Board of Inland Revenue. In practice, it is usually made by applying the remittance basis in making the claimant's self assessment. The section reflects this practice and does not require the claim to be made either to the Board or to the Inland Revenue. (Those terms are defined in section 878(1).) See *Change 149* in Annex 1.

1649. *Subsections (2)* to *(4)* set out the conditions for a valid claim. In the source legislation condition B has a further requirement, that the claimant is a Commonwealth citizen or a citizen of the Republic of Ireland. That requirement is not rewritten. See *Change 132* in Annex 1.

1650. Income arising in the Republic of Ireland is never charged on the remittance basis, so such income is excluded from a claim under this section.

Section 832: Relevant foreign income charged on the remittance basis

1651. This section is based on section 65 of ICTA.

1652. The source legislation has separate rules for calculating the amount of income charged on the remittance basis under Schedule D Case IV and under Case V. As there is no significant difference in these bases in practice no such distinction is made in this section. See *Change 133* in Annex 1.

1653. The words "in respect of relevant foreign income" have been included, indicating that the sums received should either comprise the relevant foreign income in question, or represent that income. Lord Radcliffe said in Thomson v Moyse (1960), 39 TC 291 HL (page 335):

> No doubt proper construction of those words [sums received] require that the sums computable must be "of" the income, by which I would understand "sums of money derived from the application of the income to achieving the necessary transfer".

1654. Generally, relevant foreign income charged on the remittance basis is charged on the full amount of sums received in the United Kingdom without any deductions. However, the source legislation (tail words of section 65(5)(b) of ICTA) permits such deductions as are allowed under the Income Tax Acts in respect of profits chargeable under Schedule D Case I, that is, income from a trade but not from a profession or vocation.

1655. *Subsections (3)* and *(4)* also apply the deductions to income from a profession or vocation carried on wholly abroad. This recognises that, in the context of income arising in the United Kingdom, the calculation of income from professions and vocations uses the trading income calculation rules. See *Change 134* in Annex 1.

1656. Paragraph 150 of Schedule 2 to this Act ensures that the remittances taxed by virtue of this section may include income which arose before the tax year 2005-06.

Section 833: Income treated as remitted: repayment of UK-linked debts

1657. This section contains anti-avoidance measures to defeat the practice of taking out loans in the United Kingdom and subsequently arranging for the debt to be transferred abroad and repaid out of unremitted relevant foreign income. It is based on section 65(6) to (9) of ICTA.

1658. The source legislation has already been rewritten for the purposes of employment income. See section 33 of ITEPA.

Section 834: Arrangements treated as repayment of UK-linked debts

1659. This section supplements section 833 and deals with indirect methods of repaying UK-linked debts using relevant foreign income. It is based on section 65(8) and (9) of ICTA.

1660. *Subsection (4)* extends the usual meaning of lender to include any person for the time being entitled to repayment (i.e. not necessarily the person who lent the money).

Section 835: Relief for delayed remittances

1661. This section allows income chargeable to tax for a tax year on the remittance basis to be reduced by sums which, for reasons outside the taxpayer's control, could not be remitted in an earlier tax year ("delayed income"). Those sums are then treated as remitted in the year in which they arose and taxed for that year. The section is based on section 585 of ICTA.

1662. Paragraph 151(1) of Schedule 2 to this Act ensures that a claim under this section covers income which arose in a tax year before 2005-06.

1663. A claim may be made in respect of some or all of the delayed remittances. See *Change 136* in Annex 1.

1664. Condition B, for income being delayed income, refers to the impossibility of obtaining currency in the territory in question and makes explicit that this means currency that can be transferred to the United Kingdom (whether the currency of that or another territory). See *Change 135* in Annex 1.

1665. The source legislation refers to "foreign currency". This means a currency other than the currency of the territory in question. Since the *local* currency must be obtainable, it is superfluous to add that currency not obtainable is 'foreign'.

1666. The requirement in the source legislation, that the inability to transfer the income to the United Kingdom was not due to any want of reasonable endeavours on the part of the claimant, is omitted. See *Change 135* in Annex 1.

1667. For periods preceding Self Assessment the basis year may be different from the tax year. Section 585(3) to (5) of ICTA contains rules which cater for that possibility. By 2005-06 no claim will be possible for a period preceding Self Assessment. For periods of Self Assessment the basis period is always the tax year, whether the amount chargeable is calculated by reference to the income arising or remitted. The rules in section 585(3) to (5) of ICTA have therefore not been rewritten in this Chapter. (But see paragraph 151 of Schedule 2 to this Act, which applies the rules where a claim is made under this Chapter and the tax year in which the income arose was 1996-97 or earlier.)

Section 836: Relief for delayed remittances: backdated pensions

1668. This section is based on section 585(2) of ICTA. It provides relief under section 835 for pension arrears charged under Part 9 of ITEPA. Paragraphs 606, 607 and 609 of Schedule 1 to this Act amend the relevant provisions of ITEPA to treat the income as relevant foreign income, so that the provisions of this Part may apply to such income.

1669. Arrears of pension income do not *arise* before the pension etc is granted, even if the grant is retrospective. So, but for this section, arrears of pension income would not meet condition A for delayed income in section 835 for all years before the year for which relief is claimed.

1670. *Subsection (3)* disapplies condition B for income being delayed income in section 835 for any period before the arrears become payable.

Section 837: Claims for relief on delayed remittances

1671. This section provides administrative rules for claims for relief under section 835. It is based on section 585 of ICTA.

Chapter 3: Relevant foreign income charged on arising basis: deductions and reliefs

Overview

1672. This Chapter provides certain deductions and a relief that may affect the calculation of the amount of relevant foreign income charged on the arising basis. "Relevant foreign income" is defined for these purposes in section 830.

1673. The deductions are of limited scope. They were introduced in FA 1914, when the remittance basis was withdrawn from most types of Schedule D Cases IV and V income for persons domiciled and ordinarily resident in the United Kingdom.

Section 838: Expenses attributable to collection or payment of relevant foreign income

1674. This section is based on section 65(1) of ICTA. The source legislation makes deductions available only to income not received in the United Kingdom. But in practice the deductions are given whether or not the income in question has been received in the United Kingdom. This section reflects practice, so the words "subject in the case of income not received in the United Kingdom" are not rewritten. See *Change 137* in Annex 1.

1675. The source legislation does not identify exactly what deductions are envisaged. The words used "the same deductions and allowances as if [the income] had been received [in the United Kingdom]" date from FA 1914 when taxpayers found their income taxed on the arising rather than the remittance basis. But it is an unhelpful analogy because the remittance basis does not allow any deductions (except in the case of trading income – see section 65(3) of ICTA). Rather than relying on an analogy, the section therefore specifies the deductions intended. This includes, for example, banking costs involved in the collection and forwarding of dividends. See *Change 138* in Annex 1.

1676. The section applies to all relevant foreign income, including trading profits within the definition of that term. It does not rewrite the restriction in section 65(3) of ICTA denying these deductions to such trading profits. See *Change 138* in Annex 1.

1677. See also Chapter 2 of Part 10 of this Act for further rules that may qualify the deductions available under this section.

