

- a. Section 118ZE(1) sets out that interest relievable under section 353 ICTA or losses that can be claimed under section 380 or 381 ICTA are subject to the new rules in a qualifying year of assessment (defined in section 118ZE(3)).
- b. Section 118ZE(2) limits the amount that may be given under section 353, 380 or 381 against general income or against chargeable gains to the amount of the partner's contribution to the trade (defined in section 118ZG).
- c. Section 118ZE(3) defines a Qualifying Year of Assessment as a year in which a partner did not devote a significant amount of time to the trade, but only for the first four years of assessment in which the partner carried on the trade. The rules only apply to a general partner or a member of a Limited Liability Partnership. The rules first apply to a year of assessment for which the basis period ends on or after 10th February 2004.
- d. Section 118ZE(4) defines a "general partner" as anyone who is not covered by the existing rules in section 117(2) ICTA covering Limited Partners and anyone in a similar position to a Limited Partner. This gives the existing section 117 rules priority where relevant. The definition also excludes a member of a Limited Liability Partnership.
- e. Section 118ZE(5) sets down what is meant by "basis period". This term is defined in sections 60 to 63 ICTA, depending on the circumstances. For a member of a partnership, section 111 ICTA applies the basis period rules to a trade deemed to be carried on by the partner individually. For example, even if the overall partnership continues a trade during a period of account, the partner's basis periods are determined as if he commenced a separate trade on the date that he joined the partnership.
- f. Section 118ZE(6) deals with the year of assessment in which the trade is first set up and commenced. The relevant legislation is in section 61(1) ICTA, but it does not use the term "basis period". This subsection ensures that the references to "basis period" in this legislation have complete coverage.
- g. Section 118ZE(7) disapplies the new rules to losses from a trade of underwriting. Lloyds underwriters are subject to a specific tax regime which reflects the nature of the business and the partners' liabilities for the underwriting losses. The new rules would not fit easily with that regime.
- h. Section 118ZE(8) makes this section subject to particular rules in section 118ZJ, and transitional rules in section 118ZK, for the first year that is affected.

7. New section 118ZF defines the "aggregate amount". The general rule is that it identifies the total amount of losses and interest that is given against general income or chargeable gains for all years of assessment up to and including the year in question - but subject to the specific rules of this section.
 - a. Section 118ZF(1) sets out that the "aggregate amount" is the total amounts of losses and interest that have been given against general income or chargeable gains for all years of assessment up to and including the year in question, but only where the year of assessment falls within subsection (2).
 - b. Section 118ZF(2) sets out the years of assessment for which losses are to be included in the "aggregate amount". The years involved are any qualifying years of assessment (defined in section 118ZE), or any year of assessment when the partner carried on the trade as a Limited Partner or a member of a Limited Liability Partnership (but only years of assessment the basis period for which ends on or after 10th February 2004). This ensures that all the provisions which require comparison of losses against the amount of a partner's contribution are covered so that the contribution is taken into account only once.

8. New Section 118ZG ICTA sets out how to calculate the partner's contribution to the trade.
 - a. Section 118ZG(1) defines the partner's contribution as the total of the amount subscribed by him, plus his undrawn profits, plus the amount that he actually contributes to the assets in winding up. Undrawn profits are those allocated to the partner in the partnership deed or agreement, but which the partner has not taken out of the partnership. Section 118ZA ICTA applies the taxes legislation to members of a Limited Liability Partnership as to members of any other type of partnership, and therefore the same rules will apply for the purpose of measuring profits allocated to a member of a Limited Liability Partnership.
 - b. The partner's contribution is measured at the end of any year of assessment for which losses or interest may potentially be claimed against general income or chargeable gains.
 - c. Section 118ZG(2) defines the amount subscribed by the partner. The starting point is the partner's capital contributions made on or after 10th February 2004. Comparison of this amount alone against the "aggregate amount" might disadvantage a partner who had contributed an amount to the trade before 10th February 2004 but had not claimed losses or interest against their general income or chargeable gains. Therefore, a further allowance is made to partners in that position by including in their contribution the amount contributed by them before 10th February 2004 that does

not exceed the losses or interest that they have claimed in respect of periods up to that time - but subject to subsection(3). The sum of these amounts is then reduced by any amount of capital which the partner has withdrawn.

- d. Section 118ZG(2)(a) ensures that any amounts of capital withdrawn are first deducted from capital contributed after 10th February 2004.
 - e. Section 118ZG(3) provides a necessary definition for the purposes of subsection (2). It ensures that capital contributed before 10th February is regarded as reduced for the purposes of subsection (2) only by losses claimed that arose in a year when the partner would have been affected by these rules had they been in force.
 - f. Section 118ZG(4) defines the amount of capital that a partner has withdrawn. In particular it prevents a partner from contributing capital temporarily at the end of a year of assessment and then withdrawing that capital.
 - g. Section 118ZG(5) provides a necessary qualification. Some amounts are treated as income chargeable to income tax by the operation of tax legislation when accountancy treatment might regard them as capital. Without this qualification, amounts returned to a partner might then be regarded as withdrawals of capital when those amounts had already been taxed on him as profits of the trade. This subsection redresses the position.
 - h. Section 118ZG(6) adapts the definition of "contribution to a trade" for a Limited Liability Partnership. The corporate nature of a Limited Liability Partnership gives the partner's capital contributions the nature of a contribution to the entity itself, rather than to the trade which it carries on. This subsection ensures that the new rules apply in the same way to all capital contributed to a partnership, irrespective of the partnership structure and how the capital is treated by that structure.
9. New Section 118ZH ICTA sets out the definition of a "significant amount of time". This is relevant for determining whether or not a general partner falls within these rules, and whether a member of a Limited Liability Partnership falls within these rules or the existing rules of section 117 ICTA applied by section 118ZB ICTA. The test is applied separately for each year of assessment by reference to what the partner did in the basis period for that year of assessment.
- a. Section 118ZH(1) defines a "significant amount of time" as being a minimum of ten hours per week, on average taken across the period. This does not mean that the individual has to spend 10 hours every week - the averaging takes account of peaks and troughs, holidays, etc. The individual must be personally engaged

in the activities of the trade. This may for example include a management or service role such as personnel, accountancy or purchasing. It does not include time spent deciding whether or not to invest, and/or how much to invest, in the partnership or its trade. Neither does it include time spent by an individual which is no more than what might be spent by an individual for their own personal interest in the trade in question.

- b. Section 118ZH(2) defines the “relevant period” for the purposes of subsection (1) as the whole of the basis period for the year of assessment, or a continuous period of at least six months either beginning with the date of commencement or ending with the date of cessation. For example, an individual commences a trade on 1st April 2004. His basis period for 2003/04 is 1st April 2004 to 5th April 2004. The relevant period ends on 30th September 2004 for the purposes of this subsection in relation to the year of assessment 2003/04. This means that the individual must meet the “significant amount of time” test for six months rather than just for 5 days.
 - c. New Section 118ZH(3) provides for a charge to income tax under Case VI of schedule D where relief is given in advance of the “activity” rules being satisfied.
10. New Section 118ZI ICTA deals with cases where a partner's losses have been restricted under these rules but where he subsequently contributes further capital to the trade. This is similar in effect to the existing rules for Limited Liability Partnerships contained in section 118ZD ICTA.
- a. Section 118ZI(1) sets out that where any losses have been restricted by the operation of section 118ZE ICTA, this section may apply to a later year of assessment where any part of those losses have still not been relieved, but only where the individual continues to carry on the trade in partnership or contributes an amount during the winding-up of the partnership.
 - b. Section 118ZI(2) defines the total restricted loss as the amount restricted by the operation of section 118ZE in qualifying years of assessment only.
 - c. Section 118ZI(3) permits some or all of the "total restricted loss" to be regarded, for the purposes of relief against general income or chargeable gains, as if that amount had arisen in a later year of assessment provided the other conditions of this section are satisfied. That later year can be a year of assessment that would not be a qualifying year of assessment apart from this section. For example, the partner may satisfy the conditions about "a significant amount of time" in that later year. This would mean that any losses arising in that later year are not subject to the new rules, but it does mean that he would be eligible to consider

whether any restricted losses could be claimed in that year - but those restricted losses are subject to the contribution rules. The definition also permits the restricted losses to be considered in a year of assessment later than the years specified in section 118ZE(3)(c), and equally it ensures that the restricted loss is not immediately eligible for relief in full at the end of that time.

