

EXPLANATORY NOTE

CLAUSE 8: CHARGE AND RATES FOR 2005-06

SUMMARY

1. Clause 8 imposes the income tax charge for 2005-06, and sets the starting, basic, and higher rates of tax at 10 per cent, 22 per cent, and 40 per cent respectively.

DETAILS OF THE CLAUSE

2. Clause 8 sets the rates of income tax for 2005-06.
3. Subsection (a) sets the starting rate of income tax at 10 per cent.
4. Subsection (b) sets the basic rate of income tax at 22 per cent.
5. Subsection (c) sets the higher rate of income tax at 40 per cent.

BACKGROUND NOTE

6. Income tax must be re-imposed annually by Parliament (even if the proposed rates are the same as the previous year). The table below sets out the rates and income bands for 2004-05 and the proposed rates and bands for 2005-06.

	<u>2004-05</u>	<u>2005-06</u>
Starting rate (at 10 per cent)	£0-£2,020	£0-£2,090
Basic rate (at 22 per cent)	£2,021-£31,400	£2,091-£32,400
Higher rate (at 40 per cent)	Over £31,400	Over £32,400

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7. The rate of tax on savings income over the starting rate limit but below the basic rate limit remains at the lower rate of 20 per cent. Dividends are taxed at 10 per cent up to the basic rate limit and at 32.5 per cent above that limit.

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**CLAUSE 9: INCOME TAX - PERSONAL ALLOWANCES
FOR THOSE AGED 65 OR MORE**

SUMMARY

1. Clause 9 determines the personal allowances for those aged 65 or over for the year 2005-06. The personal allowance for those aged 65 or over but under 75 will be set at £7,090 and the personal allowance for those aged 75 or over will be set at £7,220.

DETAILS OF THE CLAUSE

2. Subsection (1)(a) specifies the personal allowance for those aged 65 or over but under 75 (section 257(2) ICTA 1988) for the year 2005-06 to the amount of £7,090.
3. Subsection (1)(b) specifies the personal allowance for those aged 75 or over (section 257(3) ICTA 1988) for the year 2005-06 to the amount of £7,220.
4. Subsection (2) disapplies statutory indexation, which would otherwise have increased both personal allowances in line with the increase in the retail prices index in the year to September 2004.

BACKGROUND NOTES

5. The personal allowance is the amount of income that an individual can have before they are required to pay tax. This clause sets the personal allowance for those aged 65 or over but under 75 to £7,090 and the personal allowance for those aged 75 or over to £7,220 for 2005-06.
6. Unless parliament otherwise determines, section 257C(1) of ICTA increases the personal allowances and married couples allowances

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in line with the increase in the retail prices index in the year to September. Consequently subsection (2) of clause 9 overrides this section for 2005-06 in relation to the personal allowances for those aged 65 or over.

EXPLANATORY NOTE

**CLAUSE 10: CORPORATION TAX - CHARGE AND MAIN
RATE FOR FINANCIAL YEAR 2006**

SUMMARY

1. Clause 10 charges corporation tax for the financial year beginning 1 April 2006 and sets the main rate at 30 per cent (no change from the previous year).

BACKGROUND NOTES

2. The main rate of corporation tax is paid by companies with profits of more than £1,500,000 (the upper profits limit).
3. Where two or more companies are associated with one another, the profits limit is reduced. This is done by dividing the limit by the number of associated companies. So, if a company has two associated companies (i.e. there are three associated companies in total), the limit becomes £500,000 (£1,500,000 divided by three) and any of the associated companies with profits above this level is liable at the main rate.
4. Around 45,000 companies are expected to pay corporation tax at the main rate in 2005-06. They are estimated to make up around 3.6 per cent of all active companies, but contribute around 84 per cent of the total corporation tax yield.

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**CLAUSE 11: CORPORATION TAX - SMALL COMPANIES'
RATE AND FRACTION FOR FINANCIAL YEAR 2005**

SUMMARY

1. Clause 11 provides for the small companies' rate of corporation tax for the financial year beginning 1 April 2005 to be 19 per cent, and for the fraction used in calculating marginal relief from the main rate to be eleven four-hundredths.