Section 839: Annual payments payable out of relevant foreign income

1678. This section is based on section 65(1) of ICTA.

1679. By virtue of *subsection (3)*, which refers to a payment that "would have been chargeable" to tax under certain provisions, the range of annual payments falling within condition B is in fact reduced by any that are within the exemption provided by section 727 (certain annual payments by individuals).

1680. *Subsection (6)* reflects differences in the source legislation between the rules for calculating income arising in the Republic of Ireland and those for calculating other relevant foreign income.

Section 840: Relief for backdated pensions charged on the arising basis

1681. This section is new. It enacts ESC A55, but adopts the method used in section 836 (and the administrative rules in section 837) as a model for providing relief. That is, the income is treated as arising in an earlier year than the year in which it in fact arose, rather than a tax adjustment being made in the later year. See *Change 139* in Annex 1.

1682. Paragraph 152 of Schedule 2 to the Act ensures that an earlier tax year to which income is attributed because of a claim under this section covers a tax year before 2005-06.

Chapter 4: Unremittable income

Overview

1683. This Chapter provides relief from income tax if income arising in a territory outside the United Kingdom cannot be remitted to the United Kingdom. The Chapter also invokes the relevant charges outside Part 8 of this Act to withdraw relief if such income ceases to be unremittable. And it explains how unremittable income is to be valued where no claim is made for the relief. The relief applies only to income charged on the arising basis so does not apply to income charged on the remittance basis (Chapter 2 of this Part). The Chapter is based on section 584 of ICTA.

1684. The Chapter applies to "income arising in a territory outside the United Kingdom". This is a wider term than relevant foreign income. So the relief may apply, for example, to some of the income charged in the source legislation under a non-schedular charge or under Schedule D Case VI. (Chapter 13 of Part 2 of this Act provides an equivalent relief in respect of unremittable receipts of a trade, profession or vocation. And section 272 (profits of a property business: application of trading income rules) applies that Chapter for the purposes of Part 3 of this Act.)

1685. The Chapter does not rewrite the appeal jurisdiction rules in section 584(9) of ICTA. An appeal on the application of the section may therefore be heard by General Commissioners (and the taxpayer retains the right to elect for a hearing by the Special Commissioners). See *Change 142* in Annex 1. (But paragraph 153(3) and (4) of Schedule 2 to this Act preserve the rules in section 584(9) of ICTA if the appeal involves income that arose in a tax year before 2005-06.)

1686. Paragraph 153(1) and (2) of Schedule 2 to this Act ensure that the Chapter applies for 2005-06 and later tax years even though the income in question arose in an earlier tax year.

Section 841: Unremittable income: introduction

1687. This section is based on section 584 of ICTA.

1688. The source legislation refers to "foreign currency". This means a currency other than the currency of the territory in question. Since the *local* currency must be obtainable, it is superfluous to add that currency not obtainable is 'foreign'.

1689. Condition A for unremittable income refers to the impossibility of obtaining currency in the territory in question and makes explicit that this means currency that can be transferred to the United Kingdom (whether the currency of that or another territory). See *Change 135* in Annex 1.

1690. The requirement in the source legislation, that the inability to transfer the income to the United Kingdom was not due to any want of reasonable endeavours on the part of the claimant, is omitted. See *Change 135* in Annex 1.

Section 842: Claim for relief for unremittable income

1691. This section is based on section 584 of ICTA.

1692. *Subsection (1)* provides that unremittable income is not taken into account for income tax purposes. This means primarily that it is omitted from taxable income in the year in which it arises.

1693. *Subsection (4)* defines an Export Credit Guarantee Department payment ("ECGD payment"). The statutory references in the source legislation have been updated. As section 13(1) of the Export and Investment Guarantees Act 1991 delegates the functions of the Secretary of State under section 2 of the 1991 Act to the Export Credits Guarantee Department, the role of that Department (rather than the Secretary of State) in administering this scheme is recognised.

1694. *Subsection (5)* sets out the time limit for making a claim under this section. The time limit is tied to the tax year for which the income would otherwise be chargeable, rather than to the tax year in which the income arises (as in the source legislation). This brings the time limit into line with the normal time limit for claims. See *Change 140* in Annex 1.

Section 843: Withdrawal of relief

1695. This section brings together the consequences both of unremittable income becoming remittable and of a payment being made by the Export Credits Guarantee Department. It is based on section 584 of ICTA.

1696. *Subsections (3)* to *(5)* set out when, and at what value, income ceasing to be unremittable is treated as arising. Income so treated as arising is charged under the provision appropriate to the income type (or types) that would otherwise have applied to the income when it arose. (Section 844 provides rules for charging income if the source of the income has ceased before the tax year in which it is treated under this section as arising.)

1697. Subsection (4) provides that, when an ECGD payment is made, income is treated as arising at that time, to the extent of the payment. This reflects the intention of the legislation as originally drafted. Amendments made by FA 1996 obscured the point. See *Change 141* in Annex 1.

1698. *Subsection (6)* indicates that subsections (3) to (5) do not apply if the income has otherwise been treated as arising as a result of this section. For example, if relief has been withdrawn because an ECGD payment is received, there is no further charge under this section – to the extent of that payment – if the income itself subsequently becomes remittable.

Section 844: Income charged on withdrawal of relief after source ceases

1699. The section is based on section 584 of ICTA.

1700. It provides that, where relief given under this Chapter cannot be withdrawn in accordance with section 843, because the trade, profession, vocation or property business in question has permanently ceased, the amount in respect of which relief is withdrawn is dealt with as a post-cessation receipt under the relevant Chapter of Part 2 or Part 3 of this Act. For other unremittable income becoming remittable, the section provides that the income should be taxed as if the source had not ceased.

1701. See *Change 22* in Annex 1.

1702. Income charged by virtue of this section is not "relevant foreign income", as defined in section 830 (see subsection (3) of that section). In the source legislation, the charge is under Schedule D Case VI (rather than Schedule D Cases IV or V). The potential relevance of such income to relief under section 392 of ICTA (Case VI losses) has been preserved by the appropriate entry in section 836B of ICTA (introduced by paragraph 340 of Schedule 1 to this Act).

Section 845: Valuing unremittable income

1703. This section is based on section 584 of ICTA.

Part 9: Partnerships

Overview

1704. This Part of the Act contains the rules that apply to partnerships.

1705. Section 1 of the Partnership Act 1890 defines partnership as "the relation which subsists between persons carrying on a business in common with a view of profit". Section 4 of the Partnership Act 1890 explains that "firm" is the term used for the purposes of that Act for persons in partnership.

1706. The sections in this Act follow the Partnership Act 1890 and refer to the partners collectively as a "firm". But the word "partnership" is commonly used as a synonym for "firm". So the title of the Part and some of the titles of the sections use the word "partnerships", again following the lead of the Partnership Act 1890.

1707. The rules in this Part of the Act determine each partner's share of the income of the firm. That income share is then charged under the normal rules for the type of income concerned.

Section 846: Overview of Part 9

1708. This section introduces this Part of the Act. It is new.

Section 847: General provisions

1709. This section introduces the concept of a "firm". It is based on section 111 of ICTA.

1710. *Subsection (2)* adopts the same approach as the trading income Part of this Act. Most of the Chapters in the trading income Part of the Act have a rule that the trading income rules apply to professions and vocations as they apply to trades. The rules themselves refer only to trades. The sections in this Part refer to trades. They apply also to professions (but not to vocations, which cannot be carried on in partnership). Paragraph (a) of the subsection ensures that there is no need to repeat the phrase "trade or profession". If the firm has other income, there are special rules for assessing it. The sections then have to deal with businesses other than trades or professions - paragraph (b) caters for that possibility.

