

FL MEMO

EXTRACTS

Tax

2009-2010



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Preface

Finance Act 2009 contains major changes to the tax regime, including important new powers in relation to tax evasion, record-keeping, inspection and tax reporting.

Tax Memo 2009-2010 has been updated to reflect law and practices at the date of Royal Assent of FA 2009, including commentary on:

- the change to the corporate taxation on distributions;
- the forthcoming changes to the VAT treatment of cross-border services;
- the harmonisation of Revenue and Customs' powers; and
- the extension of the new penalties regime for errors and inaccuracies across all taxes.

Tax Memo 2009-2010 provides up-to-date commentary on the major UK taxes. In addition to the handbook the service includes:

- a full **online service**, with integrated updates;
- **fortnightly emails** detailing developments or points of interest; and
- emails providing a full analysis of both the pre-Budget and **Budget** reports.

Tax Memo 2009-2010 is unique in its style, with the full complexities of tax law explained in a language you can understand, reliably written by our experienced in-house tax professionals. The **precise text** is founded on statute, case law and other official material, with legislative references given throughout. The book is also packed with **worked examples** and practical tips to enhance the expert commentary.

Tax Memo 2009-2010 is **easy to navigate**, progressing from section plan through chapter outline to specific paragraph, which means you can easily find the answer to your particular query. Each section is devoted to a specific topic, comprehensively indexed and fully cross-referenced to related issues. The appendix contains many useful tables of numerical and factual data.

CHAPTER 5

Other income and expenses

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C. Research and development expenditure

1. Overview

Available claims

794
ss 1039 – 1142
CTA 2009

Companies incurring certain revenue expenditure on qualifying research and development (R & D) or vaccine research can claim a **deduction** of an amount greater than the actual expenditure.

Alternatively, a small or medium sized enterprise (SME) that has a trading loss may claim a **payment** (known as an R & D tax credit) from Revenue and Customs (¶810) instead.

- MEMO POINTS**
1. Traders that **do not qualify for this enhanced relief** may be able to claim a revenue deduction (¶152) depending on the nature of the expenditure.
 2. **Capital expenditure** incurred on qualifying R & D may qualify for capital allowances (¶683).
 3. Relief cannot be claimed for any expenditure attributable to **disqualifying arrangements**. Arrangements are disqualifying where the main object, or one of them, is to obtain, or to increase the amount of, a claim to tax relief or tax credit.

Large company or SME?

795
ss 1119, 1120
CTA 2009

The qualifying expenditure and deduction available differs slightly depending upon whether the company is a small or medium sized enterprise (SME) or a large company, which are **defined as** follows:

- a. large companies are all companies which are not SMEs; and
- b. small or medium sized enterprises are ones which have fewer than 500 employees, and which have either:
 - turnover of not more than €100m; or
 - balance sheet assets of not more than €86m.

When establishing whether a company is an SME, the results of any related enterprise must be taken into account when determining the thresholds.

A company is **specifically excluded** from the SME definition if more than 25% of its share capital or voting rights are owned by enterprises that are not themselves SMEs (unless the enterprises are investment corporations, venture capital companies or institutional investors that do not exercise control over the company).

- MEMO POINTS**
1. Prior to 1 August 2008 these limits were:
 - 250 employees;
 - turnover of not more than €50m; or
 - balance sheet assets of not more than €43m.
 2. If a company that **was previously an SME** breaches the thresholds, it will only cease to be an SME if the thresholds are breached for two consecutive periods. Similarly, a company that **was not previously an SME** must satisfy the conditions for two consecutive periods to become an SME. (However this condition does not apply in a period where it is only the related enterprise that exceeds the limit, but the company in isolation does not).
 3. From 1 December 2008 where an SME joins a group, or is taken over in some other way, resulting in it becoming large it will be considered to be large for the entire period in which it joins the group.
 4. A **related enterprise** is essentially a:
 - linked enterprise where one enterprise is able to exercise control, either directly or indirectly, over the affairs of the other; or
 - a partner enterprise where one of them holds (either on its own or in combination with other enterprises with which it is linked), 25% or more of the capital or voting rights in the other.

2. Qualifying R & D activities

Research and development takes its definition from normal accounting practice, specifically Statement of Standard Accounting Practice (SSAP) 13. Under SSAP 13, R & D may **take the form of**:

- a. pure research (i.e. experimental or theoretical work undertaken primarily to acquire new scientific or technical knowledge for its own sake, rather than directed towards any specific aim or application);
- b. applied research (i.e. original or critical investigation undertaken in order to gain new scientific or technical knowledge which is directed towards a specific practical aim or objective); or
- c. development (i.e. the use of scientific or technical knowledge to:
 - produce new or substantially improved materials, devices, products or services;
 - install new processes or systems prior to the commencement of commercial production or commercial application; or
 - substantially improve those already produced or installed).

There are two **key factors** which can be identified from the above definitions. Firstly, the research or development must be in a scientific or technical field, and secondly there must be advancement of knowledge. The aim must be to acquire new information or knowledge or to produce something new or improved.

SSAP 13 provides a list of **examples** of activities which would generally be considered as R & D and a corresponding list of activities which would be excluded from the definition.

Activities normally included	Activities normally excluded
Experimental, theoretical or other work aimed at the discovery of new knowledge, or the advancement of existing knowledge	Testing analysis either of equipment or products for the purposes of quality or quantity control
Searching for applications of that knowledge	Periodic alterations to existing products, services or processes even though these may represent some improvement
Formulation and design of possible applications for such work	Optional research not tied to specific research and development activity
Testing in search for, or evaluation of, product, service or process alternatives	Cost of corrective action in connection with breakdowns during commercial production
Design, construction and testing of pre-production prototypes and models and development batches	Legal and administrative work in connection with patent applications, records and litigation and the sale or licensing of patents
Design of products, processes, services or systems involving new technology or substantially improving those already installed	Activity, including design and construction engineering, relating to the construction, relocation, rearrangement or start up of facilities or equipment other than facilities or equipment whose sole use is for a particular research and development project
Construction and operation of prototypes and pilot plants	Market research

3. Qualifying expenditure

Conditions

Expenditure will qualify for R & D relief if:

- a. it is incurred on qualifying R & D activities, for one or more of the following:
 - staffing costs;
 - software or consumable items;

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ss 1041, 1042
CTA 2009
s 837A ICTA 1988

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ss 1061 – 1063,
1065, 1076 – 1079
CTA 2009

- payments to volunteers for participating in clinical trials; or
 - qualifying subcontracted R & D;
- b.** it is at least \$10,000 in a 12 month accounting period (proportionately reduced for periods of less than 12 months); and
- c.** the R & D is for a trade carried on by the company, or which the company will carry on. This includes R & D which is expected to result in an extension to an existing trade, or research of a medical nature which has special significance for employees in the trade, for example, research into the implications of coal dust for the health of miners. Where the company undertaking the R & D is an SME, any intellectual property (e.g. industrial information and techniques (¶719), patents, trademarks etc) created by the R & D must vest in the company (whether alone or with other persons).

MEMO POINTS R & D expenditure will be qualifying even if it is **subsidised**. Expenditure is subsidised to the extent that:

- a grant or subsidy is received;
- a person other than the company meets the expense; or
- state aid (as approved by the European Commission) is received for the R & D or any other expenditure attributable to the project.

Staffing costs

The costs which can be attributable to R & D differ depending upon the nature of the payments, as follows:

- a.** 100% of the payments made for **directors and employees** directly and actively engaged in R & D will be attributable to R & D if they are for:
- emoluments, excluding benefits;
 - secondary (i.e. employer's) Class 1 National Insurance Contributions; or
 - pension contributions.

Where the director or employee is not wholly engaged in R & D, the proportion of expenditure allowable will be apportioned on a just and reasonable basis.

Staffing costs incurred for support services (for example secretaries) are not attributable to R & D;

- b.** 65% of the qualifying payments made to another person (a 'staff provider') for the supply of **external workers** will be attributable to R & D if the external workers are directly engaged in qualifying R & D activities of the company. (If they are only partly so engaged, the costs are split on a just and reasonable basis).

MEMO POINTS 1. **External workers** are individuals who are not directors or employees of the company, but who, as a result of their contract with the staff provider, are required personally to provide services to the company, subject to the usual supervision and direction as to how these services are performed.