- d. Section 118ZI(4) describes how to calculate how much of the total restricted loss remains outstanding at the end of any year of assessment. It is the total amount that has been restricted by the application of section 118ZE ICTA, less any amounts already relieved (in any way) and less any further amounts relieved following the application of section 118ZI to an earlier year of assessment. The amounts relieved will include, for example, any amount given under section 385 ICTA against profits of the same trade.
 - e. Section 118ZI(5) deems that, where this section applies, the year of assessment is to be regarded as a qualifying year of assessment if it would not otherwise be so. This ensures that the "aggregate amount" includes any amounts allowed by this section.
 - f. Section 118ZI(6) makes a necessary qualification, set out in subsection (7), to allow this section to operate where the individual no longer carries on the trade in partnership but where he makes a contribution to the assets of the partnership in a winding up.
 - g. Section 118ZI(7) ensures that this section can apply during a winding-up despite other provisions in the Tax Acts, outside this new set of rules, which would otherwise prevent any loss relief being given for that year of assessment.
 - h. Section 118ZI(8) imports the definition of a "qualifying year of assessment".
11. New section 118ZJ ICTA 1988 sets out the commencement provisions for the new rules, and in particular sets out how the rules apply to a year of assessment, the basis period for which includes the date on which the legislation was announced.
- a. Section 118ZJ(1) applies the rules in this section only to a year of assessment the basis period for which includes 10th February 2004.
 - b. Section 118ZJ(2) ensures that where the 10th February 2004 falls within the basis period for more than one year of assessment, this section will only apply to the first of those years.
 - c. Section 118ZJ(3) adapts the new rules for the purposes of the first qualifying year of assessment. It sets up a definition of the amount of the loss that can be allowed for that year only. The amount is the sum of two parts.

- d. Section 118ZJ(4) defines the first part of the loss – the “pre-announcement allowance” – as being the loss sustained or interest paid between the beginning of the basis period for the year of assessment and 9th February 2004 inclusive.
- e. Section 118ZJ(5) defines the second part of the loss – the “post-announcement allowance” - as being the loss sustained or interest paid between 10th February 2004 and the end of the basis period inclusive, but only to the extent that it does not exceed the partner’s contribution to the trade, measured at the end of the year of assessment.
- f. Section 118ZJ(6) further defines the losses for the purposes of subsections (4) and (5). It deems the partnership to draw up a set of accounts and strike a profit or loss as at 9th February 2004, and a separate set of accounts for the period from 10th February 2004 to the end of the basis period. The tax-adjusted profit or loss derived from these separate sets of accounts then determines what part of the loss falls before 10th February, or on or after that date.
- g. Section 118ZJ(7)(a) deals with the situation where any part of the loss derives from capital allowances, given under the Capital Allowances Act 2001. Under that Act, capital allowances are treated as expenditure incurred for the purposes of the trade. This subsection deems the allowance to arise (for the purposes of this section) at the time that the relevant capital expenditure is incurred, for the purposes of determining whether a loss falls before, on or after 10th February 2004.
- h. Section 118ZJ(7)(b) deals similarly with losses derived from expenditure that is deductible in accordance with section 42 Finance (No 2) Act 1992. That section allows expenditure to be deducted in computing the profits of the trade over a minimum of three years. This rule ensures that where the relevant expenditure was incurred before 10th February 2004 any loss derived from the annual deduction given under section 42 Finance (No 2) Act 1992 is not subject to the new rules.
- i. Section 118ZJ(8) deals with a situation where a partner acquires an interest in the partnership after 9th February 2004 but before 26th March 2004. The purpose is to tackle a practical issue that arises from the method of computing and allocating partnership profits and losses. Some individuals continued to join partnerships between 10th February 2004 and 25th March 2004 in the expectation that they could access a share of losses arising to the partnership before 10th February 2004.
- j. Where this situation arises a partner who acquires an interest in the partnership between 10th February 2004 and 25th March 2004 inclusive is deemed to have an interest in the partnership on 9th

February 2004. This allows him to be allocated a share of losses arising in the part of the basis period before 10th February 2004.

- k. However, where an accounting period of the partnership ends before the partner actually acquired his interest then this subsection will not allow the partner to access a share of any losses arising in that accounting period.
12. New Section 118ZK ICTA contains provisions to deal with certain transitional issues.
 - a. Section 118ZK(1) sets out that this section applies to years of assessment other than the year determined in section 118ZJ.
 - b. Section 118ZK(2) covers the same position as section 118ZJ(7). It removes from the losses affected by the new rules any amount derived from capital allowances or from expenditure deductible under section 42 Finance (No 2) Act 1992 where the actual expenditure was incurred before 10th February 2004.
 - c. Section 118ZK(3) similarly ensures that any such amounts are left out of the "aggregate amount".
 - d. Section 118ZK(4) ensures that the "pre-announcement" allowance, found under section 118ZJ(4), is not taken into account in computing the "aggregate amount".
 - e. Section 118ZK(5) applies a just and reasonable basis where necessary for identifying the part of a loss that may be attributable to a capital allowance or to expenditure deducted in accordance with section 42 Finance (No 2) Act 1992.
 - f. Section 118ZK(6) imports necessary definitions.
 13. Subsection (2) of the clause amends section 117(2) ICTA 1988 to include in the losses considered there any losses arising in a qualifying year of assessment as defined in section 118ZE. This ensures that where a partner is considering their loss relief at a time when they are a Limited Partner or a Limited Liability Partner (but not subject these new rules) any losses to which these new rules apply are also taken into account so that the capital contributed to the trade is taken into account only once.
 14. Subsection (3) amends section 118ZB of the Income and Corporation Taxes Act 1988 (ICTA), by adding a new subsection (2). The new section 118ZB(2) means that for a "non-active" member of a Limited Liability Partnership (LLP), section 117 ICTA is applied by reference to the new section 118ZE and not by reference to section 118ZB and 118ZC.
 15. Subsection (4) makes a similar amendment to section 118ZD ICTA.

BACKGROUND NOTE

16. Where individuals carry on a trade in partnership, they are each individually regarded as carrying on the trade. Partnerships determine their total profit and loss by drawing up a set of accounts for the partnership. The partnership then allocates its profits and losses between the partners in accordance with the partnership agreement and each partner is liable to income tax on his share of the profits.
17. Similarly, any loss allocated to a partner is regarded as a loss incurred in a trade carried on by the partner individually. That loss can be claimed and relieved against the partner's other income under section 380 or section 381 ICTA 1988, or against chargeable gains under section 72 Finance Act 1991.
18. For the purposes of allocating profits and losses, each partner is regarded as carrying on a separate trade which is deemed to commence on the date when the partner joins the partnership, and which is deemed to end when the partner leaves the partnership.
19. Restrictions already exist for certain types of partner or partnership in how much relief for trading losses may be claimed against other income or gains. Section 117 ICTA 1988 limits the amount that may be so claimed to the amount of the partner's contribution to the trade. The rules apply to Limited Partners (defined in section 117(2) ICTA 1988) and to Limited Liability Partners (with adaptations set out in sections 118ZB, 118ZC and 118ZD ICTA 1988).
20. A Limited Liability Partnership has a corporate structure, but for tax purposes the profits and losses are allocated to the partners in accordance with their interests in the partnership in the same way as for general partnerships.
21. Capital allowances are given under the Capital Allowances Act 2001 in respect of certain types of qualifying capital expenditure. The rates vary, but commonly allowances are given at an annual rate of 25% on a reducing balance basis. The allowance is given as if it were an expense of the trade.
22. Section 42 Finance (No 2) Act 1992 allows a deduction for expenditure incurred in the course of a trade on the production of a qualifying film or the acquisition of the master version of a film. Under this provision expenditure can be deducted for tax purposes over a minimum of three years. A film is a qualifying film if it is certified as such by the Secretary of State for Culture Media and Sport under Schedule 1 to the Films Act 1985.

EXPLANATORY NOTE

CLAUSE 120: LOSSES DERIVED FROM EXPLOITING LICENCE: INTRODUCTORY

SUMMARY

1. This clause, together with clauses 121 to 124 inclusive, is an anti-avoidance measure which tackles schemes used by individuals in a partnership to reduce their tax on income from a licence or similar agreement. The partners aim to benefit from early loss relief against income tax, but then sell the income rights for a lower taxed capital sum. The new rules ensure that the disposal of income rights is charged to income tax. The new rules apply on or after 10th February 2004 but only to a partner who did not spend a significant amount of time in the trade when the losses arose. This clause sets out the conditions which give rise to a charge to income tax under this measure.

DETAILS OF THE CLAUSE

2. Subsection (1) sets out the conditions which trigger a charge to income tax under these new rules. Taken together they identify and bring together relief for trading losses resulting from expenditure incurred in exploiting a licence, and a disposal sum arising from that licence.
3. Subsection (1)(a) requires that, for the rules to apply, an individual who carries on a trade in partnership makes a disposal on or after 10th February 2004, in one of two ways. The disposal can involve the disposal of a licence acquired in carrying on the trade, or the disposal of rights to income under a related agreement. A related agreement is defined in subsection (6). Clause 123 expands the meaning of a disposal of a licence.
4. Subsection (1)(b) requires that the amounts realised must be not otherwise chargeable to income tax, nor brought into charge under clause 114. The definition of "non-taxable" consideration is in subsection (5).
5. Subsection (1)(c) requires that a claim must have been made by the individual for relief for trading losses against his other income or gains in respect of a "licence-related loss", defined in subsection (2). The loss claim is only relevant if it is made in respect of a trading loss arising in the first four years of assessment in which the individual carries on the trade in partnership.
6. Subsection (2) defines a "licence-related loss" as one that arises from expenditure incurred in the partnership's trade in exploiting the licence.