Section 848: Assessment of partnerships

1711. This section makes it clear that, for income tax purposes, a firm is not an entity distinct from the partners in the firm. It is based on section 111(1) of ICTA.

1712. In the case of firms established under English law this provision merely confirms their position under that law. But Scottish firms, for example, are legal entities. This provision ensures that all firms are treated in the same way.

Section 849: Calculation of firm's profits or losses

1713. This section contains the basic rules for calculating the profits of a firm. It is based on section 111 of ICTA.

1714. If some of a firm's partners are resident in the United Kingdom and some are not, the profits of the firm's trade must be calculated on different bases. For the resident partners, the calculation includes profits arising outside the United Kingdom; for the non-resident partners, the calculation is restricted to profits arising in the United Kingdom.

1715. Section 111 of ICTA is not explicit that the profits may have to be calculated on more than one basis. This section brings together the rules for resident and non-resident partners. *Subsection (1)* introduces the idea that more than one calculation may be needed.

1716. The source legislation refers to the computation of the profits from the actual trade "for any period". Profits are calculated for a period of account. So subsections (2) and (3) make it clear that the section applies to a period of account. It is possible for a partner to be both resident (for one tax year) and non-resident (for another) within a single period of account. In such a case, the firm's profit has to be calculated twice to arrive at the partner's share of the profits.

1717. *Subsection (2)* sets out the normal basis for calculating the profits, for an individual resident in the United Kingdom. The profits are calculated as if the firm were an individual resident in the United Kingdom.

1718. *Subsection (3)* sets out an additional basis for calculating the profits. If the partner (who may be a non-resident company liable to income tax) is not resident in the United Kingdom the profits of the firm are calculated as if the firm were an individual not resident in the United Kingdom.

Section 850: Allocation of firm's profits or losses between partners

1719. This section is the link between the firm's profits and the amounts assessable on the partners. It is based on section 111(3) of ICTA.

1720. *Subsections (2)* and *(3)* set out what happens if the calculation of a partner's share of the firm's profits under subsection (1) produces a loss, even though the overall result for the firm is a profit. This is most likely to arise when one or more partners are entitled to a salary or interest on the firm's capital. The "loss" determined under subsection (1) is reallocated to the other partners, to reduce their shares of the profit. See *Change 143* in Annex 1.

1721. It is also possible for the calculation of a partner's share under subsection (1) to produce a profit, even though the overall result for the firm is a loss.

1722. *Subsections (4)* and *(5)* set out what happens in the case of an overall loss. The "profit" determined under subsection (1) is reallocated to the other partners, to reduce their shares of the loss. See *Change 143* in Annex 1.

1723. *Subsection (6)* contains definitions. If at least one of the partners in the firm is liable to corporation tax, the firm's profit (FP) or loss (FL) will include part of the profits or losses allocated to the partner liable to corporation tax, even though that part of the profits is not charged to income tax. So it is necessary, in the reallocation of the profits under subsection (3) or losses under subsection (5), that the total profits (TP) or losses (TL) include those allocated to the partner liable to corporation tax. The definition of "partner" for the purposes of the section makes it clear that partners liable to corporation tax are part of the picture.

Section 851: Calculations etc. where firm has other income or losses

1724. This section sets out the rule for a firm's non-trading income. It is based on section 111(7) of ICTA.

1725. Section 847(2)(a) of this Act applies to this section but section 847(2)(b) does not. So the reference to a "trade" in subsection (1)(a) of this section is to be read as including a profession but not a business.

1726. A trading firm may have income that does not arise from the trade or from a business. Such income is calculated and allocated to the partners in the same way as trading income, in accordance with sections 849 and 850. Each partner's share is assessed using the basis period rules set out in section 854.

Section 852: Carrying on by partner of notional trade

1727. This section gives the rules for determining when a partner's notional trade starts and ceases. It is based on sections 110, 111 and 112 of ICTA.

1728. *Subsection (1)* introduces the "notional trade" carried on by each partner. This phrase is used instead of the "deemed trade or profession" in section 111(4) of ICTA. The basis period rules in Chapter 15 of Part 2 of this Act apply to the notional trade carried on by each partner.

1729. *Subsection (2)* deals with a partner joining the firm. The general rule is that the notional trade starts when the partner joins the firm. The subsection makes it clear that the notional trade may start when the firm starts to trade. This is merely implicit in section 111 of ICTA.

1730. *Subsection (3)* is an exception to the general rule. If a firm is formed by a sole trader taking another person into partnership to carry on the same trade, the original trader is treated as starting to carry on a notional trade at the start of the actual trade. This provides continuity of treatment for the original trader.

1731. *Subsection (4)* deals with a partner leaving the firm. The general rule is that the partner ceases to carry on the notional trade when the partner leaves the firm. The subsection makes it clear that the notional trade may end when the firm ceases to trade. This is merely implicit in section 111 of ICTA.

1732. *Subsection (5)* is an exception to the general rule. If a firm is dissolved and its trade is continued by a sole trader, the continuing partner's notional trade is treated as ceasing only when the actual trade ceases. This provides continuity of treatment for the continuing trader.

1733. *Subsection (6)* is the equivalent for partners of the general rule for individuals in section 17 of this Act.

1734. Section 112(1B) of ICTA operates by treating a partner who changes tax residence as ceasing to be a partner. That triggers a cessation of the deemed trade or profession in accordance with section 111(4)(e) of ICTA. This subsection says directly that a continuing partner who becomes, or ceases to be, resident in the United Kingdom is treated as ceasing to carry on one notional trade and starting another.

1735. *Subsection (7)* preserves the partner's right to carry forward trading losses even if the notional trade is treated as ceasing by subsection (6).

Section 853: Basis periods for partners' notional trades

1736. This section sets out the rules for determining the basis periods for the assessment of each partner's share of the firm's profits or loss. It is based on section 111 of ICTA.

1737. *Subsection (1)* sets out the general rule that the basis periods for the partner's notional trade are determined by reference to the accounting dates of the firm's actual trade. The subsection repeats the assumption in section 111(2) of ICTA that the notional trade is carried on by an individual.

1738. Section 111(4)(c) of ICTA ensures that, in most cases, the basis period for the partner's deemed trade or profession is determined by reference to the same periods of account as are used by the firm. Section 111(4)(d) of ICTA also ensures that, even if the firm has a change of accounting date, the general rule usually still applies.

1739. This result is stated explicitly in subsection (1)(b) of the section.

1740. *Subsection (2)* deals with an exception to the general rule.

1741. Section 111(5) of ICTA applies if the firm has an "ineffective" change of accounting date. In that case, the basis period rules are applied as if the accounts were drawn up to the old accounting date. The description of the change as ineffective does not appear in the source legislation or elsewhere in the text of this Act. But it appears in the heading to section 219 of this Act and is used here in conjunction with a cross-reference to section 216.

1742. *Subsection (3)* sets out how a firm can give the notice required by section 217 of this Act. It goes on to set out how the firm can appeal against a notice by the Inland Revenue under section 218.