2. The provision of the externally provided worker must not be as part of a **subcontractor relationship** (¶803).

Where a company and the staff provider supplying external workers are **connected** the 65% restriction on qualifying payments does not apply. Instead the payments attributable to R & D are the lower of:

- the whole of the payment to the staff provider; or
- the whole of the expenditure incurred by the staff provider on staffing costs.

This treatment is **only available where** the full amount of the payment to the staff provider and the expenditure of the staff provider has, in accordance with normal accountancy practice, been brought into account in computing the staff provider's profit or loss. The amount must be brought into account in an accounting period which ends no later than 12 months after the period of account in which the company deducts the payments to the staff provider.

MEMO POINTS It is possible for **unconnected parties to make a joint election** for the connected party rule to apply. This election must be made in writing within 2 years of the end of the accounting period in which the contract is entered into. The election is irrevocable and applies to all staff provision payments paid under the same contract.

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ss 1123, 1124
CTA 2009

s 1128 CTA 2009

800

ss 1129–1131
CTA 2009

Software or consumable items

Expenditure on software or consumable items is attributable to R & D if the items are directly employed in R & D. If the items are only partly so employed, an appropriate apportionment of the expenditure can be made.

Software or consumable items specifically include:

- consumable or transformable materials;
- utility costs; and
- software licences where the software is used directly and actively in the R & D.

801
ss 1125, 1126
CTA 2009

Clinical trial volunteers

Payments to volunteers participating in clinical trials is qualifying R & D expenditure where it is incurred by a large company on or after 1 April 2006, or on or after 1 August 2008 by an SME.

MEMO POINTS A **clinical trial is defined as** an investigation in human subjects undertaken in connection with the development of a healthcare treatment or procedure.

802
s 1140 CTA 2009

Subcontracted R & D

Where payment is made to a subcontractor, 65% of it will be qualifying R & D expenditure (even if the subcontracted work is not R & D in its own right, provided it is part of a larger project that is R & D). This category includes expenditure on qualifying R & D activities that are subcontracted out by:

- a. an **SME** to another person, that is not an SME itself; or
- b. a **large company** (or a person whose trading activities are not within the scope of UK tax), to an SME.

As a result of these rules, relief is denied where work is subcontracted to an SME by another SME, as this would effectively result in a double credit.

Relief will be given if the SME has incurred the minimum expenditure on its aggregate R & D (i.e. its subcontracted and own R & D expenditure).

- MEMO POINTS** 1. To qualify for relief under **b.** above, the subcontracted work must be either:
- carried out by the SME; or
 - further subcontracted out by the SME to a qualifying body, individual or partnership with no corporate members.
2. A **qualifying body** is a charity, higher educational institution, scientific research organisation or health service body.

803
s 1133 – 1136
CTA 2009

Where the company and the subcontractor are **connected**, the 65% restriction on qualifying payments does not apply. Instead the qualifying payments are the lower of:

- the subcontractor payment; or
- the relevant R & D expenditure incurred by the subcontractor (i.e. the unsubsidised revenue expenditure on staffing costs (including externally provided workers), software or consumable items and payments to clinical trial volunteers).

This treatment is **only available where** the full amount of the subcontractor payment and the relevant expenditure has, in accordance with normal accounting practice, been brought into account in computing the subcontractor's profit or loss for a relevant period. A relevant period is a period for which the subcontractor makes up accounts and which ends no later than 12 months after the end of the period of account in which the company deducts the payment in its accounts.

MEMO POINTS It is possible for **unconnected parties to make a joint election** for the connected party rule to apply. This election must be made in writing within 2 years of the end of the accounting period in which the contract is entered into. The election is irrevocable and applies to all subcontractor payments made between the two parties.

804
s 1135 CTA 2009

4. Relief

Amount of relief

806ss 1044(8), 1063(7),
1068(8), 1074(7)
CTA 2009

The following trading deductions can be claimed:

a. SMEs may claim a deduction for 175% of the qualifying expenditure, provided the company is a **going concern**, unless the work is:

- subcontracted to an SME when the deduction is 130% for the sub-contractor SME; or
- subsidised R & D (¶798) undertaken by an SME when the deduction is again 130%.

b. large companies may claim a deduction for 130% of the qualifying expenditure.

ss 1046, 1057
CTA 2009**MEMO POINTS**

1. For expenditure prior to 1 August 2008 the rates were 150% and 125% respectively.

2. A company is considered a going concern where its last published accounts were prepared on a going concern basis and nothing in those accounts indicated that the availability of R & D relief or tax credits (¶810) was the only reason the accounts were prepared on that basis.

s 1113 CTA 2009

3. From 1 August 2008 the amount of expenditure on which relief can be claimed is capped at €7.5m per qualifying project. Prior to this date the relief was uncapped.

CHAPTER 5

Employment income

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2. Agency workers

3004 Agency workers are often used by employers (referred to here as end-users) to help on a short term basis, and are hired from agencies who supply them on assignments where they will work under the end-user's instructions and control. Such workers are often temporary or casual workers of the agency, and they will often sign on with one or more agencies to increase their chances of obtaining a regular supply of work.

There is no **obligation** on the part of an agency worker to accept an assignment, though once he does he is bound by various obligations according to that agency's written statement of terms and conditions. Likewise, in return the agency will be obliged to pay the worker for work done in accordance with the assignment. Usually, the end-user pays the agency for the services of the worker and the agency pays the worker directly according to its agreement with him.

For details of the legal rights of agency workers, and further discussion of their status, see *Employment Memo*.

How to determine status

3005 Where a worker is supplied to a client through an agency (or similar organisation), the employment status is usually determined by considering the **relationship between** the worker and the agency. However, even if there is only a contract for services with regard to the general relationship between the worker and the agency, there may be a contract of service (i.e. of employment) in relation to a specific assignment, which will last for the duration of the assignment. *McMeechan v Secretary of State for Employment* [1997]

3006 A worker will be an **employee** of the agent, and all related remuneration will therefore be employment income, where all of the following conditions are met by the worker who:
 – provides personal services, other than excluded services, to a third party;
 – is subject to supervision, management and control in carrying out those services;
 – is not treated as employed under the normal rules; and whose
 – services are supplied under the terms of an agency contract.

s 47 ITEPA 2003

MEMO POINTS

1. **Excluded services** are those:

- of an actor, musician, singer, other entertainer or model; or
 - which are carried out somewhere else other than at premises controlled by the client (and this is not because of the specific nature of the work).
2. For the deductibility of **travel expenses**, see ¶3155.

3008 Recent case law has indicated that with regard to **long term assignments** (over a period of years, as distinct from weeks or months typical of temporary or casual work), where:
 – an end-user has exclusive day-to-day control of the agency worker; and
 – it is the end-user who tells the agency when it no longer requires the worker, there may be an implied contract of employment between the agency and the agency worker. *Brook Street Bureau v Dacas* [2004]

3. Personal service companies

3010 The personal service company rules (otherwise known as IR35) attack arrangements which convert employment income into investment income (which is taxed at a lower rate and avoids NIC).

s 49 ITEPA 2003

They **apply to** anyone who provides his services to a client through an intermediary (usually a company), where he would be treated as an employee of the client but for the existence of the intermediary. The factors outlined in ¶2988 above are used to decide whether a worker would be an employee (pretending that a hypothetical contract exists between the client and worker).

If deemed to be an employee, a certain amount of employment income is taxed on the worker, irrespective of the amount of income (in any form) actually received from the intermediary.

These rules will **not apply** where the worker:

- receives sufficient employment income from the intermediary;
- controls the intermediary and the client, taking into account any interests of his associates (i.e. relatives (¶2105), business partners, and trustees of settlements established by the individual or his relative); or
- is a non-resident entertainer or sportsman (¶4330).

s 51(2) ITEPA 2003
s 966 ITA 2007

Comment 1. The **rationale** behind these rules is that an individual who provides services to a business via an intermediary, but otherwise acts as an employee, should pay broadly the same amount of tax and NIC as he would have done had he in fact been an employee of the business.

2. Case law shows that the issues surrounding these rules are complex, and it is good practice for **all potentially affected businesses** to regularly review whether they fall within the rules.

3. **Managed service companies** are also subject to special rules (¶3029).

Intermediary

Where the intermediary is a **company**, an individual may be caught by the IR35 provisions if any of the following apply, so that the worker (and/or his associates):

- controls more than 5% of ordinary share capital;
- is entitled to receive more than 5% of any company dividends; or
- could receive payments or benefits from the company in recognition of his services rendered to clients.