7. Subsection (3) qualifies subsection (2) in the case of an individual who was a member of the partnership before 26th March 2004. For an individual in that position the "licence-related loss" does not include any part of a loss derived from expenditure incurred before 10th February 2004.
8. Subsection (4) defines a "qualifying year" as being any of the first four years of assessment in which the individual carries on the trade in partnership, but only where he did not devote a significant amount of time (defined in clause 124) to the partnership trade in that particular year.
9. Subsection (5) defines "non-taxable" consideration in relation to a disposal as consideration not otherwise chargeable to income tax. The subsection also prevents any double charge between this clause and clause 114 – the exit charge in relation to film relief. The consideration received and to be charged to income tax under these new rules can be part of a larger sum, part of which may be chargeable to income tax under other provisions.
10. Subsection (6) defines a "related agreement".
11. Subsection (7) expands the type of agreement or contract that can be regarded as a licence for these purposes. Normally a licence gives its holder the right to do something. The definition is expanded here to include agreements which oblige the licence holder to do certain things. Exploitation of the licence is similarly expanded to include things done in fulfilling obligations rather than a narrower meaning.

BACKGROUND NOTE

12. Where individuals carry on a trade in partnership, they are each individually regarded as carrying on the trade. Partnerships allocate their profits between the partners in accordance with the partnership agreement and each partner is liable to income tax on his share of the profits.
13. Similarly, any loss allocated to a partner is regarded as a loss incurred in a trade carried on by the partner individually. That loss can be claimed and relieved against the partner's other income or gains under section 380 or section 381 ICTA 1988, or section 72 Finance Act 1991.
14. The disposal of a licence or other right to earn income may or may not be chargeable to income tax. There is no tax legislation covering such licences generally, although some specific instances are covered. There is a body of case law which has set out characteristics which determine whether or not a disposal is chargeable to income tax or whether it is capital. It is therefore possible that a disposal could be chargeable to income tax before the introduction of these new rules.

EXPLANATORY NOTE

CLAUSE 121: CHARGE TO INCOME TAX

SUMMARY

1. This clause is part of an anti-avoidance measure, introduced by clauses 120 to 124 inclusive, which tackles schemes used by individuals in a partnership to reduce their tax on income from a licence. This particular clause sets out how and when the charge to income tax arises under these rules.

DETAILS OF THE CLAUSE

2. Subsection (1) sets out when a “chargeable event” arises under these rules. A chargeable event requires there to be both a claim for a trading loss to be set against a partner's general income or chargeable gains and a disposal not otherwise chargeable to income tax. The subsection makes it clear that it is immaterial whether or not the disposal happens before or after an individual has made a claim for a loss. The chargeable event is deemed to arise in the year of assessment when the later of the claim or the disposal occurs.
3. Subsection (2) sets out the charge to tax. The receipt from any disposal affected by these rules is charged to income tax under Case VI of Schedule D, but only to the extent that the “total consideration”, defined in subsection (3), exceeds the “chargeable amount”, defined in subsection (4).
4. Subsection (3) defines “total consideration” to include all the amounts, not otherwise chargeable to income tax, received by an individual in the year of assessment or an earlier year from disposals in respect of the same licence or agreement.
5. Subsection (4) defines “chargeable amount”. The starting point is the excess of the “total consideration” (defined in subsection (3)) to the extent that it exceeds the “net licence-related loss” (defined in subsection (5)). This amount is then reduced by any amount brought into charge by this measure in an earlier year of assessment.
6. Subsection (5) defines the “net licence-related loss”. This is the excess of the losses that an individual has claimed and had allowed against their general income or chargeable gains over the profits that have been

brought into charge to income tax in respect of the same licence or agreement. The income could have arisen in any year, not just a “qualifying year” (that is, one of the first four years of assessment in which the individual carried on the trade and when he did not spend a significant amount of time in the trade).

7. Subsection (6) sets out that consideration received is only to be taken into account for these rules if it is received on or after 10th February 2004, and only if it relates to the licence in question. The subsection also makes it clear that the disposal of any rights to income under an agreement related to the licence are also included under this provision. This is to prevent schemes which try to separate the licence under which the losses arose and an agreement giving rise to income from the same subject matter.
8. Subsection (7) imports necessary definitions.

BACKGROUND NOTE

9. Where individuals carry on a trade in partnership, they are each individually regarded as carrying on the trade. Partnerships allocate their profits between the partners in accordance with the partnership agreement and each partner is liable to income tax on his share of the profits.
10. Similarly, any loss allocated to a partner is regarded as a loss incurred in a trade carried on by the partner individually. That loss can be claimed and relieved against the partner’s other income or gains under section 380 or section 381 ICTA 1988, or section 72 Finance Act 1991.
11. The disposal of a licence or other right to earn income may or may not be chargeable to income tax. There is no tax legislation covering such licences generally, although some specific cases are covered. There is a body of case law which has set out characteristics which determine whether or not a disposal is chargeable to income tax or whether it is capital. It is therefore possible that a disposal could be chargeable to income tax before the introduction of these new rules.

EXPLANATORY NOTE

CLAUSE 122: DEFINITIONS FOR PURPOSES OF SECTION 121

SUMMARY

1. This clause is part of an anti-avoidance measure, introduced by clauses 120 to 124 inclusive, which tackles schemes used by individuals in a partnership to reduce their tax on income from a licence. This particular clause sets out definitions necessary for clause 121.

DETAILS OF THE CLAUSE

2. Subsection (1) states that the definitions in this clause only apply for the purposes of defining what is a “licence-related loss” in subsection (5) of clause 121. And Subsection (2) sets out the definition of a “claimed licence-related loss”. This only encompasses a loss arising in a “qualifying year” (one of the first four years of assessment in which the individual carried on the trade, but did not spend a significant amount of time personally engaged in the activities of the trade). In addition, the loss must be incurred in exploiting the licence and it must be a loss that the individual has claimed to set against his general income or chargeable gains.
3. Subsection (3) sets out what to do when not all of the loss derives from expenditure set out in subsection (2). The loss is to be allocated between different periods and different activities on a just and reasonable basis.
4. Subsection (4) qualifies subsection (2) in relation to an individual who became a member of the partnership before 26th March 2004. For such an individual the losses to be included in the computation are limited to those derived from expenditure incurred on or after 10th February 2004.
5. Subsection (5) defines what profits are to be taken into account in computing the “net licence related loss” in subsection (5) of clause 121. The profits are those arising from any rights under the licence or a related agreement.
6. Subsection (6) ensures that where profits fall partially into the definition in subsection (5) and partially not, any apportionment should be done on a just and reasonable basis.

EXPLANATORY NOTE

CLAUSE 123: DISPOSALS TO WHICH SECTION 120 APPLIES

SUMMARY

1. This clause is part of an anti-avoidance measure, introduced by clauses 120 to 124 inclusive, which tackles schemes used by individuals in a partnership to reduce their tax on income from a licence. This particular clause sets out the circumstances which give rise to a disposal which is chargeable to income tax under these new rules.

DETAILS OF THE CLAUSE

2. Subsection (1) sets out a list of circumstances which give rise to a disposal which is chargeable to income tax under these new rules. The list is not exhaustive and does not limit the transactions that may be the disposal of a licence or of rights to income to the type of transaction listed in the subsection.
3. Subsection (2) makes it clear that the legislation also encompasses a situation where a disposal to which clause 120 applies is part of a larger disposal.
4. Subsection (3) sets out what happens when the occasion is a change in profit sharing arrangements. The new entitlement in a later period is deemed to take effect from the beginning of the later period. It also ensures, for the avoidance of doubt, that a nil share in profits can nonetheless be a share of profits for this purpose.

EXPLANATORY NOTE

CLAUSE 124: “A SIGNIFICANT AMOUNT OF TIME”

SUMMARY

1. This clause is part of an anti-avoidance measure, introduced by clauses 120 to 124 inclusive, which tackles schemes used by individuals in a partnership to reduce their tax on income from a licence. This particular clause sets out the definition of a “significant amount of time”. This is important because the legislation only applies to individuals who do not spend a significant amount of time engaged in the activities of the trade. The test is applied separately for each year of assessment by reference to what the partner did in the basis period for that year of assessment.