1743. *Subsection (4)* is a special rule to deal with the case of enterprise allowance received by an individual partner. It explains how section 207 of this Act operates so that the allowance is taxed only once.

Section 854: Carrying on by partner of notional business

1744. This section gives the rules for determining when a partner starts or ceases to carry on a notional business. It is based on sections 111 and 112 of ICTA.

1745. *Subsection (1)* introduces the "notional business" carried on by each partner in the firm. The notional business consists of the partner's share of the untaxed income of the firm that is not trade profits.

1746. *Subsection (2)* deals with the start of the notional business.

1747. The general rule in section 111(8) of ICTA is that a partner's income from the notional business (in ICTA, "the second deemed trade or profession") is assessed using the same basis periods as those for the notional trade (in ICTA, "the deemed trade or profession") carried on by the partner. But this rule applies only if section 111(2) and (3) of ICTA apply in relation to the profits of an actual trade (see section 111(7) of ICTA). So, if a firm is formed to receive non-trading income, the general rule does not apply and the non-trading income is assessed on the usual tax year basis.

1748. A problem may arise if the members of an existing firm start trading for the first time. A strict interpretation of section 111(8)(b) of ICTA seems to require that the basis periods for each partner's notional business are determined to be the same as those for the notional trade, not only for the year in which trading starts but also for all the years since the firm was formed. Subsection (2)(b) of this section makes it clear that the partner's "notional business" does not start until the firm starts to trade. See *Change 144* in Annex 1.

1749. *Subsection (3)* makes it clear that the notional business continues even though particular sources of untaxed income may start and cease.

1750. The date on which a partner starts to carry on a notional business is determined by the date on which the partner joins a firm, or (if later) the date on which the firm starts the actual trade. It does not matter when the firm starts to receive untaxed income. Nor does it matter whether in a particular year there is income from the notional business. The basis periods for a partner's notional business may be determined before the firm starts to receive untaxed income. And, once the basis periods are established for the partner, they change only if the accounting date of the actual trade changes.

1751. *Subsection (4)* deals with the date on which a partner ceases to carry on a notional business. This happens when the partner leaves the firm or (if earlier) when the firm ceases to carry on the actual trade.

1752. *Subsection (5)* is the equivalent for partners of the general rule for individuals in section 17 of this Act.

1753. Section 112(1B) of ICTA operates by treating a partner who changes tax residence as ceasing to be a partner. That triggers a cessation of the second deemed trade or profession in accordance with section 111(8)(d) of ICTA. This subsection says directly that a continuing partner who becomes, or ceases to be, resident in the United Kingdom is treated as ceasing to carry on one notional business and starting another.

Section 855: Basis periods for partners' notional businesses

1754. This section gives the rules for determining the basis periods for the assessment of a partner's share of the non-trading income of a firm if the firm carries on a trade. It is based on section 111 of ICTA.

1755. There is no special basis of assessment for a partner's share of the taxed income of a firm, or of the untaxed income of a firm that does not carry on a trade. In those cases, the usual tax year basis applies.

1756. *Subsection (1)* gives the general rule that the basis period for the partner's notional business is the same as that for the partner's notional trade.

1757. *Subsections (2)* and *(3)* are similar to section 852(3) and (5), dealing with notional trades.

1758. If a firm is formed by a sole trader taking another person into partnership to carry on the same trade, subsection (2) makes it clear that the original trader's notional business starts with the formation of the firm. Similarly, if a firm is dissolved and a partner carries on the same trade alone, subsection (3) makes it clear that the continuing trader is treated as ceasing to carry on a notional business.

1759. It follows from the rules in sections 854 and 855 that the income from the partner's notional business is assessed in accordance with the commencement and cessation rules in sections 199, 200 and 202 of this Act.

Section 856: Overlap profits from partners' notional businesses

1760. This section sets out a special rule to deal with the possibility that the deduction of overlap profit may produce a loss. It is based on section 111(9) of ICTA.

1761. A consequence of the application of the trading income basis period rules is that there may be overlap profit (see section 204 of this Act) of a partner's notional business.

1762. *Subsection (1)* deals with the case where a deduction is made for overlap profit on a change of accounting date (to a date later in the tax year), in accordance with section 220.

1763. *Subsection (2)* deals with the case where a deduction is made for overlap profit on cessation of the firm's actual trade, in accordance with section 205.

1764. *Subsection (3)* gives relief for any excess of overlap profit over the income otherwise to be assessed for the year of the change of accounting date or cessation. This excess would not usually qualify for relief against total income because it is not a trading loss. But this section ensures that relief is given in that way.

Section 857: Partners to whom the remittance basis may apply

1765. This section gives a special rule for the treatment of the profits of a firm that is managed and controlled outside the United Kingdom. It is based on section 112(1A) of ICTA. The source legislation charges the remittance basis partner's share of the profits of such a firm under Schedule D Case V.

1766. In most cases, the charge under Case V rather than Case I has no practical effect on the partner's income tax liability. But, if the profits of the firm arise from the carrying on of a trade wholly or partly outside the United Kingdom, an individual who is assessed on the basis of the amount of income received in the United Kingdom (the "remittance basis") is charged only to the extent that the overseas profits are received in the United Kingdom.

1767. This result is achieved by two rules in section 112(1A) of ICTA which require:

- computation of the firm's profit as if the trade were carried on by an individual not resident in the United Kingdom; and
- treatment of any profits arising outside the United Kingdom as arising from a "possession out of the United Kingdom".

1768. *Subsection (2)* of the section reproduces the first ICTA rule. The assumption in ICTA that the trade is carried on by a non-resident individual means that the computation of the firm's profits excludes any profits that arise outside the United Kingdom. This section does not require that assumption. Instead, this rule is directed specifically at the profits arising in the United Kingdom to produce the same result. The determination of the firm's profits in accordance with section 849 will involve subsection (2) of that section (because the partner is resident in the United Kingdom – see *subsection (1)(c)* of this section).

1769. *Subsection (3)* of the section reproduces the second ICTA rule. The assumption that the profits arising outside the United Kingdom arise from a "possession out of the United Kingdom" means that the partner's share of those profits may be assessed on the remittance basis. This section treats the profits as "relevant foreign income" for the purposes of this Act. So the remittance basis may apply.

1770. Section 112(1A) of ICTA applies if "any of the partners … satisfies the Board that he is not domiciled in the United Kingdom…". The quoted words (introduced in 1995) are based on section 65(4) of ICTA as it was until 1996.

1771. As part of the introduction of Self Assessment, all such references to the Board being satisfied were intended to be removed – a person self-assessing could not know whether the Board were satisfied. So the words in section 65(4) of ICTA were changed, by section 134 of and Schedule 20 to FA 1996. The words became "any person who makes a claim to the Board stating that that he is not domiciled …".

1772. The corresponding amendment to section 112 of ICTA was not made. It is clear that section 112(1A) of ICTA should apply to exactly the same category of person as section 65(4) of ICTA.

1773. This section applies if a partner is an individual who satisfies the conditions in section 831 of this Act. So the rule for a non-domiciled partner is expressed in the same way as the rule for non-domiciled individuals generally.

Section 858: Resident partners and double taxation agreements

1774. This section ensures that a UK resident partner's share of the income of a foreign firm remains liable to United Kingdom tax even though the income of the firm as a whole is exempt from United Kingdom tax in accordance with a double taxation agreement. It is based on section 112(4) and (5) of ICTA.