3014
s 51 ITEPA 2003

MEMO POINTS Where the intermediary is a **partnership**, an individual may be caught by these provisions if any of the following apply:

- the individual is entitled to at least 60% of the partnership's profits;
- all or most of the partnership's profits relate to a single client; or
- the profit sharing agreement allows the individual to receive an amount which reflects the client's payments in respect of his services.

s 51 ITEPA 2003

Relevant contract A relevant contract is the **relationship between** the intermediary and client, where an employment would exist between the client and individual.

3016
s 50(4) ITEPA 2003

MEMO POINTS For **NIC purposes**, the test is whether the worker would be regarded as employed in an employed earner's employment by the client. This means that the following could be deemed to be an employee for NIC purposes (but not necessarily for income tax purposes):

- non-executive directors without a service contract;
- cleaners;
- lecturers, teachers and instructors; and
- entertainers.

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EXAMPLE Mr Smith provides services to C plc via his personal company, B Ltd.

If, in the absence of B Ltd, Mr Smith would effectively be an employee of C plc, then the relationship between B Ltd and C plc is known as a relevant contract.

Mr Smith would be taxed as if he had received employment income from C plc.

Case law In a case which found that a worker was caught by these provisions, an **agent** was involved in finding work for the intermediary company. In the contract between these two parties, there was a **substitution clause** so that another individual could carry out the work instead of the taxpayer. However, there was no similar substitution clause in the contract between the intermediary company and the client, and this counted against the worker being self-employed. The taxpayer also **worked for a period** of 17 months for the client, with average weekly hours of 58 hours per week, which suggested that the client was obliged to find work for the taxpayer. *Usetech Ltd v Young* [2004]

3017

In another case, it was held that despite the existence of a **service company**, an individual remained employed by his original employer. The individual had been forced into using a service company which was engaged by an agency, but continued to provide the same services to his previous employer. Although there was a contract of employment between the individual and the service company, and there was an intervening agency agreement, this did not preclude the existence of an **implied and enforceable contract** of employment

between the individual and the employer. In addition, the employer supplied a mobile phone and laptop to the individual, and paid his phone bills. Internally, the individual still had an employee number. *Cable & Wireless v Muscat* [2006]

A software engineer's company contracted with an agency to provide his services almost exclusively to the Automobile Association (AA) for a period of 3 years. It was held that the engineer should be regarded as an employee of the AA because he was:

- integrated into the business, working mainly at the AA's premises or at home with an internet connection to the office server;
- working as part of a highly skilled team; and
- subject to control by the AA, as his work allocation was decreed by the team leader.

Whilst there was an effective substitution clause in the contract between the company and the agency, this was not the case in the contract between the agency and the AA. The **paperwork retrospectively put in place** to confirm that the AA would indeed accept a substitute, if the need arose, did not reflect the reality of the relationship. *Dragonfly Consulting Ltd v HMRC* [2008]

Implications for the worker

3018 An individual will be taxed on the gross **income**, received by the intermediary in respect of all relevant contracts, less the following **expenses**:

s 54(1) ITEPA 2003

- a flat 5% of the gross income received by the intermediary which relates to the contracts affected;
- those incurred by the intermediary which would have been deductible expenses if incurred by an employee (¶3135);
- pension contributions paid by the intermediary to a registered scheme; and
- employer's Class 1 NIC and Class 1A NIC paid during the year, including NIC on the deemed earnings payment.

3020 The **taxable amount** (otherwise known as the deemed earnings payment) is then reduced by any employment income actually received (and taxed under PAYE) in the tax year. PAYE and NIC are levied on the balance as if it was paid on 5 April (even though it may never actually be paid).

s 50 ITEPA 2003

Entries are required on the year end PAYE returns (¶4704). Provisional figures are normally used when the forms are first submitted because few workers will have done their accounts by May, so long as subsequent amendments are made by the filing date (¶4484) to reflect the actual position. The related tax and NIC must be paid by 19 April immediately following the tax year to avoid interest charges.

s 57 ITEPA 2003

- MEMO POINTS**
1. If the individual **stops working** for the intermediary during the tax year, the deemed earnings payment will be assessed at the date of cessation.
 2. The **deemed earnings** payment is taken into account for the following:
 - the classification of the employee (¶3116) for the purposes of expenses and benefits; and
 - earnings for the purposes of registered pension schemes.
 3. Intermediaries can benefit from the **online filing incentives** for form P35 (¶4722).

3022 To avoid taxing the same income twice, **dividends** paid out of the amount that has been taxed as a deemed earnings payment will not be taxed again if an appropriate claim is made by the intermediary (within 5 years of 31 January following the tax year in which the dividend is paid).

s 58(5) ITEPA 2003

The deemed earnings payment should be set against dividends of:

- a. the same year before those of other years; and then
- b. earlier years before those of later years.

- MEMO POINTS**
1. In the less common situation of a **partnership**, the amount of deemed earnings will be excluded from the individual's taxable trading income.
 2. Where a claim is made, the **associated tax credit** will also be ignored in the income tax computation (¶4462).
 3. There is no relief in the situation where **further salary is paid** to the individual after the deemed earnings payment crystallises, so further remuneration should preferably be taken in the form of dividends.

s 58(5) ITEPA 2003

Calculation

This **pro-forma** shows the calculation of the taxable amount.

3024

MEMO POINTS Where **no employment income** is actually paid in the year, the NIC calculation at step 4 below should reduce amount A by the employer's earnings threshold (£5,715 for 2009/10).

	£	£
1. Gross income received by the intermediary on relevant contracts	X	
Deduct 5%:	<u>(X)</u>	
		X
2. Add other payments or benefits received by the worker, in respect of the relevant contracts, but not received by the intermediary		<u>X</u>
		X
3. Deduct the following:		
Expenses incurred that would be deductible if incurred by an employee	X	
Capital allowances deductible by employee	X	
Pension contributions paid by the intermediary	X	
Employer's NIC paid in respect of the worker	X	
Amounts paid to the worker already assessed as employment income	<u>X</u>	
		<u>(X)</u>
		A
4. Calculate employer's NIC: $\text{Employer's rate} / (\text{Employer's rate} + 100) \times A$		(B)
		<u>C</u>
Deemed earnings payment		<u>C</u>

The deemed earnings payment and related NIC is deductible against the **intermediary's taxable profits** as if it was incurred on 5 April. Trading losses may result from the increased employment costs.

3026

MEMO POINTS 1. If the intermediary has a **year end** of 31 March, relief for the deemed earnings payment will be delayed by almost a year, so it is advisable for an intermediary to have a year end of 5 April.

2. If a company is also subject to the **construction industry scheme**, any repayments due under that scheme may be set against the PAYE on the deemed earnings payment.

3028

EXAMPLE In 2009/10, D Ltd receives gross income of £100,000 from relevant contracts involving Mr E. Mr E also receives vouchers worth £500 as a Christmas present from D Ltd's clients. Mr E receives an annual salary of £40,000 (employer's NIC thereon £4,500) from D Ltd. Travel expenses of £4,000 are incurred, and D Ltd pays a pension contribution of £5,000 to Mr E's pension scheme. D Ltd has a year end of 31 March.

The deemed earnings payment is calculated as follows:

Step	£	£
1. Gross income	100,000	
Less: 5%	<u>(5,000)</u>	
		95,000
2. Amounts received from clients		<u>500</u>
		95,500
3. Less: Expenses		
Travel expenses	4,000	
Pension contributions	5,000	
Employer's NIC paid	4,500	
Salary paid	<u>40,000</u>	
		<u>(53,500)</u>
		42,000
4. Employer's NIC: $12.8/112.8 \times 42,000$		<u>(4,766)</u>
Deemed earnings payment		<u>37,234</u>

So Mr E is taxed as if he received extra salary of £37,234 on 5 April 2010, and the related income tax and NIC should be paid by 19 April 2010 to avoid interest.

D Ltd only obtains relief for the extra salary in the year ended on 31 March 2011. So if D Ltd receives £105,000 of income, incurs other costs of £20,000, and all the same expenses are repeated in that year, the taxable result of D Ltd will be:

	£	£
Turnover		105,000
Less: Expenses		
Salary	40,000	
Employer's NIC paid	4,500	
Pension contributions	5,000	
Travel expenses	4,000	
Other costs	<u>20,000</u>	
		<u>(73,500)</u>
Taxable profits before adjusting for deemed earnings		31,500
Less: Deemed earnings payment	37,234	
Employer's NIC thereon	<u>4,766</u>	
		<u>(42,000)</u>
Trading loss		<u>(10,500)</u>

CHAPTER 1

General principles

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Inheritance tax (IHT) is a tax on bequests, gifts and other transfers of property by individuals, either during lifetime or on death. It can also be charged on property held in a trust or owned by a close company. The charge to tax is determined by the nature of the transfer, the relationship between the parties, and the circumstances of the individual, trust or company making the transfer.