DETAILS OF THE CLAUSE

2. Subsection (1) defines a “significant amount of time” as being a minimum of ten hours per week, on average taken across the period. This does not mean that the individual has to spend 10 hours every week - the averaging takes account of peaks and troughs, holidays, etc. The individual must be personally engaged in the activities of the trade. This may for example include a management or service role such as personnel, accountancy or purchasing. It does not include time spent deciding whether or not to invest, and/or how much to invest, in the partnership or its trade. Neither does it include time spent by an individual which is no more than what might be spent by an individual for their own personal interest in the trade in question.
3. Subsection (2) defines the “relevant period” as the whole of the basis period or a continuous period of at least six months either beginning with the date of commencement or ending with the date of cessation. For example, an individual commences a trade on 1st April 2004. The relevant period ends on 30th September 2004 for the purposes of this subsection in relation to the year of assessment 2003/04. This means that the individual must meet the “significant amount of time” test for six months rather than just for 5 days.
4. Subsection (3) defines "basis period".
5. Subsection (4) defines the basis period for the year of assessment in which the individual first carried on the trade.

EXPLANATORY NOTE

CLAUSE 125: COMPANIES IN PARTNERSHIP

SUMMARY

1. This clause, together with clause 126, is an anti-avoidance measure which tackles avoidance schemes used by companies to shelter taxable profits within a partnership structure. The schemes allocate profit shares out of proportion to the shares of capital contributed by the partners to the partnership. Typically the income is allocated to a non-UK partner and the capital to the UK company, which then realises untaxed profits as capital. The legislation tackles this by deeming profits to arise to the UK company in line with its partnership share, and taxing those profits when the UK company realises capital. The new rules apply to capital realisations comprising untaxed profits arising on or after 17th March 2004.

DETAILS OF THE CLAUSE

2. Subsection (1) sets out the conditions which trigger a charge to tax under these new rules.
3. Subsection (1)(a) requires that, for the rules to apply, a company realises capital from a partnership on or after 17th March 2004. The company may realise capital in one of two ways.
4. Subsection (1)(a)(i) states that capital can be realised by receiving back, directly or indirectly, any of its capital from the partnership. This is not limited to the amount that the company put into the partnership, but can also encompass the type of scheme being tackled here where the company pays a nominal sum for a capital share which it subsequently realises.
5. Subsection (1)(a)(ii) states that capital can be realised by a company disposing of all or part of its partnership interest.
6. Subsection (1)(b) requires that the amounts realised must exceed the amount that a company has put into a partnership, either by contribution or by purchase. The company's contribution is defined in subsection (2)(d). For this purpose it includes the amount paid by the company for another's partnership share, but not the value of that acquired share.

7. Subsection (1)(c) requires that the excess in paragraph (b) must result, wholly or partly, from an arrangement whereby profits were not shared between the partners in accordance with their capital shares in the partnership.
8. Subsection (1)(d) requires that profits have arisen to the partnership that have not been taxed on the company because of the allocation of profit shares, but which would have been allocated to and taxable on the company if profits had been shared in line with shares of partnership capital.
9. Subsection (2) provides definitions relevant to subsection (1).
10. Subsection (3) states that, for the purposes of deciding how much profit should have arisen to the partners had those profits been computed in accordance with partnership shares, the partners' shares are to be computed as an average for the chargeable period in which the profits arose. This means that each chargeable period is considered separately, and the profit shares for each period are calculated by reference to the partnership position during that period.
11. Subsection (4) directs that where all the required conditions apply, the company will be charged to tax under Case VI of Schedule D on an amount calculated in accordance with subsection (5).
12. Subsection (5) sets out the amount to be charged to tax under these rules. The amount is the lower of two alternatives, calculated at the point in time when the company realises capital.
13. Subsection (5)(a) sets out the first alternative amount, which is the amount by which the company's realised capital (by withdrawal or disposal) exceeds the amount that it has put in (by way of contribution or acquisition).
14. Subsection (5)(b) sets out the second alternative amount. This is the amount by which the company's share of profit calculated in accordance with its share in the partnership (its "due share") exceeds the share that has actually been allocated to it.
15. Subsection (6) sets out what happens when there is more than one event which triggers a charge under this section. A second or subsequent charge is calculated taking into account all profit shares, profit allocations, capital contributions and capital realisations – but the second or subsequent charge is then reduced by any amount already brought into charge under this section

BACKGROUND NOTE

16. Where a company is a member of a partnership, the partnership profits for tax purposes are computed as if the partnership was a company chargeable to UK corporation tax. The profits computed on that basis are then allocated to any company partners in accordance with their interest in the partnership.
17. Partnerships allocate their profits between the partners in accordance with the partnership agreement. These profit shares are followed for tax purposes.

EXPLANATORY NOTE

CLAUSE 126: COMPANIES IN PARTNERSHIP: SUPPLEMENTARY

SUMMARY

1. This clause, together with clause 125, is an anti-avoidance measure which tackles avoidance schemes used by companies to shelter taxable profits within a partnership structure. The new rules apply to capital realisations comprising untaxed profits arising on or after 17th March 2004. This clause provides supplementary definitions for the purposes of clause 125.

DETAILS OF THE CLAUSE

2. Subsection (1) provides a definition of "capital". It includes anything accounted for as capital.
3. Subsection (2) deals with the dissolution of the partnership. Where this happens, the remaining partner is deemed at that point to realise all its capital for the purposes of this legislation.
4. Subsection (3) provides that where a chargeable period straddles 17th March 2004, profits shall be allocated to the periods before and after 17th March 2004 on a just and reasonable basis.
5. Subsection (4) expands the definition of "capital contributed" for the purposes of clause 125(2)(f) only. This is relevant for the purposes of measuring the company's "due share" of the profits. For this purpose, the partner's capital is deemed to include the value of any amount of capital that it has acquired from another partner.
6. Subsection (5) brings into the definition of "capital contributed" amounts put in by way of loans that carry interest below a genuine arm's length rate. This ensures that the "due share" of profits is calculated by reference to all amounts contributed by the company.
7. Subsection (6) ensures continuity for the purposes of this legislation when the members of a partnership change.

**CLAUSE 127 AND SCHEDULE 23: FINANCE
LEASEBACKS**

SUMMARY

1. The clause and Schedule introduce measures to prevent the continuing exploitation of loopholes in the capital allowance rules. The measures apply to the sale and leaseback or lease and leaseback of plant or machinery and prevent businesses from gaining an unintended tax advantage from the double benefit of retaining capital allowances and obtaining deductions for lease rentals.
2. The rules restrict the amount of lease rentals allowable in computing profits. They also deal with the tax consequences of leases being terminated but allow existing arrangements to be brought to an end in a way that is consistent with the aims of the measure.

DETAILS OF THE CLAUSE

3. Clause 127 introduces new sections in the Capital Allowances Act 2001 on finance leasebacks and introduces Schedule 23.
4. Subsection (1) of clause 127 inserts sections 228A to 228G after section 228 Capital Allowances Act 2001.

New Section 228A

5. This new section explains that the new rules apply to plant and machinery that is subject to sale and finance leaseback or lease and finance leaseback.
6. Subsection (1) states that new sections 228B to 228D apply where the plant or machinery is the subject of a sale and finance leaseback and section 222 Capital Allowances Act 2001 has restricted the disposal value.
7. Subsection (2) extends the application of new sections 228B to 228E where plant or machinery is the subject of a lease and finance leaseback. The term “lease and finance leaseback” is defined in new section 228F.

New Section 228B

8. This new section sets a limit on the amount of lease rentals that may be deducted in computing a lessee's income or profits.
9. Subsection (1) restricts the amounts that may be deducted in respect of payments under a leaseback to a "permitted maximum".
10. Subsection (2) says that the "permitted maximum" is the total of the finance charge shown in the accounts and the amount of depreciation that would have been charged had it been based on the restricted disposal value under section 222 CAA 2001.
11. Subsection (3) provides that in the period of account in which the leaseback terminates the permitted maximum will be increased by an amount calculated in accordance with subsection (4). This will, in effect, allow a deduction for termination rentals.
12. Subsection (4) gives the calculation required by subsection (3). The calculation is to ensure that where a sale and finance leaseback was at anything other than net book value the correct measure of relief is given to the lessee.

New Section 228C

13. This new section deals with early terminations and similar events that would have the effect of crystallising the future benefits that could have been obtained if the lease had continued to maturity.
14. Subsection (1) explains that subsection (2) applies where the leaseback terminates. Termination is defined in section 228G(1) to include assignments and certain arrangements and variations, as well as terminations.
15. Subsection (2) says where there is a termination then the income or profits of the lessee is increased by an amount calculated in accordance with subsection (3). The reference to relevant qualifying activity links the charge to the activity for which the asset was last used.
16. Subsection (3) quantifies the increase required by subsection (2) and defines the terms used in the calculation. The formula takes the amount not brought into charge to tax on the sale and reduces it to an amount equivalent to the amount by which the termination rental could have been restricted if it had been paid.
17. Subsection (4) explains the meaning of "relevant qualifying activity" for the purpose of subsection (2).
18. Subsection (5) ensures that the existing tax treatment of any refund of rentals is not affected by section 228B.