1775. The business profits article of the United Kingdom/Jersey double taxation arrangement exempts the profits of a Jersey firm from United Kingdom tax. In the case of Padmore v CIR (1989), 62 TC 352 CA[12], the Court of Appeal decided that the exemption extended to the share of the profits arising to a United Kingdom resident individual. The rules in section 112(4) and (5) of ICTA were enacted in 1987 to remove the exemption.

1776. *Subsection (1)* sets out the type of individual and firm with which the section is concerned. It goes on to identify the sort of exemption from tax that was considered in the Padmore case.

1777. For United Kingdom tax purposes, if it is necessary to consider where a firm is resident, the question is likely to be decided by the place where the firm's business is controlled and managed. But it is possible that, under foreign law, a firm may be considered to be resident elsewhere, for example, by reference to where the firm was established. So the section uses both the "control and management" test and the "resides" test.

1778. *Subsection (2)* makes it clear that the section does no more than remove any exemption under a double taxation arrangement. It does not deny other reliefs, such as tax credit relief. See *Change 145* in Annex 1.

1779. *Subsection (3)* deals with United Kingdom tax credits. A double taxation arrangement may give a non-resident person an entitlement to payment of a tax credit on a distribution by a United Kingdom company. The entitlement is restricted to the share of the distribution that arises to a United Kingdom resident partner.

[12] STC [1989] 493

Section 859: Special provisions about farming and property income

1780. This section clarifies the position of firms that carry on a farming trade or property business. It is based on sections 15 (paragraph 1(3) of Schedule A), 53(2) and 65A(4) of ICTA.

1781. In section 53(2) of ICTA there is a rule that all farming carried on in the United Kingdom by a person is a single trade. The section refers to a "particular person or partnership or body of persons".

1782. In section 15 of ICTA there is a similar rule that all property income activity carried on by a person forms a single property business. Paragraph 1(3) of Schedule A refers to a "particular person or partnership". Section 65A(4) of ICTA, which deals with overseas property businesses, also refers to a "particular person or partnership".

1783. *Subsection (1)* is the rule that all farming carried on by a firm is a single trade. The subsection also makes it clear that the firm's single farming trade is separate from any farming trade carried on personally by a partner in the firm.

1784. *Subsections (2)* and *(3)* are the corresponding rules for UK property businesses and overseas property businesses.

Section 860: Adjustment income

1785. This section sets out the rules for taxing adjustment income when a trade is carried on in partnership. It is based on paragraph 13 of Schedule 22 to FA 2002.

1786. *Subsection (1)* provides that there can be a change of basis at the same time as a partial change in the membership of the firm.

1787. *Subsection (3)* ensures that the adjustment income rules are applied to the firm, rather than to the individual partners.

1788. *Subsection (7)* ensures that the special rules in this section apply instead of the main partnership rules. In particular, the income is allocated between the partners in accordance with subsection (2) instead of section 850. And the charge is on income treated as arising on the last day of the new period of account in accordance with section 232 of this Act instead of by reference to the basis period rules in sections 852 and 853.

Section 861: Sale of patent rights: effect of partnership changes

1789. This section sets out what happens when there is a sale of patent rights by a trader and there is change in the membership of any firm that carries on the trade. It is based on section 558 of CAA.

1790. The rules for intellectual property are split:

- the rules that give capital allowances are in CAA;
- the rules that charge non-trading profits from the sale of patent rights are in Chapter 2 of Part 5 of this Act; and
- the special rules that apply to firms are set out in this section and section 862.

1791. If a trader receives a sum from the sale of patent rights in the ordinary course of the trade the sum is a trade receipt. In that case, it is not a "capital sum" and section 524(1) of

ICTA ensures that the special rules do not apply. In this Act the treatment is the same because section 575(1) ensures that a charge under Part 2 of this Act takes precedence over a charge under Part 5 of this Act (which includes income from intellectual property in Chapter 2 of that Part).

1792. If a trader receives a capital sum from the sale of patent rights, the sum is excluded from the calculation of the trade profits by the general rule that excludes capital receipts. Instead, the sum is separately charged to income tax under section 587 of this Act. The profit on the sale is charged to tax over six years. But the seller may elect to have the sum charged in the year in which the proceeds of sale are received. Or the charge may be spread in accordance with section 591 or 592.

1793. *Subsection (2)* sets out the "tax condition" for the section to apply. The condition is that the charge on the proceeds from the sale of patent rights is spread over several tax years.

1794. *Subsection (3)* sets out the "partnership condition" for the section to apply. The condition is that the trade that gives rise to the sale of patent rights is carried on in partnership, either at the time of the sale or at any time during the tax spreading period. In this case the charge under section 524 of ICTA "falls to be made on two or more persons jointly" (section 525(3) of ICTA).

1795. *Subsection (4)* sets out the "non-cessation condition" for the section to apply. The condition is that the there is not a complete change in the persons carrying on the trade. If there is such a change, section 862 applies instead.

1796. *Subsection (5)* sets out the what happens if all the conditions in the previous three subsections are met: the charge on the proceeds of sale of the patent rights is made on the current partners in the firm. This subsection is based on section 558(3) of CAA.

1797. *Subsection (6)* makes clear the assumptions on which the charge on the current partners is to be calculated. All the current partners step into the shoes of the persons who were partners at the time of the original sale.

Section 862: Sale of patent rights: effect of later cessation of trade

1798. This section sets out what happens when there has been a sale of patent rights to which the previous section applied and there is a complete change in the persons carrying on the trade. It is based on section 525 of ICTA.

1799. *Subsection (1)* sets out the conditions for the section to apply.

1800. *Subsection (1)(b)* is the condition that the current charge on the proceeds from a sale of patent rights is made on a firm. It is possible for an individual to "inherit" such a charge from a firm as a result of section 861. In that case when the individual ceases to carry on the trade the assessment of the remaining instalments of the charge is not disturbed.

1801. *Subsection (1)(d)* is the condition that there is a complete change in the persons carrying on the trade. If there is a partial change, section 861 applies.

1802. *Subsection (2)* is the main rule that when the firm ceases to carry on the trade the remaining tax charges are "rolled up" in the last year of the trade.

1803. *Subsection (3)* sets out how the "rolled-up" charge is split between the current partners on cessation of the trade.

1804. *Subsections (4)* to *(6)* allow an election to have the remaining tax charge spread evenly over the years since the original sale of patent rights.

1805. The time limit for the election is the same as that in section 593 and is brought into line with the time limit for other elections in this Act. See *Change 104* in Annex 1.

1806. This section does not specify that the election is to be made to "the inspector". Section 878(4) of this Act draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to "an officer of the Board".

Section 863: Limited liability partnerships

1807. This section contains the rules that treat limited liability partnerships ("LLPs") in the same way for tax purposes as ordinary partnerships ("firms" in this Act). It is based on section 118ZA of ICTA.

1808. The Limited Partnerships Act 1907 established "limited partnership". It built on the Partnership Act 1890 and established a class of partner whose liability for the debts of the firm did not extend beyond the partner's contribution to the firm. But there had also to be at least one general partner whose liability was not so limited and the firm was not a separate legal person.