6375

SECTION 1

Overview

A. Chargeable persons: Individuals

Individuals who are **domiciled** in the UK will be subject to IHT on any chargeable transfers, regardless of whether the property transferred is located in the UK or overseas. Non-UK domiciled individuals are only subject to IHT on property located in the UK (subject to exceptions outlined in ¶6388).

6380

s 267 IHTA 1984

MEMO POINTS The basic concept of domicile (¶4163) is **extended** for IHT purposes. An individual who is domiciled abroad will be treated as domiciled in the UK (known as **deemed domicile**) if he was:

- domiciled in the UK at any time during the 3 years immediately before that time; or
- resident (¶4154) in the UK for at least 17 out of the previous 20 tax years of assessment, ending with the year in question. The years of residency do not have to be consecutive.

This means that a non-UK domiciled resident should consider his potential liability to IHT before the end of the 16th year of UK residency, as, if he is resident in the UK at the start of the 17th year of residency, the deemed domicile rule will apply.

6382 An individual may make transfers during his lifetime and is deemed to make a transfer of all his estate on death.

Lifetime transfers are divided into those that are immediately chargeable to IHT and those that are potentially exempt. A potentially exempt transfer will only give rise to an IHT charge if the donor dies within 7 years of making the transfer.

Transfers on death arise in relation to the property in the estate of the deceased.

6384 For some IHT purposes it is necessary to consider **connected persons**, who are defined as follows:

s 270 IHTA 1984

Person	Connected with	Includes
Individual	Relatives	Siblings, parents, children, uncle, aunt, nephew or niece and the spouses of each
	Spouse	Spouse's relatives and their spouses
Trustee ¹	Settlor	Persons connected with the settlor, such as a spouse, relatives and company controlled by the settlor
Partner	Partners	Partner's spouse and partner's relatives
Company	Another company under common control Person controlling the company	
Note: 1. Trust is defined as a disposition of property, however effected, where the property is: <ul style="list-style-type: none"> – held in trust for individuals in succession, or for an individual subject to a contingency; – held by trustees to accumulate the income, or to make discretionary payments out of the trust; or – used to make an annuity payment or a similar arrangement. 		

MEMO POINTS In this Part, unless stated otherwise, references to:

- marriage, weddings and married couples include civil partnership ceremonies and civil partners;
- a spouse, husband or wife, include a civil partner;
- divorce include the dissolution of a civil partnership; and
- a widow or widower include a surviving civil partner.

Chargeable persons: Settled property

6386 Trusts are covered in detail from ¶7160 but as settled property is relevant to IHT, it is helpful to introduce some of the commonly used phrases here.

An individual is said to have an **interest in possession** in settled property if he has an immediate right to receive any income from that property, or to use or enjoy the property if he so chooses. For example, it has been held that allowing a tenant to live rent free in a property owned by a trust constituted an interest in possession. *IRC v Lloyds Private Banking Limited* [1998]. However, no interest in possession exists where a tenant can only occupy a property for such period or periods as the trustees in their absolute discretion think fit. *Judge and another, personal representatives of Walden (deceased) v HMRC* [2005]

A **reversionary interest** is a future interest under a settlement, and may be either vested or contingent. For example, a settlement may be established allowing A to live in a property until he reaches the age of 18, at which time the property reverts to B. If it reverts directly to B, the property is vested in B. If the property only reverts to B if he is married by the age of 25, it is a contingent reversionary interest.

Chargeable persons: Close companies

IHT only applies to transfers made by individuals and, in certain circumstances, by trustees. As an anti-avoidance measure, however, some transactions by **close companies** are liable to IHT, because they are treated as having been made by the individuals who are the participants in the company. This situation is covered in detail in ¶6990.

6387
s2 IHTA 1984

B. Location of property

There are no specific rules with regard to the location of property for IHT purposes, and the following general law provisions therefore apply:

6388

Property	Location
Leasehold and freehold land	The country in which it is situated
Tangible property	
Bank account	The branch at which the account is held
Goodwill	The country in which the business it relates to is carried on
Life policies	The country in which the proceeds are payable
Registered shares and securities	The country of registration unless the shares are transferable in more than one country, in which case they are located in the country in which they will be dealt with in the normal course of events
Bearer shares and securities	The country in which the certificate of title is located ¹
Debts	The country in which the debtor resides. If this does not indicate a clear country of residence, the terms of the contract may specify
Judgement debts	Where the judgement is recorded
Debt evidenced by deed	Where the deed is located
Partnership interests	The country in which the partnership business is carried on
Trust property	Follows the rules for the type of asset
1. This contrasts with the rule for capital gains tax purposes, which treats bearer shares in UK incorporated companies as situated in the UK.	

C. Timing of transfers

The timing of transfers is important because IHT is a cumulative tax and takes account of other transfers made in the 7 years immediately prior to a particular transfer.

The **general rule** is that a transfer is deemed to have taken place once the value has moved from one estate to the other, which is basically when all of the legal requirements with respect to the change of ownership have been fulfilled. For most assets, a transfer will be effected by a written assignment or a declaration of trust.

The following **exceptions** apply:

- a transfer of **shares** will only be complete when it has complied with all of the requirements of the company's Articles of Association;
- a **cheque** will only be deemed to have been transferred once it has been cleared by the paying bank *Re Owen (deceased)*; *Owen v IRC* [1949]; and
- **insurance policies** are treated as commencing once one party has notified the other party of their unconditional acceptance of an offer (or counter-offer).

6390

SECTION 2

Transfers of value

6395
s 2 IHTA 1984

IHT is charged when a chargeable transfer, including a deemed transfer, takes place. A **chargeable transfer** is defined as any transfer of value made by an individual which is not an exempt transfer. Some transactions may appear to be a transfer of value but are deemed not to be. Some transfers of value are specifically exempted, and some property is exempt from tax because it is identified as excluded property for IHT purposes. The IHT payable is calculated on the value transferred by the chargeable transfer (¶6465).

1. Transfers within the scope of IHT

Dispositions

6398
s 3 IHTA 1984

The term disposition is not specifically defined by the legislation, and therefore takes on its **general meaning** of an act of disposing, bestowing or transferring money, goods or rights in property to another person.

A disposition **results in** the value of a person's estate immediately after the disposition being less than it was before (¶6465). The fall in value is deemed to be the value transferred.

Gifts either to an individual or to a trust are the most common form of disposition for IHT purposes, but the following are also relevant:

- **sale of property at an undervalue** (e.g. a mother selling shares worth £25,000 to her son for £10,000);
- **failure to exercise** a right (such as the failure to collect a debt) which results in a fall in the value of one person's estate and an increase in another person's estate, unless the omission is shown not to be deliberate;
- a **loan** for a fixed or minimum period for inadequate consideration; or
- **alteration of share capital** in a close company (¶7000).

MEMO POINTS A **failure to exercise a right** is deemed to occur on the latest date that the right could have been exercised.

Deemed dispositions

6400

Deemed dispositions include:

- transfers on death (¶6575);
- termination of an interest in possession (¶7530); and
- transfers of value made by a close company (¶6990).

6402
s 272 IHTA 1984

Associated operations As an anti-avoidance measure, the term disposition is also **deemed to include** a disposition effected by a series of associated operations (¶6925).

s 268 IHTA 1984

Associated operations are **defined** as any multiple operations of any kind which affect the same property, or which are effected by reference to each other. Operations can be associated whether they occur at the same or different times, and whether the same or different people carry them out. An omission can be an operation for these purposes.

An **example** of associated operations would be giving away a set of four antique chairs in separate transfers to the same person. The value of an individual chair is likely to be less than one quarter of the value of a matching set, and these transfers will be treated as a single disposition.

6404
s 102 FA 1986

Gifts with reservation A further anti-avoidance principle arises where an individual makes a gift but retains some sort of interest or benefit from the property transferred. In this case the gift with reservation rules (¶6935) state that a transfer will arise on making the gift, and a further transfer will be deemed to occur when the reservation is lifted.