19. Subsection (6) ensures that, for tax purposes, any amount received by way of refund is not reduced by any amount that may be due to the lessor.

New Section 228D

20. This new section gives rules for computing the income or profits of a lessor in a sale and leaseback. The rules reflect the disallowance of lease rentals in the hands of the lessee by not taxing the full amount of the lease rentals in the hands of the lessor.
21. Subsection (1) provides that, in computing a lessor's income or profits for a period of account, payments receivable under a leaseback may be disregarded to the extent that they exceed the "permitted threshold".
22. Subsection (2) explains that the permitted threshold is the gross earnings (effectively the finance charge element of the lease rentals) and a proportion of the capital repayment of the lease rentals.
23. Subsection (3) defines "gross earnings".
24. Subsection (4) explains how to calculate the "allowable proportion of the capital repayment". In broad effect it takes the amount qualifying for capital allowances and spreads it across the term of the lease.
25. Subsection (5) provides that where the leaseback is terminated the "amounts receivable under the leaseback" referred to in subsection (1) cover the whole of the lessor's entitlement and is not reduced by any amount due to the lessee, such as a refund of lease rentals.
26. Subsection (6) ensures the gross rentals receivable by the lessor remain taxable under the current rules where the lessee assigned his interest under the lease prior to 17 March 2004. This is because in such a case there would be no effect on the lessee and so there is no justification for changing the lessor's tax treatment.

New Section 228E

27. This new section provides that where the lessor makes a refund of rentals to the lessee following the sale of the plant or machinery then the refund of rentals is only allowed to the extent that the lessor was required by section 62 Capital Allowances Act 2001 to bring a disposal value into his capital allowances computation.
28. Subsection (1) explains that subsection (2) applies where the leaseback terminates and the plant or machinery is disposed of by the lessor and the amount of the disposal proceeds taken to the capital allowances computation is limited because of section 62 CAA 2001.

29. Subsection (2) then provides that the amount of any refund of rentals that may be allowed in calculation the lessor's income or profits for the termination period is limited to an amount that does not exceed the section 62 CAA 2001 disposal value.

New Section 228F

30. This new section defines a lease and finance leaseback and applies, with necessary modifications, the new rules for sale and finance leaseback transactions to lease and finance leaseback transactions.
31. Subsection (1) introduces the rules modifying sections 228B to 228E where the plant or machinery is the subject of a lease and finance leaseback.
32. Subsection (2) states that the permitted maximum under section 228B is computed by reference only to the finance charge in the accounts.
33. Subsection (3) amends the calculation in section 228C so that it gives an appropriate result in a lease and finance leaseback.
34. Subsection (4) amends section 228D in a lease and finance leaseback so that the lessor's income is calculated only by reference to finance charges as, in these situations, the lessor does not incur any allowable capital expenditure on which he could claim capital allowances.
35. Subsection (5) explains when plant and machinery is subject to a lease and finance leaseback. It takes the definition in section 221 Capital Allowances Act 2001 for sale and finance leaseback and applies it to lease and finance leaseback.
36. Subsection (6) explains what is meant by the term "lease" in the term "lease and finance leaseback"
37. Subsection (7) defines the terms "lessee" and "lessor" for the purposes of sections 228B to 228D.

New Section 228G

38. This new section contains definitions of terms used in sections 228A to 228F. It also gives the effective date of clause 127 and provides the link to the transitional provisions in Schedule 23.
39. Subsection (1) defines "current book value" for the purposes of sections 228A to 228F. The definition ensures that the computations required by the new measure are based on what the current book value would have been had the asset been depreciated up to the time of the events in

sections 228A to 228F and on the assumption that any revaluation gains or losses and impairments are ignored.

40. Subsection (1) also explains that “lessee” does not include a person who is a lessee by way of assignment. This means that any lessee by way of assignment will not suffer any restriction of lease rental payments or be subject to a termination charge.
41. Subsection (1) also ensures that there is no confusion by defining the term “restricted disposal value”
42. Subsection (1) also defines “termination” other than for the purposes of section 228E. The definition ensures that the termination provisions apply when the lease has been assigned, terminated in commercial terms but not in legal terms, or varied such that it is no longer a finance lease.
43. Subsection (2) provides that where no or incorrect accounts have been drawn up the provisions of sections 228A to 228F apply as if correct accounts had been drawn up and the amounts referred to in those sections are those that would have appeared in the “correct accounts”. The term “correct accounts” is defined in subsection (4).
44. Subsection (3) ensures that where accounts have to be drawn up which rely on amounts derived from an earlier period where no or incorrect accounts were drawn up the amounts in the later period are those that would have been shown if correct accounts had been drawn up for the earlier period.
45. Subsection (4) defines “correct accounts” as accounts drawn up in accordance with generally accepted accounting practice.
46. Subsection (2) of clause 127 confirms that the references in sections 228A to 228G to the Capital Allowances Act 2001 also include a reference to an equivalent provision of the Capital Allowances Act 1990.
47. Subsection (3) of clause 127 says that the clause will only affect chargeable periods ending on or after 17 March 2004.
48. Subsection (4) of clause 127 links to the transitional provisions in Schedule 23.

DETAILS OF THE SCHEDULE

49. This Schedule contains transitional provisions in connection with clause 127. The Schedule preserves the current tax treatment of lease rentals paid or payable, received or receivable, or relating to periods on or before, 17 March 2004.

50. Schedule 23 also suspends the application of section 228C (provisions on termination of leaseback) where an existing is terminated on or after 17 March 2004 and the original owner reacquires the asset. If the owner disposes of the plant or machinery during a period of six years beginning on the date of the termination the charge is reinstated in a modified form.
51. Paragraph 1 states that, for existing leasebacks, new sections 228A to 228E of the Capital Allowances Act 2001 are subject to Schedule 23.
52. Paragraph 2 ensures that the tax treatment of lease rentals paid or payable by lessees for periods prior to 17 March 2004 is preserved. The paragraph ensures that the measure does not seek to recover any tax where the relief given exceeds the amounts paid or payable for periods prior to 17 March 2004.
53. Paragraph 2(1) requires that the “pre-commencement rentals” are greater than the total of the “actual rental deductions” for periods of account up to but excluding the “transitional period of account”. Paragraph 2(7) defines “actual rental deduction”. Paragraph 9(1) defines both “pre-commencement rental” and “transitional period of account”. If the pre-commencement rental is less than the actual rental deductions then no transitional relief is due as all amounts paid or payable by the lessee in respects of periods prior to 17 March 2004 have been fully allowed for tax purposes.
54. Paragraph 2(2) disapplies section 228B where, in either the transitional period or a subsequent period of account, the excess rentals, or any unrelieved portion of the excess rentals, are greater than the amount that would have been allowed prior to the permitted maximum imposed by section 228B.
55. Paragraph 2(3) modifies section 228B by applying sub-paragraph (4) where there are excess rentals, or any unrelieved portion of excess rentals, but these are less than the amount that would have been allowed prior to the permitted maximum imposed by section 228B.
56. Paragraph 2(4) states that where paragraph 2(3) applies the permitted maximum will be increased to the excess rentals, or any unrelieved portion of the excess rentals, plus an amount calculated in accordance with section 228B but restricted in the ratio of the notional rentals to the balance of the notional rentals after excluding the amount to be allowed as excess rentals. The term “notional rentals” is defined at paragraph 2(6) as the amount that would have been allowed in a period of accounts if the restriction in section 228B did not apply.

57. Paragraph 2(5) provides that in the transitional year the permitted maximum shall not be an amount less than the appropriate fraction of the notional rental. This is the amount that would have been allowed up to 17 March 2004 where an accounting period begins before but ends after 17 March 2004.
58. Paragraph 2(6) defines “the lessee’s excess rentals” and “the unrelieved portion of the excess rentals”.
59. Paragraph 2(7) defines “actual rental deduction” and “notional rental deduction”.
60. Paragraph 2(8) ensures that if a termination occurs in the transitional year then the permitted maximum will still, in effect, allow a deduction for the lessee’s termination rentals.
61. Paragraph 2(9) ensures that the transitional rules end when the lessee’s excess rentals have been fully relieved.
62. Paragraph 3 ensures that if the lease terminates before all of the unrelieved portion of the excess rentals can be used then the balance is relieved in that period by increasing further the permitted maximum.
63. Paragraph 4 ensures that where a leaseback terminated before 17 March 2004 then the provisions in section 228C do not apply.
64. Paragraph 5 provides for the operation of section 228C to be suspended where an existing leaseback is terminated with the original owner reacquiring ownership of the asset. The rules apply provided the capital expenditure by the original owner results in a restriction under section 226 Capital Allowances Act 2001 that is greater than the section 228C charge and is not disposed of by the owner for a period of six years from the date of termination. If the asset is disposed of within six years then an amount based on the disposal proceeds is brought into account. If the section 226 restriction is less than the section 228C charge then the section 228C charge is held over to the extent of the section 226 restriction with the same six year rule applying to any subsequent disposal. If there is no section 226 restriction then the section 228C charge is not held over.
65. Paragraph 5(1) sets out the conditions that must be met before the operation of section 228C is suspended. The first condition is that the existing leaseback must be terminated prematurely. The second condition is that within one month of the date of termination the original owner must acquire the asset, either directly from the lessor or from a person connected with the lessee. But for this to apply, no person who is not connected with the lessee should have owned the asset in the

intervening period. The inclusion of an associate of the lessee ensures that where the lessee cannot re-acquire the asset directly from the lessor, the provision still applies where he can do so via an associate. The third condition is that whoever acquires the asset from the lessor must incur capital expenditure at least equal to the market value of the asset. This ensures that the proper consequences flow where the lessee is entitled to all or part of the sales proceeds. The final condition is that the original owner's qualifying expenditure is restricted under section 226 CAA 2001.