1809. The Limited Liability Partnerships Act 2000 created a new form of legal entity, a limited liability partnership. It is a body corporate with legal personality separate from its members. In many ways, LLPs are treated for non-tax purposes in the same way as companies. In particular, there are requirements as to accounts and audit. Members of an LLP may be subject to disqualification in the same way as directors. And various provisions relating to insolvency and winding up apply to LLPs as they do to companies.

1810. A first version of section 118ZA of ICTA was inserted by the Limited Liability Partnerships Act 2000. FA 2001 replaced it with a new section. Those Acts also introduced special rules (which are not in this Act) for:

- losses;
- capital gains;
- relief for interest; and
- some types of investment vehicle.

1811. *Subsection (3)* ensures that the basic rule in subsection (1) continues to apply to an LLP if the LLP would otherwise temporarily fail to qualify for treatment as an ordinary firm on account of the LLP:

- ceasing to carry on a trade with a view to profit; or
- being wound up.

Part 10: General provisions

Chapter 1: Introduction

Section 864: Overview of Part 10

1812. This section introduces Part 10. It is new.

Chapter 2: General calculation rules etc.

Overview

1813. Chapter 2 contains a number of generally applicable rules modelled on similar rules in Parts 2 and 3 of this Act. They apply to income charged to income tax other than income within those Parts.

1814. These rules are included here to save repetition at numerous points in the Act. Some of the rules apply provisions from the Parts 2 and 3 equivalent rules, rather than repeat them here. Section 1 signposts at the beginning of the Act that there are general calculation rules in this Part.

Section 865: Unpaid remuneration: non-trades and non-property businesses

1815. This section is based on section 43 of FA 1989. That section applies where profits or gains are to be "charged under Schedule D for a period of account…". Profits or gains may be calculated for a period of account in respect of a business which is neither a trade, profession or vocation nor a property business (for example, a business whose income is charged under Chapter 3 of Part 5 of this Act (films and sound recordings: non-trade businesses)).

1816. This section uses "profits or other income", as do other sections in this Chapter, rather than "profits or gains", to define the scope of the rule. See the commentary on the omission of "gains" in the overview to Chapter 2 of Part 2 of this Act.

1817. The section alters the claim procedure. See *Change 8* in Annex 1.

1818. See the related commentary on sections 36 and 37 of this Act.

1819. See also paragraph 154 of Schedule 2 to this Act which preserves the commencement rule for the amendment of the source legislation by Schedule 24 to FA 2003.

Section 866: Employee benefit contributions: non-trades and non-property businesses

1820. This section is based on Schedule 24 to FA 2003. The provisions in that Schedule apply where "a calculation is required to be made for tax purposes of a person's profits for any period…". Profits may be calculated for a period in respect of a business which is neither a trade nor a property business.

1821. This section applies sections 39 to 44 in Part 2 of this Act in calculating the profits of a business for the purpose of any income tax charge which is not in Parts 2 or 3 of this Act. For further detail, see the commentary for those sections.

1822. See also paragraph 155 of Schedule 2 to this Act which preserves the commencement rule for the amendment of the source legislation by Schedule 24 to FA 2003. And see paragraph 156 of Schedule 2 to this Act which preserves source legislation as it applies before the FA 2004 rules about pension schemes take effect from 6 April 2006.

Section 867: Business entertainment and gifts: non-trades and non-property businesses

1823. This section is based on section 577 of ICTA. That section denies a deduction for certain expenses "in computing profits chargeable to tax under Schedule D". Profits chargeable to tax under Schedule D include profits of a business which is neither a trade, profession or vocation nor a property business. And section 577(7)(b) of ICTA indicates that references to a trade, for the purposes of the section, include references to a business.

1824. Although in theory the section is applicable to all profits or other income charged to income tax, other than profits charged in Parts 2 and 3 of this Act, some of which are not charged under Schedule D in the source legislation, the application of the section is qualified. *Subsection (1)* restricts its scope to profits or other income "which arise from the carrying on of a business" . In effect, this puts the scope of the rule in line with that of the source legislation.

1825. This section applies the same rules regarding business entertainment and gifts as are in sections 45 to 47 in Part 2 of this Act. For further detail, see the commentary for those sections.

1826. *Subsection (5)* contains a number of exceptions, using sections 46 to 47 for this purpose. Section 47(5) makes an exception for gifts to charities and named bodies. The source legislation, section 577(9) of ICTA, limits this exception to the computation of profits under Schedule D Cases I and II, that is, to income calculated under rules rewritten in Part 2 of this Act. It was not intended that the exception be applied narrowly to the disadvantage of a business other than a trade or property business. This subsection extends the exception to such businesses. See *Change 146* in Annex 1.

Section 868: Social security contributions: non-trades etc.

1827. This section prevents a deduction for most social security contributions in calculating profits or income. It is based on section 617 of ICTA.

1828. The rule is that there can be no deduction for a taxpayer's own social security contributions. The section achieves this by prohibiting a deduction for any contributions and making an exception for contributions that an employer makes for employees.

1829. The rule in section 617 of ICTA applies generally for tax purposes. This Act splits the rule:

- This section sets out the income tax rule for non-trading income charged to tax by this Act (including rents from "concerns" charged to tax by Chapter 8 of Part 3 of the Act);
- Section 53 sets out the income tax trading income rule (applied also to property income by section 272);
- A new section 360A of ITEPA is introduced by this Act (see paragraph 594 of Schedule 1 to this Act) to set out the rule for employment income; and
- Section 617 of ICTA as consequentially amended (see paragraph 262 of Schedule 1 to this Act) continues to apply for corporation tax.

Section 869: Penalties, interest and VAT surcharges: non-trades etc.

1830. This section contains the general rule that tax penalties and interest are not to be deducted for tax purposes. It is based on section 90 of TMA and section 827 of ICTA.

1831. The section brings together all the rules prohibiting a deduction for penalties, interest and surcharges imposed by statute. So it deals with interest on unpaid income tax (imposed by TMA) in the same section as the penalties, interest and surcharges relating to the indirect taxes that are dealt with in section 827 of ICTA.

1832. The table in subsection (4) sets out the specific statutory references because a general description of the penalties etc would not be precise enough. But the second column of the table is a description of the tax to indicate what is involved.

Section 870: Crime-related payments: non-trades and non-property businesses

1833. This section is based on section 577A of ICTA. That section denies a deduction for certain crime-related expenses "in computing profits chargeable to tax under Schedule D…" Profits chargeable to tax under Schedule D include profits of a business which is neither a trade, profession or vocation nor a property business.

1834. The section applies to profits or other income charged to income tax other than in Parts 2 and 3 of this Act. Some of those profits or other income are not charged under Schedule D in the source legislation. But the prohibition of a deduction is not thought to have any practical effect on profits or other income which are not charged under Schedule D in the source legislation. The scope of the prohibition is therefore unchanged.

1835. See the related commentary for section 55 of this Act. See also paragraph 157 of Schedule 2 to this Act which preserves the commencement rule for the amendment of the source legislation by section 68 of FA 2002.

Section 871: Apportionment etc. of miscellaneous profits to tax year

1836. This section is based on section 72 of ICTA. That section applies where it is necessary to apportion profits or losses for a period of account between tax years "in the case of any profits or gains chargeable under Case I, II or VI of Schedule D…" The application of section 72 of ICTA is therefore not limited to profits or losses of a trade, profession or vocation.