BACKGROUND NOTES

2. The small companies' rate is kept at 19 per cent. Companies with profits between £50,000 and £300,000 pay at this rate.
3. Companies with profits between £300,000 and £1,500,000 (the lower and upper profits limits) benefit from marginal relief from the main rate.
4. Marginal relief has the effect of gradually increasing the rate of tax for a company as its profits move from the lower to the upper profits limit.
5. The example below illustrates the effect of marginal relief for a company with taxable profits of £500,000. Its tax liability is calculated as follows:

£500,000 @ 30%	£150,000
minus 11/400 of £1,000,000*	£27,500
Tax payable:	£122,500

* £1,000,000 is the difference between the profit and the upper limit

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6. Where two or more companies are associated with one another, the profits limits for the small companies' rate are divided by the number of associated companies.
7. Around 170,000 companies are expected to pay corporation tax at the small companies' rate in 2005-06, with about a further 25,000 benefiting from marginal relief.

EXPLANATORY NOTE

**CLAUSE 12: CORPORATION TAX STARTING RATE AND
FRACTION FOR FINANCIAL YEAR 2005**

SUMMARY

1. Clause 12 provides for the starting rate of corporation tax for the financial year beginning 1 April 2005 to be 0 per cent, and for the fraction used in calculating marginal relief from the small companies' rate to be nineteen four-hundredths.

BACKGROUND NOTES

2. The starting rate of corporation tax is kept at 0 per cent. This applies to companies with profits up to £10,000.
3. Companies with profits between £10,000 and £50,000 (the first and second relevant amounts) benefit from marginal relief from the small companies' rate.
4. Marginal relief has the effect of gradually increasing the rate of tax for a company as its profits move from the first relevant amount to the second relevant amount.
5. The example below illustrates the effect of marginal relief for a company with taxable profits of £20,000. Its tax liability is calculated as follows:

£20,000 @ 19%	£3,800
minus 19/400 of £30,000*	£1,425
Tax payable:	£2,375

* £30,000 is the difference between the profit and the second relevant amount

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6. Where two or more companies are associated with one another, the profits limits for the small companies' rate are divided by the number of associated companies.
7. Around 310,000 companies and unincorporated associations are expected to take advantage of the starting rate in 2005-06, and so will have no corporation tax to pay on retained profits. A further 250,000 companies are expected to benefit from marginal relief from the small companies' rate on retained profits.
8. However, around 350,000 of these companies are also expected to be subject to the non-corporate distribution rate (see clause 13).

EXPLANATORY NOTE

**CLAUSE 13: THE NON-CORPORATE DISTRIBUTION
RATE FOR FINANCIAL YEAR 2005**

SUMMARY

1. Clause 13 provides for the non-corporate distribution rate of corporation tax for the financial year beginning 1 April 2005 to be 19 per cent.

BACKGROUND NOTES

2. The non-corporate distribution rate is a minimum rate of corporation tax. It affects companies that are otherwise liable to corporation tax at a rate that is less than the non-corporate distribution rate.
3. It is applied to at least part of a company's profits for an accounting period where distributions are made to persons other than companies on or after 1 April 2004.
4. The payment of distributions to other companies does not attract the non-corporate distribution rate.
5. If there are no profits in the accounting period in question then the non-corporate distribution rate is not charged even where profits are distributed from reserves.
6. Where distributions exceed the profits for the period, the excess is carried forward for allocation against future profits or, if the company is part of a group, is allocated to group members
7. Around 350,000 companies and unincorporated associations are expected to pay the non-corporate distribution rate in 2005-06.

However, they can still benefit from the lower rates of corporation tax on retained profits.

8. The operation of the non-corporate distribution rate is demonstrated in the following example:

Assume the profits for an accounting period are £20,000 and a dividend of £15,000 is paid to individuals.

The underlying rate of corporation tax on profits of £20,000 = 11.88 per cent¹.

The non-corporate distribution rate of 19 per cent is greater than 11.88 per cent and so the non-corporate distribution rate applies to profits of £15,000 (the amount of the distributed profits).

Amount of corporation tax due

Non-corporate distribution rate	£15,000 x 19%	= £2,850
Corporation tax on retained profits	£5,000 x 11.88%	= £ 594
Total corporation tax due		= £3,444

¹ The underlying rate of tax is determined as follows:

Profits chargeable to corporation tax:	£20,000 @ 19 per cent	= £3,800
Less: Marginal relief	(£50,000 – 20,000) x 19/400	= (£1,475)
Corporation tax due on profits (if retained)		= £2,375
Underlying rate of corporation tax	£2,375/£20,000	= 11.88%

EXPLANATORY NOTE

CLAUSE 14: SPECIAL TRUST RATES NOT TO APPLY TO FIRST SLICE OF TRUST INCOME

SUMMARY

1. Clause 14 provides for the first £500 of income arising to a trust that is chargeable at the special trust tax rates to be charged, instead, at the appropriate basic, lower or dividend ordinary rate, depending on the type of income. This change takes effect from 6 April 2005.