66. Paragraph 5(2) provides that the operation of section 228C is suspended if the "section 226 restriction" is greater than the section 228C charge. But if the asset is subsequently disposed of then section 228C operates as modified by paragraph 5(5).
67. Paragraph 5(3) provides that if the "section 226 restriction" is less than the section 228C charge then the amount by which the profits are increased by the section 228C charge are reduced by the amount of the "section 226 restriction". The balance of the section 228C charge is held over until the asset is disposed of. Again, if the asset is subsequently disposed of then section 228C operates as modified by paragraph 5(5).
68. Paragraph 5(4) defines when an asset is disposed of and limits it to disposals that take place during a period of six years beginning with the date of termination of the leaseback. This means that if the asset is disposed of after that time section 228C will not operate.
69. Paragraph 5(5) amends the amount calculated in section 228C(3) to take account of the final sales proceeds of the plant or machinery. The adjustment ensures that the operation of section 228C(3) takes account of the ultimate disposal proceeds (or market value if higher) after excluding the restricted amount qualifying for capital allowances. The fraction cannot be greater than one or less than zero.
70. Paragraph 5(6) defines "disposal proceeds".
71. Paragraph 5(7) defines "restricted qualifying expenditure", "lessee acquisition expenditure" and "section 226 restriction".
72. Paragraph 6 preserves the existing the tax treatment of lessors for lease rentals paid or payable by lessees for periods prior to 17 March 2004.
73. Paragraph 6(1) requires that the "pre-commencement rentals" are greater than the total of the "actual taxed rentals" for periods of account up to but excluding the "transitional period of account". Paragraph 6(7) defines "actual taxed rentals" and paragraph 9(1) defines both "pre-commencement rentals" and "transitional period of account". If the pre-

commencement rentals are less than the actual taxed rental then no transitional measure is needed as all amounts paid or payable by the lessee in respects of periods prior to 17 March 2004 have been fully taxed.

74. Paragraph 6(2) disapplies section 228D where, in either the transitional period or a subsequent period of account, the lessor's excess rentals, or any untaxed portion of the lessor's excess rentals, are greater than the amount that would have been taxed prior to the permitted threshold imposed by section 228D.
75. Paragraph 6(3) modifies section 228D by applying paragraph 6(4) where there are excess rentals, or any untaxed portion of the lessor's excess rentals, but these are less than the amount that would have been taxed prior to the permitted threshold imposed by section 228D.
76. Paragraph 6(4) states that, where paragraph 6(3) applies, the permitted threshold will be increased to the excess rentals, or any untaxed portion of the lessor's excess rentals, plus an amount calculated in accordance with section 228D(2) but restricted in the ratio of the notional taxed rentals to the balance of the notional taxed rentals after excluding the amount to be taxed as excess rentals. The term "notional taxed rentals" is defined at paragraph 6(7) as the amount that would have been taxed in a period of accounts if the relief given by section 228D did not apply.
77. Paragraph 6(5) provides that in the transitional year the permitted threshold shall not be an amount less than the appropriate fraction of the notional taxed rental. This is the amount that would have been taxed up to 17 March 2004 where an accounting period begins before but ends after 17 March 2004.
78. Paragraph 6(6) defines "the lessor's excess rentals" and "the untaxed portion of the lessor's excess rentals".
79. Paragraph 6(7) defines "actual taxed rental" and "notional taxed rental".
80. Paragraph 6(8) ensures that if a termination occurs in the transitional year then the permitted threshold rules in section 228D(5) can be increased.
81. Paragraph 6(9) ensures that the transitional rules end when the lessor excess rentals have been fully taxed.
82. Paragraph 7 ensures that if the lease terminates before all of the untaxed portion of the lessor's excess rentals can be taxed then the balance is taxed in that period by increasing the permitted threshold.

83. Paragraph 8 ensures that the tax treatment for lessors is not changed where the termination occurred before 17 March 2004.
84. Paragraph 9 contains interpretations and definitions.
85. Paragraph 9(1) defines “existing leaseback”, “pre-commencement rentals” and “transitional period of accounts”.
86. Paragraph 9(2) explains that the appropriate fraction is the fraction of the pre-commencement period to the whole period. The pre-commencement period is the number of days that fall prior to 17 March 2004 and whole period is the number of days in the whole period.

BACKGROUND NOTE

87. This clause and Schedule close loopholes in the Capital Allowances legislation that some businesses have used to gain an unintended double benefit.
88. Plant or machinery can be sold for a sum, or leased out for a premium, that is largely or wholly untaxed, allowing the business to retain capital allowances. The plant or machinery is then leased back and the lease rentals are allowable for tax purposes, giving the businesses a double benefit of the capital allowances retained and the deductible lease rentals.
89. The commercial effect of the transactions is that the business has borrowed money and obtains tax relief for all or part of the cost of repaying the amount borrowed. Normally tax relief is available on the interest payable on a loan, but not on the repayments of the amount borrowed.
90. This measure will remove the unintended tax benefits for lessees by limiting the relief for the lease rental payments, bringing the tax treatment of these transactions more closely into line with their commercial substance.
91. Businesses could terminate, assign or vary leases in a way that could allow them to side-step this measure. Therefore the measure introduces a charge where a lease is terminated, assigned or varied in such a way that the lease is no longer a finance lease. The charge restricts the double benefit to that which had accrued up to Budget day. This charge is suspended in certain circumstances to help businesses to bring existing arrangements to an end in a way that is consistent with the aims of the measure.

EXPLANATORY NOTE

CLAUSE 128 AND SCHEDULE 24: MANUFACTURED DIVIDENDS

SUMMARY

1. The Clause introduces Schedule 24 and strengthens existing anti-avoidance legislation concerning the income tax treatment of sale and repurchase (repo) and stock lending arrangements over UK equities.
2. It prevents individuals and trusts from entering into schemes involving a repo or stock loan in order to exploit the difference in the effective rate of tax charged on a dividend received compared with the effective rate of tax relief on an equivalent payment representing that dividend (a 'manufactured dividend').
3. The clause also covers a development of the scheme whereby a capital gain on the UK equities is generated, by restricting relief for the manufactured dividend to the capital gains regime in such cases.
4. The effect of the clause is to make repo and stock loans neutral for income tax purposes. The changes apply to individuals where the dividend was received and the manufactured payment made on or after 6 November 2003. The changes apply to trusts and to the capital gains version of the scheme from 17 March 2004.

DETAILS OF THE CLAUSE

5. The Clause introduces Schedule 24.

DETAILS OF THE SCHEDULE

6. Paragraph 1(1) inserts a new subsection (1A) into section 231AA Income and Corporation Taxes Act (ICTA) 1988 which provides that where a 'relevant person' who is the interim holder under a repo or the borrower under a stock lending arrangement is not entitled to a tax credit under section 231 in respect of a qualifying distribution, section 233 does not apply to treat that distribution as having suffered income tax at

- 10%. A ‘relevant person’ is a person resident in the UK, not being a company.
7. Paragraph 1(2) inserts an equivalent new sub-section (1A) into section 231 AB ICTA 1988 which provides that where a ‘relevant person’ who is the original owner under a repo is not entitled to a tax credit under section 231 in respect of a qualifying distribution, section 233 does not apply to treat that distribution as having suffered income tax at 10%. A ‘relevant person’ is a person resident in the UK, not being a company.
 8. Paragraph 1(3) amends section 233 to make it subject to both section 231AA(1A) and section 231AB(1A).
 9. Paragraph 1(4) provides that the changes to section 231AA and the consequential change to section 233 apply to qualifying distributions received by a relevant person on or after the ‘commencement date’ where the equivalent manufactured payment is also made on or after that date.
 10. Paragraph 1(5) provides that the commencement date for relevant persons who are individuals is 6 November 2003, and for relevant persons who are not individuals is 17 March 2004.
 11. Paragraph 1(6) provides that the changes to section 231AB and the consequential change to section 233 apply to qualifying distributions received by a relevant person on or after Royal Assent.
 12. Paragraph 2(1) provides for paragraph (2A) of Schedule 23A ICTA to be amended.
 13. Paragraph 2(2) amends sub-paragraph (1) of paragraph (2A) of Schedule 23A to define ‘the relevant amount’ in relation to a manufactured dividend paid, to limit the relevant amount to the lesser of the amount of the manufactured dividend not otherwise allowable or the underlying dividend which it represents, and to provide that income tax relief is available only under sub-paragraphs (1ZA) or (1A) of Schedule 23A.
 14. Paragraph 2(3) inserts new sub-paragraphs (1ZA) and (1ZB) into paragraph (2A) of Schedule 23A. These provide that relief for the relevant amount is available only to the extent that a dividend on the UK equities is received and chargeable to income tax. Any relief can be set only against the dividend received rather than deducted against total income. Relief is available only where the dividend is received in the same year, or the year immediately before or immediately after that in which the manufactured dividend is paid.
 15. Paragraph 2(4) makes consequential amendments to sub-paragraph (1A) of paragraph (2A) of Schedule 23A, and removes the right to relief

against total income for the manufactured payment where a capital gain arises on the UK equities.