An **example** of a gift with reservation would be giving a house to someone else but continuing to live there.

2. Dispositions which are not transfers of value

The following dispositions (explained in further detail below) do not constitute a transfer of value for IHT purposes:

- expenditure for family maintenance;
- expenditure without gratuitous intent;
- alterations in the distribution of the estate of a deceased person;
- retirement benefits;
- waiver of remuneration;
- waiver of a dividend;
- expenditure allowable for income tax or corporation tax;
- the grant of an agricultural tenancy; or
- voidable transfers.

6406

Expenditure for family maintenance

Expenditure incurred during lifetime for the maintenance of family members does not constitute a transfer of value in any of the following circumstances:

- a.** one **party to a marriage** pays for the maintenance of the other party, whether during the marriage or on separation or divorce;
- b.** where it is incurred for the purposes of a **child's** maintenance, education or training by:
 - a party to a marriage in favour of a child of either party to the marriage;
 - any person in favour of a child not in the care of a parent; or
 - the parent of an illegitimate child in favour of that child; or
- c.** the provision of reasonable care and maintenance of a **dependent relative** of the donor.

A disposition that only **partially** satisfies the provisions outlined here will be split into exempt and non-exempt parts.

- MEMO POINTS** 1. **Child** in this case includes adopted and step-children. Expenditure relating to maintenance, education or training incurred up to 5 April following the child's 18th birthday (or after ceasing full-time education and training, if later), is not a transfer of value.
2. Where payments are made to a **child who is not cared for by a parent**, any expenditure up to the cessation of full-time education or training after the date of the child's 18th birthday will not be a transfer of value, provided the child was in the care of the donor for substantial periods.

6408

s 11 IHTA 1984

Expenditure without gratuitous intent

In order to protect a person who merely makes a bad bargain, a disposition will not constitute a transfer of value between two **unconnected persons** where there is no intent to confer a gratuitous benefit.

This will only apply to a transaction between **connected persons** if it was undertaken on a commercial arm's length basis.

These provisions will only apply to sales of **unquoted shares or securities** if it can also be shown that the price was (or was such as might have been) freely negotiated at the time of the sale.

- MEMO POINTS** **Partners in a partnership** are not connected persons for the purposes of transferring partnership assets from one partner to another, and so long as any arrangement has no gratuitous intent, no liability to IHT will arise.

EXAMPLE Mr B sells a painting valued at £20,000 to his daughter for only £15,000. The undervalue will not be liable to IHT if no gratuitous benefit was intended by him, and he would have sold the painting to a stranger for the same amount.

6410

s 10 IHTA 1984

Alterations in the distribution of the death estate

6412
s 17 IHTA 1984

Where an individual receives property under a will or intestacy he is not obliged to accept it. In the normal course of events, to refuse property would constitute a transfer of value. To correct this inequity, the following alterations in the distribution of a deceased's estate will not constitute a transfer of value (see ¶6617 onwards):

- variation or disclaimer of disposition under a will or intestacy;
- alteration on the express wishes of the testator;
- election by a surviving spouse for a redemption of a life interest; or
- renunciation of a claim under the Scottish law provisions of legitim.

Retirement benefits

6414
s 12(2) IHTA 1984

Contributions to a registered pension scheme are not a transfer of value.

For the treatment of members' rights and benefits under pension schemes, see ¶6589.

Waiver of remuneration

6416
s 14 IHTA 1984

The waiver or repayment of remuneration will not be a transfer of value if, apart from the waiver or repayment, the remuneration would have been:

- assessed as employment income of the **recipient**; and
- allowable as a deduction in computing the profits for income tax or corporation tax purposes of the **payer**.

Waiver of a dividend

6418
s 15 IHTA 1984

A transfer of value will not arise where a person waives a dividend (of any type) **within a period** of 12 months before the date on which any right to the dividend accrued. A general waiver is only effective for 12 months so this should be renewed annually.

Expenditure allowable for tax purposes

6420
s 21(1) IHTA 1984

A disposition will not constitute a transfer of value where the transferor could claim an allowable deduction for the transfer in calculating his profits for income tax or corporation tax purposes. An **ex gratia** payment that is not an allowable deduction will therefore be treated as a transfer of value.

MEMO POINTS If a payment is **partly allowable**, only the non-allowable part will be a transfer of value.

Grant of an agricultural tenancy

6422
s 16 IHTA 1984

The grant of a tenancy of agricultural property in the UK, the Channel Islands or the Isle of Man is not a transfer of value, provided that the property is used for agricultural **purposes**, and the transfer is made for full **consideration** in money or money's worth.

Voidable transfers

6424
s 16 IHTA 1984

Where a transfer has been made under duress, undue influence, or is in some other way void, a claim can be made that it should be treated for IHT purposes as if it had never taken place. For example, if an individual has granted an **enduring power of attorney** (or, from 1 October 2007, a lasting power of attorney) due to reduced mental ability, the Court of Protection will need to authorise any substantial gifts, otherwise they will be void.

3. Exempt transfers

6426

Exempt transfers are those which would normally constitute a transfer of value but which will never be chargeable to IHT because of specific statutory provisions. There are two types

of exempt transfer: those that apply only to lifetime transfers and those that **also** apply to transfers on death (§6438).

a. Lifetime transfers only

The following are exempt lifetime transfers:

- gifts covered by the annual exemption;
- small gifts;
- normal expenditure out of income; and
- gifts in consideration of marriage.

6428

Annual exemption

For any tax year the first £3,000 of lifetime transfers of value (taken in date order) are exempt from IHT. Where the annual exemption is not fully utilised in one tax year it is carried forward to the next tax year only, and if not then fully utilised, it is lost. The **current year exemption** is always used before the brought forward exemption.

6430
s19 IHTA 1984

MEMO POINTS 1. Where several transfers are **made on the same day**, the annual exemption is pro-rated based on the value of each transfer (§6538).

2. Where **many transfers** are made in the same tax year, the annual exemption will be allocated to whichever transfer is made first. This may result in a wasted exemption (§6554).

EXAMPLE Mr A made chargeable transfers of £2,000 in Year 1 and of £3,750 in Year 2.

Year 1	£
Chargeable transfer	2,000
Less: Year 1 annual exemption	<u>(2,000)</u>
	<u>Nil</u>
Annual exemption carried forward – £1,000	
Year 2	
Chargeable transfer	3,750
Less: Year 2 annual exemption, used first	(3,000)
Year 1 annual exemption brought forward (restricted)	<u>(750)</u>
	<u>Nil</u>
Annual exemption carried forward – Nil	

Small gifts

For any tax year, small gifts to a maximum of £250 **per recipient** in that tax year are exempt transfers. There is no restriction on the number of recipients. A gift in excess of £250 will not qualify for the exemption so, for example, the whole of a gift of £300 will be a chargeable transfer of value, whereas a gift of £200 will be exempt.

6432
s20 IHTA 1984

Normal expenditure out of income

A transfer of value will be an exempt transfer if:

- taking one year with another, it is made out of **after-tax income** (as opposed to capital); and
- after taking into account all transfers of value made out of normal expenditure, the donor is left with **sufficient income** to maintain his usual standard of living.

Normal expenditure for these purposes is deemed to be the typical or habitual expenditure of the donor. Examples would include regular payments such as gifts at Christmas and birthdays, or regular premium payments to an insurance policy for another person.

The first gift **in a series** may still be treated as an exempt transfer under this provision if it can be shown that there is clear evidence of an intention to make further gifts. *Bennett v IRC* [1995]

6434
s21 IHTA 1984

Gifts in consideration of marriage

6436
s 22 IHTA 1984

Whether a gift is an exempt transfer depends on the **relationship** between the donor and a party to the marriage. The following table indicates the maximum exemption available for each relationship, which applies to the total gift made to the couple rather than to each of them individually. Where the amount of the gift is more than the maximum exemption, the excess will be subject to IHT in the normal way.

The gift **should be made** before the wedding, and should be conditional on the marriage taking place.

- MEMO POINTS**
1. An exempt gift may be made **after the wedding** providing it follows a binding obligation made on or before the day of the wedding.
 2. A gift into a **marriage settlement** will still qualify under these provisions providing the only persons entitled to benefit from the settlement are the parties to the marriage, their children and the spouses of their children.