DETAILS OF THE CLAUSE

2. Subsection (1) of Clause 14 inserts a new section 686D into the Taxes Acts.

Section 686D ICTA 1988

- Subsection (1) sets out what type of income the new legislation will apply to – that is, income charged to trustees in the relevant tax year which is subject to a special trust tax rate (“the special trust tax rate income”).
- Subsection (2) defines what income is included in “income subject to a special trust tax rate”.
- Subsection (3) provides that the first £500 of income that would otherwise be charged at the ‘special trust tax rate’ should, instead, be charged at the appropriate income tax rate, depending on the nature of the income.
- Subsection (4) sets out what effect subsections (5)-(8) have. They determine what deemed income (for tax purposes) should fall within the £500 limit set out in subsection (3) and at what rate this income should be charged.

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- Subsection (5) sets out that, if any of the special trust tax rate income is already chargeable in the trustees' hands at the basic, lower or dividend ordinary rate, this income should be disregarded for the purposes of subsection (4).
 - Subsection (6) sets out what types of deemed income (for tax purposes) should be charged at the dividend ordinary rate. These are receipts from distributions when a company purchases its own shares and stock dividends from UK resident companies.
 - Subsection (7) sets out what types of deemed income (for tax purposes) should be charged at the basic rate. These are profits or gains from disposals of interests in certain offshore funds, certain deemed income receipts of trustees of employee share ownership trusts, and guaranteed returns on disposals of futures or options.
 - Subsection (8) sets out what types of deemed income (for tax purposes) should be charged at the lower rate. These are accrued income scheme receipts, profits from deeply discounted securities and gains from contracts for life assurance.
3. Subsection (2) of Clause 14 amends subsection (1) of section 686 ICTA 88, to include a reference to the new section 686D.
 4. Subsection (3) of Clause 14 amends subsection (3) of section 687 ICTA 88 to allow the reduced amount of tax paid by trustees under the new subsection 686D (3) to be set against tax to be paid by the trustees as a result of discretionary payments to beneficiaries by trustees.
 5. Subsection (4) of Clause 14 inserts a new subsection (3A) into section 687 ICTA 88 to prevent paragraphs (a1) to (bc) of subsection (3) from applying to income charged to tax under the new section 686D (3).
 6. Subsection (5) of Clause 14 provides that the changes will take effect for the tax year 2005-06 and for subsequent years.

BACKGROUND NOTES

7. The rate applicable to trusts (currently 40%) and the Schedule F trust rate (currently 32.5%) are the rates of tax which apply to

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various trusts and estates. In particular the rate applicable to trusts applies to:

- the income (apart from dividend type income) of discretionary and accumulation trusts,
- some special receipts received by all trusts,
- chargeable gains accruing to the trustees of trusts, and
- chargeable gains accruing to the personal representatives of deceased persons.

8. The dividend trust rate applies to:

- the dividend income of discretionary and accumulation trusts, and
- some dividend type income received by all trusts,

9. Dividend-type income is defined at section 686(5A) ICTA88 and is mainly company dividends and other distributions including share buy-backs.

10. Under Clause 14 the first £500 of relevant income will not be charged at the special trust tax rates, but will instead be charged at the income tax rate appropriate to the type of income. Additionally, if payments are received net of tax (for example, building society interest) up to the limit of the standard rate band, then the trustees will have no further tax to pay.

Example

Trust 'Y' receives income of £700, made up of the following –

- A - £150 income from property
- B - £250¹ savings income from building society account
- C - £300² dividend income.

This would all normally be chargeable at the special trust tax rates so, as a result of this Clause will be taxed as follows –

A - £150 taxed at basic rate (22%) =	£33
B - £250 taxed at lower rate (20%) =	£50
C - £100 ³ taxed at dividend ordinary rate (10%) =	£10

¹ £200 after deduction of £50 at source

² actual receipt of £273 with a £27 non-payable tax credit

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C - £200 taxed at Schedule F trust rate (32.5%)	=	£65
Total tax paid	=	£158 ⁴

Previously this would have been –

A/B - £400 at rate applicable to trusts (40%)	=	£160
C - £300 at Schedule F trust rate (32.5%)	=	£97.5
Total tax paid	=	£257.5 ⁵

Costs

This measure will cost around £5 million.

³ £100 charged at dividend ordinary rate (10%) to reach total of £500 within standard rate band. This leaves £200 at Schedule F trust rate (32.5%)

⁴ with credits of £50 (for tax deducted at source) and £27 (non-payable credit on the dividends), leaving £81 to pay.

⁵ with the same credits as above, leaving £180.50 to pay.