1837. The section applies where income is chargeable under a provision to which section 836B of ICTA applies (that section is inserted by paragraph 340 of Schedule 1 to this Act). Although section 836B of ICTA does not apply to relevant foreign income, *subsection (2)* of this section qualifies the reference to that section so that the benefit of the apportionment rules extends to such income (that is, to income charged under Schedule D Case IV or V in the source legislation). See *Change 147* in Annex 1.

1838. The section uses "profits" rather than "profits or gains" to define the scope of the rule. See the commentary on the omission of "gains" in the overview to Chapter 2 of Part 2 of this Act.

1839. *Subsection (5)* reflects the practice of making the apportionment by reference to a factor other than a strict count of days, if it is reasonable to do so and the alternative basis of apportionment is applied consistently. The subsection makes clear that the option to choose an alternative basis of apportionment is exercisable only by the taxpayer (not the Inland Revenue). See *Change 52* in Annex 1.

1840. See the related commentary for section 203 of this Act. See also paragraph 158 of Schedule 2 to the Act which provides for the situation where a period of account straddles end of the tax year 2004-05 and the beginning of 2005-06.

Section 872: Losses calculated on same basis as miscellaneous income

1841. This section is based on numerous provisions, including section 827 of ICTA.

1842. The application of the section is limited to "miscellaneous income", defined in *subsection (3)* by reference to section 836B of ICTA (that section is inserted by paragraph 340 of Schedule 1 to this Act). The source legislation does not generally limit the scope of the rule. For example, section 827(1) of ICTA says "the payment shall not be allowed as a deduction in computing any income, profits or losses for any tax purposes". But in practice these provisions affect only the calculation for income tax purposes of amounts, other than profits within Parts 2 or 3 of this Act, chargeable under a provision listed in the table in section 836B of ICTA.

1843. *Subsection (2)* ensures that this rule does not overturn any rules already provided for the computation of losses. For example, see section 398 of ICTA (which supplements the calculation of losses for the purposes of a claim under section 392 of ICTA).

1844. See the related commentary for section 26 of this Act.

Chapter 3: Supplementary and general provisions

Section 873: Orders and regulations made by Treasury or Board

1845. This section is based on section 828 of ICTA.

Section 874: Activities in UK sector of continental shelf

1846. This section is based on section 830 of ICTA.

Section 875: Meaning of "caravan"

1847. This section is based on sections 15 and 65A of ICTA, section 29 of the Caravan Sites and Control of Development Act 1960, section 13 of the Caravan Sites Act 1968, section 8 of the Mobile Homes Act 1975 and Schedule 9 to the Roads (Scotland) Act 1984.

1848. It effects a change in the law in two ways. First it provides a uniform definition of "caravan" for the whole of the United Kingdom. Second it applies that definition to all occurrences of "caravan" in this Act. See *Change 148* in Annex 1.

Section 876: Meaning of "farming" and related expressions

1849. This section defines "farming" and "market gardening" and clarifies the meaning of "forestry" and "woodlands". It is based on section 832(1) of ICTA and section 154 of FA 1995.

1850. Section 832(1) of ICTA defines "farm land" and "market garden land". It then goes on to say that "farming" and "market gardening" "shall be construed accordingly". The reasons for this approach are largely historic and date from the time when the charge on farming and market gardening was under Schedule B. "Farm land" and "market garden land" are no longer terms used in the rules concerned with farming and market gardening; they remain only in the definition in section 832(1) of ICTA.

1851. The definitions in this section take a different approach. They define "farming" and "market gardening" by reference to the nature of the activity, not the land on which the activity is carried out. Farming excludes market gardening.

1852. Farming is an activity which is given differing taxation treatment depending on whether or not the land is situated in the United Kingdom. Section 832(1) of ICTA provides that the definitions of "farm land" and "market garden land" are confined to land occupied in the United Kingdom.

1853. There is no territorial restriction in the definitions in this Act. Instead the territorial restriction is included in the rewrite of section 53(1) and (2) of ICTA as section 9 of this Act and not in the definitions.

1854. *Subsection (1)* provides the definition of "farming". It requires the land to be occupied wholly or mainly for the purposes of husbandry. This reflects a long-standing distinction in tax law between profits resulting from the taxpayer's occupation of the land and profits from an activity in which occupation of the land is merely incidental.

1855. In the first case the trader exploits or uses the land, for example, by growing crops or grazing animals. In the second case the trader occupies the land only because a physical location, such as a shop or factory, is needed from which to carry on the trade. Factory farming, that is the intensive rearing of fish or livestock, is not farming for income tax purposes. This is because the animals do not live or draw their sustenance from the land.

1856. Husbandry is a fairly old-fashioned term but one that is the subject of a considerable body of case law. The status of any marginal case must be determined in the light of that case law subject to the clarification given in *subsection (2)*.

1857. The definition of "farm land" in section 832 of ICTA excludes "any dwelling or domestic offices". This section does not repeat this exclusion of farmhouses.

1858. As originally enacted, the definition of farm land in section 832(1) of ICTA specifically included the farmhouse and farm buildings as part of the farm land. The House of Lords in IRC v Korner and Others (1969), 45 TC 287 HL, held that the effect of this provision was that a farmhouse was an asset of the trade for which a 100% deduction could be obtained. This applies even if the farmer also uses the farmhouse as a private residence. An amendment was introduced in FA 1969 to reverse the effect of that decision. This is why the definition of "farm land" in section 832(1) of ICTA excludes "any dwelling or domestic offices".

1859. In practice a farmer is allowed to make deductions in respect of expenditure of a revenue nature on office buildings used purely for business purposes. Such expenditure has always been treated as being incurred wholly and exclusively for the purposes of the trade and not prohibited from being deducted under section 74(1)(a) of ICTA.

1860. Section 74(1)(c) of ICTA deals with the deduction of rent where only part of a dwelling house or domestic offices are used for trade purposes. Again, in practice, a taxpayer whose trade is farming is permitted to make deductions in respect of such houses and offices.

1861. In the case of any other expenses of a residential property which is subject to dual private and business use a trader is permitted to apportion these and the proportion attributable to trade use is allowed as a deduction. Again this treatment applies to farmers. See section 34 of this Act (expenses not wholly and exclusively for trade and unconnected losses).

1862. A farmer who wishes to claim a deduction for the proportion of expenses of his or her farmhouse attributable to trade rather than private purposes can do so through section 34. Omitting the exclusion of farmhouses and domestic offices from the definition of farming gives statutory effect to what occurs in practice.

1863. *Subsection (2)* identifies two specific types of activity as "husbandry" and therefore farming.

1864. *Paragraph (a)* is based on the definition of market garden land in section 832(1) of ICTA. Hop growing is generally recognised to be farming but is often spoken of as taking place in a garden. This could bring it within the definition of "market garden land" in section 832(1) of ICTA but for the fact that hop growing is excluded from that definition. Subsection (2)(a) makes clear that hop growing is farming.

1865. *Paragraph (b)* is based on the ordinary meaning of the word farming. Stud farming has generally been assumed to be farming for income tax purposes. The reference to "the breeding and rearing of horses and the grazing of horses in connection with those activities" makes clear what that activity encompasses for the purposes of this Act.