Relationship to a party to the marriage	Maximum
Parent	£5,000
Grandparent or great-grandparent	£2,500
Other party to the marriage	£2,500
Any other person	£1,000

b. Both in lifetime and on death

6438 The following transfers are exempt whether made as a result of a lifetime transfer or on death:

- gifts to spouses;
- gifts to UK charities;
- gifts to political parties;
- transfers to employee trusts;
- gifts to housing associations;
- gifts for national purposes; and
- transfers to maintenance funds for historic buildings.

All these exemptions, other than the gift to spouse, are subject to anti-avoidance provisions (§6454) which apply when the transfers are not true gifts.

Gifts to spouse

6440
s 18 IHTA 1984

Any transfer of value made to a spouse, whether during the lifetime of the transferor or on death, is an exempt transfer. The only exception to this rule is where the recipient spouse is **domiciled** overseas. In this case only the first \$55,000 of transfers from a UK domiciled spouse will be exempt. The exemption is a cumulative amount, covering transfers made during lifetime and on death.

Before 22 March 2006, all transfers to **trusts** in which the spouse had an interest in possession qualified for this exemption. Transfers made on or after 22 March 2006 only qualify for the exemption where the trust is created on death, and the spouse has an immediate post-death interest (§7178).

Where a person who was beneficially entitled to an interest in possession before 22 March 2006 dies, and a surviving spouse becomes entitled to a transitional serial interest (§7178), the spouse exemption will apply on the death.

s 49D IHTA 1984

- MEMO POINTS** A **common law** husband or wife does not qualify as a spouse for these purposes. *Holland (Holland's Executor) v IRC* [2003]

Gifts to UK charities

A gift to charity is an exempt transfer providing the **property transferred** becomes the property of the charity, or is held on trust for charitable purposes. A charity is defined using the standard income tax definition of any body of persons or trust established for charitable purposes only.

Charities **registered abroad** are excluded for these purposes, although UK charities carrying on relief abroad are still eligible for the exemption. *Camille and Henry Dreyfus Foundation Inc v IRC* [1956]

6442

s 23 IHTA 1984
s 519(1) ITA 2007
s 506(1) ICTA 1988

CHAPTER 2

Taxation of estates

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SECTION 1

General principles

7210 On the death of an individual, the property in his estate does not pass directly to the legatees or under the rules of intestacy. Instead, the property vests in the personal representatives who are responsible for collecting the property, settling any outstanding liabilities or obligations, and then distributing the residue.

A distinction can therefore be drawn between an estate in the course of administration and a will trust. The former relates to the period of time between the death of an individual and the completion of the administration of the estate. The latter relates to a trust created by the will of the deceased or through the rules of intestacy.

7212 The personal representatives are responsible for the tax liabilities arising before the death of the deceased that have not yet been settled, and for those associated with the estate while it is in administration. The remainder of this chapter deals with the income tax and capital gains tax liabilities of the personal representatives. The inheritance tax implications are covered from ¶6575.

Personal representatives

7214
s 989 ITA 2007

A personal representative is **defined** for income tax purposes as someone who is responsible for administering the death estate, whether in the UK or elsewhere.

There will often be more than one personal representative, but they are treated as a single taxpayer for tax purposes.

s 151 FA 1989

MEMO POINTS

1. A **valid will** usually appoints executors to act as personal representatives and to obtain a grant of probate and administer the estate in accordance with the terms of the will. If the will does not appoint an executor (or appoints an executor who does not obtain a grant of probate), the court will appoint an administrator who will act as personal representative and administer the estate in accordance with the terms of the will.
2. If there is **no valid will**, the personal representative will be an administrator appointed by the court to administer the estate in accordance with the rules of intestacy.

Residence status The residence status of the personal representatives is relevant in determining the liability to **income tax**.

7216

Residency of personal representatives	Status of deceased	Residency of estate
All UK resident or ordinarily resident	n/a	UK resident
All non-resident and not ordinarily resident	n/a	Non-resident ¹
At least one is UK resident, and another is non-resident	Either UK resident, or ordinarily resident, or UK domiciled	UK resident
	Non-resident, not ordinarily resident, and not UK domiciled	Non-resident ¹
Note: 1. Only taxable on UK source income.		

s 834 ITA 2007

For **capital gains tax purposes**, the personal representatives are treated as having the same residence, ordinary residence and domicile as the deceased at the time of the death.

7217

s 62(3) TOGA 1992

If a deceased person was not resident and not ordinarily resident in the UK at the date of death, the personal representatives will only be liable to CGT where any of the following apply:

- a. the deceased had an unpaid CGT liability; or
- b. the deceased was carrying on a trade, profession or vocation in the UK through a branch or agency, and:
 - there are related unpaid CGT liabilities; or
 - the personal representatives carry it on.

The **remittance basis** (£4200 onwards) is not available to personal representatives.

SECTION 2**Income tax**

An income tax charge in relation to estates may arise in a number of different situations:

7220

- personal representatives may be liable in respect of income payable in the period before death and during the administration of the estate;
- beneficiaries may be liable where payments of income are made out of the estate; or
- a charge may arise where a payment is made out of a foreign estate to a UK resident beneficiary.

A. Personal representatives

The income tax liability of the personal representatives in respect of the estate can be divided into the following:

7222

- the tax liability of the deceased; and
- tax on any income of the estate arising during the period of administration.

The distinction between the income of the deceased and that of the personal representatives is important because the personal representatives are not entitled to a personal allowance, whereas in the year of death a full personal allowance is available to the deceased, if he would have been entitled to one while alive (¶4392).

Deceased's tax liability

7224
s 74 TMA 1970

The personal representatives will be **liable for** payment of the final tax liability of the deceased up to the date of death, and for any unassessed income tax relating to any income of the deceased arising prior to the date of death.

A tax return (¶4476) must be prepared and submitted for the period from 6 April prior to death up to the date of death. The personal representatives may also need to complete earlier outstanding tax returns.

Income receivable before the date of death will be included in the final income tax computation of the deceased, regardless of whether it was actually received by that date. Income receivable after the date of death will be taxable on the personal representatives even if it relates to the period before death.

MEMO POINTS 1. Where the deceased's **tax liability** for earlier years is **adjusted** following death (for example, as a result of the cessation rules for trading profits (¶2452)), the relevant assessment must be issued within 3 years after the end of the year of assessment in which the death occurred. 2. A **dividend** which is declared due before death, but paid after death, will be included as income of the deceased. *Re Sebright* [1944]

EXAMPLE Mr A died on 1 June 2009. Among his sources of income were two bank accounts which paid interest as follows:

Account	Amount (£)	Due date	Received	Relating to
B	1,000	25 May 2009	15 June 2009	6 months ended 30 April 2009
C	2,000	1 July 2009	1 July 2009	12 months ended 31 May 2009

The income from Account B will be included in Mr A's final tax bill because it was receivable before the date of death. The income from Account C will be included in the liability of the personal representatives because it was receivable after the date of death.

7226

The personal representatives will also be responsible for **discharging** any associated interest and penalties. Tax may be discharged out of the assets of the estate, and the liability of the personal representatives is therefore limited to that amount.

ESCA17

By concession, where the taxpayer dies before the due date for the payment of tax, and the personal representatives are unable to settle the liability until the **grant of probate** or letters of administration, the due date for payment may be extended to 30 days after the date of the grant.

MEMO POINTS Income tax is a debt of the death estate and so reduces the amount liable to **inheritance tax** (¶6594).

During the administration of the estate

7228
s 653 ITTOIA 2007

Income arising during the administration period (which runs from the date of death to the date when the administration of the estate is complete) is deemed to be the income of the estate, and the personal representatives are therefore liable to account for income tax on it.

MEMO POINTS The date of the **completion of administration** is not defined by statute, but can be taken to be the date when the residue left in the estate has been ascertained and is ready for distribution.

7230

Deductions The **individual circumstances** of the personal representatives are not taken into account in the calculation of income tax of the estate.

Personal representatives may, however, claim **relief for** interest payments (other than interest charges in respect of unpaid inheritance tax) and for trading losses incurred by them in running a business.

Relief may also be claimed if the personal representatives take out a **loan to pay an inheritance tax liability** (not a bank overdraft) providing the liability is payable before the grant of representation. To qualify for relief the interest must have arisen within 1 year of the date on which the loan was made. If the income in the year in which the interest is paid is not sufficient to use the relief, the excess may be carried back to previous years and then, if insufficient relief is given, against income of the following years, however, relief is only given against one loan. If it is necessary to borrow further money for the inheritance tax liability, that loan will not be eligible for relief.