16. Paragraph 2(5) makes consequential changes to sub-paragraph (1B) of paragraph (2A) of Schedule 23A.
17. Paragraph 2(6) amends the meaning of “deductible” in sub-paragraph (4) of paragraph (2A) of Schedule 23A to remove superfluous references to corporation tax.
18. Paragraph 2(7) provides that the changes to income tax relief under paragraph (2A) of Schedule 23A, apart from the restriction to the lesser of the amount of the manufactured dividend and the amount of the dividend which it represents, apply to dividend manufacturers where the manufactured dividend is paid on or after the ‘commencement date’ and the dividend of which it is representative is or was received on or after that date.
19. Paragraph 2(8) provides that the commencement date is 6 November 2003, where the dividend manufacturer is an individual, and 17 March 2004 in any other case.
20. Paragraph 2(9) provides that certain consequential changes to the wording of paragraphs (1A) and (1B) of paragraph (2A) apply from 17 March 2004.
21. Paragraph 2(10) provides that the overriding restriction of income tax relief under paragraph (2A) of Schedule 23A to the lesser of the amount of the manufactured dividend and the amount of the dividend which it represents applies to manufactured dividends paid on or after Royal Assent.
22. Paragraph 2(11) removes the entitlement to income tax relief under paragraph (2A) of Schedule 23A for manufactured payments in cases where chargeable gains accrue on the UK equities where either the gain accrues, or the manufactured dividend is paid, on or after 17 March 2004.
23. Paragraph 3(1) inserts a new section 263D into the Taxation of Chargeable Gains Act 1992. This section provides that the manufactured payment is to be treated as a capital loss where one of three sets of conditions is met.
24. The first condition is that a chargeable gain arises on UK equities acquired under a repo. The second condition is that a chargeable gain arises on UK equities acquired under a stock loan. The third condition is that a chargeable gain arises on UK equities acquired under a ‘short sale

transaction’, which is defined as a contract or other arrangement for transfer of UK equities but which is not a repo or stock loan.

25. The amount of the allowable loss is not to exceed the lesser of amount of the chargeable gain arising on the UK equities and ‘the adjusted amount’. The adjusted amount is equal to the lesser of the amount of the manufactured dividend and the dividend that it represents, as reduced by the amount of any relief allowed for income tax purposes.
26. The capital loss is treated as accruing on the date on which the chargeable gain on the UK equities accrued, and can be set only against that gain.
27. Paragraph 3(2) applies the regulatory powers in section 737E ICTA 1988 to the new section 263D TCGA 1992.
28. Paragraph 3(3) provides for the treatment of a manufactured dividend as a capital loss, in cases where chargeable gains accrue on the UK equities, to apply where either the gain accrues or the manufactured dividend is paid on or after 17 March 2004.

BACKGROUND NOTE

29. This clause and associated schedule strengthen the anti-avoidance measures introduced in FA 1997 and FA 2002 to restrict income tax relief for manufactured payments made in respect of UK equities.
30. A sale and repurchase agreement (repo) is an agreement for sale of securities with a related agreement to buy back the securities at an agreed future date at a price agreed at the outset. A repo is a common form of financing transaction in the financial markets, particularly for secured lending of cash.
31. A stock lending arrangement is an arrangement for the transfer of securities otherwise than by way of sale, but with a requirement for equivalent securities to be transferred back at a future date. Despite the name, full beneficial ownership in the securities is transferred to the ‘borrower’, who provides collateral and pays the lender a fee. Stock lending is common in the financial markets as a means of maintaining liquidity in stocks by ensuring sellers have enough stock to meet their obligations.
32. Standard repo and stock lending agreements provide that if the securities pay a dividend or interest during the term of the agreement, the counterparty has to pay an equivalent amount (a ‘manufactured payment’) to the original owner or lender by way of compensation. This

ensures that the economic risks and benefits of owning the securities stay with the original owner or lender.

33. Under current income tax rules, a dividend received on UK equities under a repo or stock loan is taxed at a lower effective rate than that at which relief is given for the manufactured payment. This is because the dividend is taxed at a maximum of 32.5% and is treated as having suffered 10% income tax, whereas the manufactured dividend is set against total income at the 40% rate.
34. Alternatively, a person acquiring the equities can sell them on at the higher cum-dividend price, repurchase later at the lower ex-dividend price and generate a capital gain. If that person has capital losses to set against the gain, there is no tax charge but relief for the manufactured dividend is still given against income tax at the full 40% rate. Effectively, the person has set capital losses against income.
35. This has led to the promotion of schemes with no economic purpose other than to take advantage of the tax benefit. The scheme customer would enter into a repo or stock loan (often a contrived arrangement involving designer equities of a special purpose vehicle set up by the scheme promoters), and make no economic profit or loss other than the tax benefit, which would be shared with the promoters by way of a fee.
36. This clause and schedule block this abuse by ensuring that repo and stock loans are neutral for tax purposes. It ensures that where a dividend is received, it is not treated as having suffered 10% income tax and relief for the manufactured dividend can only be set against that same dividend so that the rate of relief matches the rate of tax charge on the dividend. Where a capital gain is generated, the clause ensures that relief for the manufactured payment is available only against that capital gain and that no relief is due against income.

EXPLANATORY NOTE

CLAUSE 129: GILT STRIPS

SUMMARY

1. This clause is an anti-avoidance provision that amends the income tax treatment of discounted securities in the form of strips of government bonds.
2. It prevents holders from artificially manipulating the prices at which strips are bought and sold in order to secure a tax advantage by substituting market value for cost of acquisition and/or proceeds of disposal.
3. This change applies to disposals of strips on or after 15 January 2004. In some versions of the gilt strip schemes, a capital loss can arise where there is no economic loss at all. The clause ensures that any such losses accruing on or after 17 March 2004 are disregarded.
4. There is a new rule to determine how market value is calculated. The clause also restricts profits and losses on strips by reference to original cost. This change applies to disposals of all strips originally acquired on or after 15 January 2004.

DETAILS OF THE CLAUSE

5. Subsection (1) provides for Schedule 13 Finance Act 1996 to be amended.
6. Subsections (2) & (3) provide for a new market value rule to apply to transactions in strips within paragraphs 8 & 9 of Schedule 13, which deal with transfers between connected persons and other transfers deemed to be at market value.
7. Subsection (4) provides that a new market value applies to strips and securities exchanged for strips. The new market value rule is in paragraph 14E of Schedule 13
8. Subsection (5) inserts a new paragraph 14B into Schedule 13. This paragraph applies where there is a scheme or arrangement and the main, or one of the main, benefits expected to accrue is the obtaining of a tax advantage. The paragraph substitutes market value in any case where

the acquisition cost is more than market value, or the disposal or redemption proceeds are less than market value.

9. Subsection (6) inserts a new paragraph 14C into Schedule 13. This provides that where, as part of any scheme or arrangement which has an unallowable purpose, a capital loss accrues, that loss is to be disregarded. A scheme or arrangement has an unallowable purpose if the main benefit, or one of the main benefits, that might have been expected to result from it is either the obtaining of a tax advantage or the accrual to any person of a capital loss.
10. Subsection (7) inserts a new paragraph 14D into Schedule 13. This paragraph restricts losses on disposals, deemed disposals or redemptions of strips to the extent that the proceeds are less than original acquisition cost. It also restricts profits to the amount by which disposal proceeds exceed original acquisition cost.
11. Subsection (8) inserts a new paragraph 14E into Schedule 13. This paragraph provides that the market value of strips or a security exchanged for strips is to be taken to be equal to the publicly quoted price for that strip or security. For strips quoted in the London Stock Exchange Daily Official List, those prices are to be used. For overseas government bonds and strips of overseas government bonds that are not quoted in the Daily Official List, the prices in the equivalent foreign stock exchange list of the territory of issue are to be used. The paragraph also provides for a regulatory power to amend the mechanism for determining market value in any case.
12. Subsection (9) makes a consequential amendment to the definition of market value in paragraph 15.
13. Subsection (10) applies the changes made to transfers between connected persons and other transfers deemed to be at market value to transfers of strips on or after 17 March 2004.
14. Subsection (11) applies the new rule for determining the market value of a strip or a security exchanged for strips to exchanges and deemed transfers and re-acquisitions on or after 17 March 2004.
15. Subsection (12) applies the rule relating to schemes or arrangements securing a tax advantage, including the new market value rule in relation to such schemes, to disposals or redemptions of all strips on or after 15 January 2004.
16. Subsection (13) applies the disregard of capital losses arising from schemes or arrangements to losses on or after 17 March 2004.