1866. *Subsection (5)* defines "market gardening". It makes it clear that the produce sold must have been grown on the relevant land rather than being bought in for resale.

Section 877: Meaning of grossing up

1867. This section explains what is meant by "grossing up" for the purposes of this Act and provides a formula for calculating the gross amount to be taxed. It is new.

Section 878: Other definitions

1868. *Subsection (1)* defines various terms.

1869. The definition of "houseboat" is based on section 15(1) of ICTA. It effects a change in the law because it applies a single definition of "houseboat" for the whole Act. See *Change 150* in Annex 1.

1870. The definition of "Inland Revenue" is new. See *Change 149* in Annex 1.

1871. The definition of "personal representatives" is new. See *Change 151* in Annex 1.

1872. *Subsection (3)* provides a general rule concerning the making of claims and elections. It is based on section 42(11) of TMA and paragraph 2 of Schedule 1A to TMA.

1873. In the source legislation some provisions specify that a claim or election has to be in writing while others are silent. But the effect of paragraph 2(3) to (5) of Schedule 1A to TMA is that claims and elections have to be in writing (unless a specific provision says otherwise).

1874. *Subsection (5)* defines whether persons are connected by reference to section 839 of ICTA. Section 839 of ICTA applies the following tests in determining whether persons are "connected":

> (1) For the purposes of, and subject to, the provisions of the Tax Acts which apply this section, any question whether a person is connected with another shall be determined in accordance with the following provisions of this section (any provision that one person is connected with another being taken to mean that they are connected with one another).
>
> (2) A person is connected with an individual if that person is the individual's wife or husband, or is a relative, or the wife or husband of a relative, of the individual or of the individual's wife or husband.
>
> (3) A person, in his capacity as trustee of a settlement, is connected with—
>
> (a) any individual who in relation to the settlement is a settlor,
>
> (b) any person who is connected with such an individual, and
>
> (c) any body corporate which is connected with that settlement.
>
> In this subsection "settlement" and "settlor" have the same meaning as in Chapter IA of Part XV (see section 660G(1) and (2)).

(3A) For the purpose of subsection (3) above a body corporate is connected with a settlement if—

(a) it is a close company (or only not a close company because it is not resident in the United Kingdom) and the participators include the trustees of the settlement; or

(b) it is controlled (within the meaning of section 840) by a company falling within paragraph (a) above.

(4) Except in relation to acquisitions or disposals of partnership assets pursuant to bona fide commercial arrangements, a person is connected with any person with whom he is in partnership, and with the wife or husband or relative of any individual with whom he is in partnership.

(5) A company is connected with another company—

(a) if the same person has control of both, or a person has control of one and persons connected with him, or he and persons connected with him, have control of the other; or

(b) if a group of two or more persons has control of each company, and the groups either consist of the same persons or could be regarded as consisting of the same persons by treating (in one or more cases) a member of either group as replaced by a person with whom he is connected.

(6) A company is connected with another person if that person has control of it or if that person and persons connected with him together have control of it.

(7) Any two or more persons acting together to secure or exercise control of a company shall be treated in relation to that company as connected with one another and with any person acting on the directions of any of them to secure or exercise control of the company.

(8) In this section—

"company" includes any body corporate or unincorporated association, but does not include a partnership, and this section shall apply in relation to any unit trust scheme as if the scheme were a company and as if the rights of the unit holders were shares in the company;

"control" shall be construed in accordance with section 416; and

"relative" means brother, sister, ancestor or lineal descendant.

1875. *Subsection (6)* applies the definition of "control" in section 840 of ICTA. Section 840 of ICTA defines "control" in relation to a body corporate as follows:

For the purposes of, and subject to, the provisions of the Tax Acts which apply this section, "control", in relation to a body corporate, means the power of a person to secure—

(a) by means of the holding of shares or the possession of voting power in or in relation to that or any other body corporate; or

(b) by virtue of any powers conferred by the articles of association or other document regulating that or any other body corporate,

that the affairs of the first-mentioned body corporate are conducted in accordance with the wishes of that person, and, in relation to a partnership, means the right to a share of more than one-half of the assets, or of more than one-half of the income, of the partnership.

Section 879: Interpretation: Scotland

1876. This section incorporates the effect of the devolution settlement and deals with the application of certain terms used in the Act to Scotland.

1877. *Subsection (1)* is based on sections 24(5) and 539(2) of ICTA which provide that in applying the provisions of Schedule A and of Chapter 2 of Part 13 of ICTA to Scotland, "assignment" means "assignation".

1878. *Subsection (2)* is based on *Change 19* in Annex 1 and gives certainty to the meaning of "Act".

1879. *Subsection (3)* is based on *Change 19* in Annex 1 and gives certainty to the meaning of "enactment".

Section 880: Interpretation: Northern Ireland

1880. This section incorporates the effect of the devolution settlement and deals with the application of certain terms used in the Act to Northern Ireland. It is new.

1881. *Subsection (1)* is based on *Change 19* in Annex 1 and gives certainty to the meaning of "Act".

1882. *Subsection (2)* is based on *Change 19* in Annex 1 and gives certainty to the meaning of "enactment".

1883. *Subsection (3)* provides that section 631 of this Act does not extend to Northern Ireland legislation. It is improbable that "enactment" in section 660B(2) of ICTA, on which section 631 is based, includes Northern Ireland legislation and to include section 631 within *Change 19* as regards to Northern Ireland would be taxpayer adverse.

Section 881: Disapplication of corporation tax: section 9 of ICTA

1884. This section ensures that the provisions of this Act which apply for income tax purposes only are not applied by section 9 of ICTA for corporation tax purposes. It is new.

Section 882: Consequential amendments

1885. This section is new. It contains a subsection introducing Schedule 1 and a power to allow the Treasury to make by order consequential amendments.

1886. The power will not be invoked without the agreement of the Tax Law Rewrite Project's Consultative and Steering Committees to the proposed modifications.

1887. *Subsection (1)* gives effect to Schedule 1.

1888. *Subsections (2)* to *(5)* contain the power. It is to be exercised by Treasury order and will where appropriate allow both amendments and repeals in consequence of this Act only. But those amendments and repeals are limited in effect by subsections (4)(a) and (5). Subsection (4)(b) allows appropriate transitional or savings provisions to be made in respect of any of those amendments or repeals.

Section 883: Commencement and transitional provisions etc.

1889. This section is new. It provides for the commencement of the Act and also provides for certain orders to take effect on passing of the Act. It also contains a power to make by order any further transitional provision or saving which might not have been dealt with in the Act.

1890. The power will not be invoked without the agreement of the Tax Law Rewrite Project's Consultative and Steering Committees to the proposed transitional provision or saving.

1891. *Subsection (1),* which sets out when the Act comes into force and has effect, deals with the position for both income tax and corporation tax. The Act is in substance an income tax only Act. But it makes numerous consequential amendments to the corporation tax code. Those consequential amendments do not change the law but do require a commencement provision.

1892. *Subsection (3)* provides that the certain provisions will come into force on the passing of the Act.

1893. *Subsection (5)* contains the power. It is to be exercised by Treasury order.

Section 884: Repeals and revocations

1894. This provision gives effect to Schedule 3.

Section 885: Abbreviations and general index in Schedule 4

1895. This provision gives effect to Schedule 4.

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