7231
ss 403–405
ITA 2007

Tax rates Personal representatives pay income tax at the following rates:

7232

Type of income	Rate of tax
Savings and other income ¹	20%
Dividends	10%
Note: 1. Savings income includes life policy gains (¶4066).	

EXAMPLE Mr A died on 1 September 2009 and the administration of his estate was completed on 20 August 2010. During the course of the administration of the estate the personal representatives received the following income:

	Gross (£)	Tax deducted (£)	Net (£)
Income from property	16,000	-	16,000
Bank interest	10,000	2,000	8,000
Dividends	20,000	2,000	18,000

The personal representatives paid tax on the income as follows:

	Non-savings £	Savings £	Dividends £
Income from property	16,000		
Bank interest		10,000	
Dividends			20,000
	<u>16,000</u>	<u>10,000</u>	<u>20,000</u>
Tax thereon:			
16,000 @ 20%	3,200		
10,000 @ 20%		2,000	
20,000 @ 10%			2,000
Less: Tax deducted at source		<u>(2,000)</u>	<u>(2,000)</u>
Net tax liability	<u>3,200</u>	<u>Nil</u>	<u>Nil</u>

B. Payments to beneficiaries

The income from the estate will retain its identity in the hands of the beneficiary and will be taxed at the rate applicable for that source.

7234
s 700(5) ICTA 1988

Payments made to beneficiaries during the administration of the estate are generally detailed in form R185 (Estate Income) issued by the personal representatives. This outlines the income and the tax treated as paid on it, which the beneficiary may use as a credit against his own tax liability. He may claim a repayment of any tax overpaid, although not in respect of the tax credits on dividends.

MEMO POINTS A beneficiary who is **not resident or ordinarily resident** in the UK (¶4152) may claim to have his tax liability adjusted to reflect the following:

- entitlement to the personal allowance;
- relief under a double taxation agreement; and
- exemption in respect of UK government securities.

Tax deducted at source

7235
s 663 ITTOIA 2005

Each source of income will be **grossed up** at basic or dividend ordinary rate as appropriate. Payments are deemed to be made out of income taxable at the basic rate and then dividend ordinary rate.

s 664 ITTOIA 2005

- MEMO POINTS**
1. The personal representatives deduct administration **expenses**, leaving a net amount available for distribution to the beneficiaries. Ideally expenses should be set against dividend income as a priority, as the associated tax credit is not repayable.
 2. The **rate** used is the one applying to the year of assessment in which the payment was made.
 3. An **annuity** may be provided for in a will, and is defined as a pecuniary legacy payable in instalments (¶7296). The personal representatives must deduct tax at basic rate, and will provide the annuitant with a form R185 showing the amount of tax deducted.

Timing of payments

7236

The property in an estate does not belong to the beneficiaries until such time as the administration is complete. The beneficiaries will not therefore be liable to income tax while the property remains in the estate.

Income distributed during the administration period will be treated as the beneficiary's income, as will payments made to the beneficiary once the administration of the estate is complete.

Type of interest in the estate

7238

The treatment of sums paid to beneficiaries during the administration of an estate will depend on whether the beneficiary has a limited or absolute interest in the estate.

Type of interest	Description	¶¶
Limited	Entitles the beneficiary to a right to income once the administration of the estate is complete (e.g. a life tenant or immediate post-death interest).	¶7240
Absolute	Once the administration of the estate is complete, the beneficiary will be entitled to both the income and capital in his own right.	¶7242

7240
s 661 ITTOIA 2005

Limited interest Payments made to a beneficiary with a limited interest will be **treated as** income of that beneficiary for the tax year in which the payment is made.

Amounts that remain payable to the beneficiary once the administration has been completed are treated as received in the year that the completion occurred. The exception to this rule is where the limited interest **ceased** before the completion of the administration, because of the death of the beneficiary, for example. In this case the income is treated as received by the beneficiary in the year of death.

7242
ss 660, 665
ITTOIA 2005

Absolute interest Payments made to a beneficiary with an absolute interest will be treated as income for the tax year in which the payment is made. The amount treated as income will, however, be **limited to** the extent of the beneficiary's entitlement to the residuary income in each tax year, up to and including the year of payment. Any excess over the entitlement to residuary income will be treated as a payment of capital.

Where there are **excess estate expenses** compared to the residuary income, these are carried forward and deducted against the income of the following year.

s 666 ITTOIA 2005

- MEMO POINTS**
1. **Residuary income** for these purposes is defined as the aggregate of estate income excluding specific dispositions and contingent distributions, less interest (other than interest on late inheritance tax) which is charged on the residue.
 2. When the **administration of the estate ends**, any unrelieved expenses will be set against any remaining income which has not yet been paid out.

EXAMPLE Mr A died on 1 January 2006 leaving his estate to his son, Mr B, absolutely. The actual income of the estate was as follows:

	2006/07	2007/08	2008/09	2009/10
	£	£	£	£
Rental income (gross)	6,500	8,500	9,500	3,000
Other savings (gross)	4,375	4,750	5,000	2,500
	<u>10,875</u>	<u>13,250</u>	<u>14,500</u>	<u>5,500</u>

The savings income includes the tax deducted at source. Rental income will be taxed at basic rate. The administration of the estate was completed on 1 June 2009.

The following payments were made out of the estate:

1 March 2007	£3,000
1 June 2007	£17,000
1 October 2008	£12,000

Year	Gross income	Tax	Net	Aggregated income entitlement	Payments to Mr B	Mr B's income ^{1,2,3}
	£	£	£	£	£	£
2006/07	10,875	2,305	8,570	8,570	3,000	3,000
2007/08	13,250	2,820	10,430	19,000	17,000	16,000
2008/09	14,500	2,900	11,600	30,600	12,000	11,600
2009/10	5,500	1,100	4,400	35,000	Nil	4,400

Note: 1. The amount deemed to be the income of Mr B in 2007/08 is restricted to the aggregate income entitlement for that year (£19,000) less the amount paid to him in 2006/07 (£3,000).

2. Similarly, the deemed income in 2008/09 is restricted to £30,600 less (£3,000 + £16,000).

3. The deemed income when the administration of the estate is complete in 2009/10 is the difference between the final aggregate income entitlement (£35,000) and the total of the amounts treated as Mr B's income to date (£3,000 + £16,000 + £11,600).

Where the **income accrued** before death is included in the value of the estate for inheritance tax purposes, relief is available to the holder of an absolute interest to prevent the inclusion of the same income in the residuary estate for income tax purposes.

The relief is given by:

- calculating the tax on the net accrued income using the average rate of inheritance tax on the estate as a whole;
- grossing up the tax on the net accrued income at the rate applicable to the accrued income i.e. basic rate, savings rate or dividend rate; and
- reducing the residuary income by the result.

EXAMPLE Mr A died in 2009/10 at which time his estate had residuary income of £50,000, of which £15,000 related to accrued income at the date of death. The average rate of inheritance tax applicable to the estate is 25%. Mr B is the sole beneficiary of the estate. For higher rate tax purposes, the income assessable on Mr B will be:

	£
Accrued income	15,000
Less: Basic rate tax @ 20%	<u>(3,000)</u>
Net accrued income	<u>12,000</u>
Inheritance tax on accrued income (12,000 @ 25%)	<u>3,000</u>
Inheritance tax on accrued income grossed up at basic rate (3,000 × 100/80)	<u>3,750</u>
Residuary income	50,000
Less: Relief for Inheritance tax paid	<u>(3,750)</u>
Residuary income taxable at higher rate (40%)	<u>46,250</u>

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NIC thresholds and rates

9976

Class of NIC	Threshold	2009/10	2008/09	2007/08	2006/07	2005/06	2004/05
1	Lower earnings limit	£95 per week	£90 per week	£87 per week	£84 per week	£82 per week	£79 per week
	Earnings threshold	£110 per week	£105 per week	£100 per week	£97 per week	£94 per week	£91 per week
	Upper earnings limit	£844 per week	£770 per week	£670 per week	£645 per week	£630 per week	£610 per week
	Employee's rate between employee's earnings threshold and upper earnings limits ¹	11%	11%	11%	11%	11%	11%
	Employee's rate above the upper earnings limit	1%	1%	1%	1%	1%	1%
	Employer's rate (on all earnings, including those above the upper earnings limit) ¹	12.8%	12.8%	12.8%	12.8%	12.8%	12.8%
1A and 1B	Rate	12.8%	12.8%	12.8%	12.8%	12.8%	12.8%
2	Standard rate ²	£2.40 per week	£2.30 per week	£2.20 per week	£2.10 per week	£2.10 per week	£2.05 per week
	Small earnings exception	£5,075 per year	£4,825 per year	£4,635 per year	£4,465 per year	£4,345 per year	£4,215 per year
3	Rate	£12.05 per week	£8.10 per week	£7.80 per week	£7.55 per week	£7.35 per week	£7.15 per week
4	Lower profits limit	£5,715 per year	£5,435 per year	£5,225 per year	£5,035 per year	£4,895 per year	£4,745 per year
	Upper profits limit	£43,875 per year	£40,040 per year	£34,840 per year	£33,540 per year	£32,760 per year	£31,720 per year
	Rate between lower and upper profits limits	8%	8%	8%	8%	8%	8%
	Rate above upper profits limits	1%	1%	1%	1%	1%	1%
Note:							
1. For the rates which apply when the employer's occupational pension scheme has contracted out see ¶5035.							
2. For the rates which apply to share fishermen and volunteer development workers , see ¶5152.							

Capital gains tax thresholds and rates

9978

Tax year	Annual exempt amount		Chattel exemption (max sale proceeds) ¹	Rate	
	Individuals, personal representatives ² , trusts for mentally disabled ³	Other trusts ³		Individuals ⁴	Trustees and personal representatives ⁵
	£	£	£	%	%
2009/10	10,100	5,050	6,000	18	18
2008/09	9,600	4,800	6,000	18	18
2007/08	9,200	4,600	6,000	10/20/40	40
2006/07	8,800	4,400	6,000	10/20/40	40
2005/06	8,500	4,250	6,000	10/20/40	40
2004/05	8,200	4,100	6,000	10/20/40	40
2003/04	7,900	3,950	6,000	10/20/40	34

Note:

- Where disposal proceeds exceed the exemption limit, marginal relief restricts any chargeable gain to 5/3 of the excess. Where there is a loss and the proceeds are less than £6,000, the proceeds are deemed to be £6,000.
- For year of death and next 2 years.
- If multiple trusts are created by the same settlor, each attracts relief equal to the annual amount divided by the number of such trusts (subject to a minimum of 10% of the full annual amount).
- Prior to 6 April 2008, gains were taxed as the top slice of income, 10% to starting rate limit, 20% to basic rate limit, and 40% above, subject to tapering in certain cases (¶5386+). From 6 April 2008, taper relief has been abolished and CGT is charged at 18% on all chargeable gains after reliefs and exemptions.
- Applicable to trustees of discretionary trusts and subject to an election by a vulnerable beneficiary (¶7388).

Retail prices index

9979

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
1965	14.47	14.47	14.52	14.80	14.85	14.90	14.90	14.93	14.93	14.96	15.01	15.08
1966	15.11	15.11	15.13	15.34	15.44	15.49	15.41	15.51	15.49	15.51	15.61	15.64
1967	15.67	15.67	15.67	15.79	15.79	15.84	15.74	15.72	15.69	15.86	15.92	16.02
1968	16.07	16.15	16.20	16.50	16.50	16.58	16.58	16.60	16.63	16.70	16.76	16.96
1969	17.06	17.16	17.21	17.41	17.39	17.47	17.47	17.41	17.47	17.59	17.64	17.77
1970	17.90	18.00	18.10	18.38	18.43	18.48	18.63	18.61	18.71	18.91	19.04	19.16
1971	19.42	19.54	19.70	20.13	20.25	20.38	20.51	20.53	20.56	20.66	20.79	20.89
1972	21.01	21.12	21.19	21.39	21.50	21.62	21.70	21.88	22.00	22.31	22.38	22.48
1973	22.64	22.79	22.92	23.35	23.52	23.65	23.75	23.83	24.03	24.51	24.69	24.87
1974	25.35	25.78	26.01	26.89	27.28	27.55	27.81	27.83	28.14	28.69	29.20	29.63
1975	30.39	30.90	31.51	32.72	34.09	34.75	35.11	35.31	35.61	36.12	36.55	37.01
1976	37.49	37.97	38.17	38.91	39.34	39.54	39.62	40.18	40.71	41.44	42.03	42.59
1977	43.70	44.24	44.56	45.70	46.06	46.54	46.59	46.82	47.07	47.28	47.50	47.76
1978	48.04	48.31	48.62	49.33	49.61	49.99	50.22	50.54	50.75	50.98	51.33	51.76
1979	52.52	52.95	53.38	54.30	54.73	55.67	58.07	58.53	59.11	59.72	60.25	60.68
1980	62.18	63.07	63.93	66.11	66.72	67.35	67.91	68.06	68.49	68.92	69.48	69.86
1981	70.29	70.93	71.99	74.07	74.55	74.98	75.31	75.87	76.30	76.98	77.78	78.28
1982	78.73	78.76	79.44	81.04	81.62	81.85	81.88	81.90	81.85	82.26	82.66	82.51
1983	82.61	82.97	83.12	84.28	84.64	84.84	85.30	85.68	86.06	86.36	86.67	86.89
1984	86.84	87.20	87.48	88.64	88.97	89.20	89.10	89.94	90.11	90.67	90.95	90.87

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
1985	91.20	91.94	92.80	94.78	95.21	95.41	95.23	95.49	95.44	95.59	95.92	96.05
1986	96.25	96.60	96.73	97.67	97.85	97.79	97.52	97.82	98.30	98.45	99.29	99.62
1987	100.00	100.40	100.60	101.80	101.90	101.90	101.80	102.10	102.40	102.90	103.40	103.30
1988	103.30	103.70	104.10	105.80	106.20	106.60	106.70	107.90	108.40	109.50	110.00	110.30
1989	111.00	111.80	112.30	114.30	115.00	115.40	115.50	115.80	116.60	117.50	118.50	118.80
1990	119.50	120.20	121.40	125.10	126.20	126.70	126.80	128.10	129.30	130.30	130.00	129.90
1991	130.20	130.90	131.40	133.10	133.50	134.10	133.80	134.10	134.60	135.10	135.60	135.70
1992	135.60	136.30	136.70	138.80	139.30	139.30	138.80	138.90	139.40	139.90	139.70	139.20
1993	137.90	138.80	139.30	140.60	141.10	141.00	140.70	141.30	141.90	141.80	141.60	141.90
1994	141.30	142.10	142.50	144.20	144.70	144.70	144.00	144.70	145.00	145.20	145.30	146.00
1995	146.00	146.90	147.50	149.00	149.60	149.80	149.10	149.90	150.60	149.80	149.80	150.70
1996	150.20	150.90	151.50	152.60	152.90	153.00	152.40	153.10	153.80	153.80	153.90	154.40
1997	154.40	155.00	155.40	156.30	156.90	157.50	157.50	158.50	159.30	159.50	159.60	160.00
1998	159.50	160.30	160.80	162.60	163.50	163.40	163.00	163.70	164.40	164.50	164.40	164.40
1999	163.40	163.70	164.10	165.20	165.60	165.60	165.10	165.50	166.20	166.50	166.70	167.30
2000	166.60	167.50	168.40	170.10	170.70	171.10	170.50	170.50	171.70	171.60	172.10	172.20
2001	171.10	172.00	172.20	173.10	174.20	174.40	173.30	174.00	174.60	174.30	173.60	173.40
2002	173.30	173.80	174.50	175.70	176.20	176.20	175.90	176.40	177.60	177.90	178.20	178.50
2003	178.40	179.30	179.90	181.20	181.50	181.30	181.30	181.60	182.50	182.60	182.70	183.50
2004	183.10	183.80	184.60	185.70	186.50	186.80	186.80	187.40	188.10	188.60	189.00	189.90
2005	188.90	189.60	190.50	191.60	192.00	192.20	192.20	192.60	193.10	193.30	193.60	194.10
2006	193.40	194.20	195.00	196.50	197.70	198.50	198.50	199.20	200.10	200.40	201.10	202.70
2007	201.60	203.10	204.40	205.40	206.20	207.30	206.10	207.30	208.00	208.90	209.70	210.90
2008	209.8	211.40	212.10	214.00	215.10	216.80	216.50	218.40	217.20	217.70	216.00	212.90
2009	210.10	211.40	211.30	211.50	212.80	213.40	213.40					