17. Subsection (14) applies the restriction of profits and losses by reference to original cost to all strips originally acquired on or after 15 January 2004.
18. Subsection (15) provides that deemed transfers and re-acquisitions are disregarded in determining when a strip was originally acquired for the purposes of the commencement rules in sub-sections (12) and (14).

BACKGROUND NOTE

19. The new rules in this clause and associated schedule prevent the avoidance of income tax by holders of strips of UK and overseas government bonds where schemes or arrangements are entered into to secure a tax advantage by manipulation of the cost of acquisition or proceeds of disposal for tax purposes.
20. Governments borrow money by issuing bonds into the financial markets and paying interest on the money borrowed. Strips are instruments created by the separation (or 'stripping') of the underlying bond into rights to payments of interest at separate future dates during the life of that bond (coupon strips) and rights to the payment of the principal at maturity of the bond (principal strip). Each strip is equivalent to a zero coupon bond and can be traded separately. A government bond can also be reconstituted from the component coupon and principal strips.
21. Strips are treated for income tax purposes as 'relevant discounted securities' (RDS). The profit or loss on transfer or redemption of an RDS is calculated by subtracting from the consideration on transfer or maturity the amount paid in respect of acquisition. Where a loss arises, which in normal market conditions would be unusual for a discounted security, no tax relief is allowed for that loss where it arose on or after 27 March 2003.
22. For RDS that are strips of government bonds, there is an additional rule that deems non-corporate holders to dispose of that strip on 5 April each year for its market value and to re-acquire it on 6 April at the same value. They are taxed on the excess over the previous 5 April value, or acquisition cost if more recent. Loss relief in respect of strips is available for income tax purposes.
23. Following removal for loss relief on RDS other than strips of government bonds, schemes have been promoted to take advantage of the availability of loss relief on strips. These involve a person acquiring a strip and granting an option to another person to buy the strip. Most of the value of the strip was realised in the form of the option premium, with the remainder received as sales proceeds under the option. Because

strips and options over strips are outside the capital gains net, the option premium was not taxed at all, and so a large loss arose for income tax purposes when the strip was sold on exercise of the option.

24. This clause blocks this abuse where there is a scheme or arrangement entered into in order to secure a tax advantage, by substituting the market value of the strip. It applies to reductions in profit as well as creation of losses.
25. In some versions of these schemes, it was possible for a capital loss to arise, even though there is no economic loss incurred. The clause provides for any such loss to be disregarded for capital gains purposes.
26. The clause also introduces detailed rules that provide that the market value of a strip, and a security exchanged for strips, is to be taken to be equal to its publicly quoted price. Where prices of a strip are quoted in the London Stock Exchange Daily Official List (DOL), those prices are to be used. Where a strip of an overseas government bond is not quoted in the DOL, the equivalent foreign stock exchange listing prices in the territory of the government of issue are to be used. The clause contains a regulatory power to cover any future situations where strips of overseas government bonds are not quoted on any recognised exchange at all.
27. It is unusual to make a loss on disposal of an RDS, because the value of a discounted security increases over the life of the bond from its issue price to the redemption proceeds. But for strips, where there is a deemed disposal and re-acquisition at each 5 April, it is possible for a loss to arise in any given year from a temporary fall in value of bonds. But it is unlikely there would be an overall loss on final disposal of a strip unless this was contrived for tax purposes. The clause therefore provides that no loss relief is available to the extent that the disposal proceeds are less than original cost. Similarly, any profit is limited to the amount by which proceeds exceed original cost. This puts strips on the same footing as RDS and other debt securities by allowing no tax relief for loss of original capital.

EXPLANATORY NOTE

CLAUSE 130: LIFE POLICIES ETC.: RESTRICTION OF CORRESPONDING DEFICIENCY RELIEF

SUMMARY

1. The Clause affects the taxation of life insurance policies, life annuity contracts and capital redemption policies. It closes an avoidance loophole by restricting the corresponding deficiency relief which is allowable against an individual's income where the computation of the gain when the policy or contract comes to an end shows a deficiency. The measure takes effect from 3 March 2004.

DETAILS OF THE CLAUSE

2. Subsection (1) is a signpost to the particular section which will be amended, namely section 549 of the Income and Corporation Taxes Act 1988.
3. Subsections (2) and (3) amend section 549(1) and insert a new section 549(1A). These impose an additional restriction on the amount of corresponding deficiency relief which an individual may be entitled to when a life insurance policy, life annuity contract or capital redemption policy comes to an end. Under the new legislation, the amount of deficiency relief which may be available to an individual cannot exceed the total of the amounts of earlier gains made on the policy or contract on earlier part surrenders and part assignments, which also formed part of that same individual's income in an earlier year of assessment.
4. Subsections (4), (5) and (6) are the commencement provisions, applying to life insurance policies, life annuity contracts and capital redemption policies respectively. The new measure applies to all new policies and contracts made or entered into on or after 3 March 2004.
5. The measure also applies to existing policies or contracts
 - which are varied on or after 3 March 2004 so as to increase the benefits secured, for instance if it is agreed with the insurer that further premiums are paid. For this purpose, exercise of an option in the policy or contract, for instance to pay more premium on or after 3 March 2004, is treated as a variation, or

- where all or part of the rights conferred by the policy or contract are assigned to another person on or after 3 March 2004. This applies whether or not the assignment is for money or money's worth, or
- where all or part of the rights conferred by the policy or contract become held as security for a debt on or after 3 March 2004.

BACKGROUND NOTE

6. Gains from life insurance policies, capital redemption policies and life annuity contracts are taxed as income. They can arise on the happening of "chargeable events". Chargeable events are the death of an insured person giving rise to benefits, the maturity of a policy, assignments for money or money's worth and surrenders of all or part of the rights under the policy.
7. The amount of a gain when a policy comes to an end is calculated by deducting the aggregate amount of premiums paid, and of any gains that have previously arisen on the policy, from the value of the benefits received. If this calculation produces a negative result or "deficiency", there is no gain. But an individual, whose income would have included the gain had there been one, may be entitled to a relief called "corresponding deficiency relief" against his or her higher-rate tax liability on other income. Corresponding deficiency relief is set off against other income and eliminates the higher rate tax otherwise due on it, leaving only basic, lower or dividend rate tax payable. For instance, relief on earned income would be worth 18% (40% higher rate tax less 22% basic rate tax).
8. This relief is only available if there have been earlier gains on the policy (say due to earlier part surrenders of the policy). The amount of the deficiency available for relief is restricted to at most the amount of those earlier gains. There is no requirement that the earlier gains need to have formed part of the income of the individual who becomes entitled to the corresponding deficiency relief when the policy ends, for example where a different person owned the policy when the earlier gains arose. This mismatch gave the opportunity to use life insurance policies to create deficiency relief in order for individuals to avoid higher-rate tax. This measure removes that opportunity.

EXPLANATORY NOTE

**CLAUSE 131: RELIEF FOR RESEARCH AND
DEVELOPMENT: SOFTWARE AND CONSUMABLE
ITEMS**

SUMMARY

1. This Clause makes a change to the SME research and development tax credit, the large company research and development tax relief and vaccines research relief. The change widens the definition of qualifying expenditure to include the costs of computer software, water, fuel and power. It also simplifies the definition of materials used in research and development.

DETAILS OF THE CLAUSE

2. The Clause amends the three R&D schemes, being the SME R&D tax credit, the large company R&D tax relief and vaccines research relief.
3. Subsection (1) provides that the existing paragraph 6 of Schedule 20 FA 2000 is replaced by a new paragraph 6.
4. Subsection (2) provides that the term “software or consumable items” which is introduced by new paragraph 6 shall replace all existing references to “consumable stores” in the three R&D schemes.
5. Subsection (3) provides that the amendments made by the clause to Schedule 12 of FA 2002 (the large company R&D scheme) shall have effect for expenditure incurred on software or consumable items on or after 1 April 2004.
6. Subsection (4) provides that, except as provided for by subsection (5), the amendments made by the clause to Schedule 20 FA 2000 (the SME R&D scheme) and Schedule 13 FA 2002 (vaccines research relief) shall have effect for expenditure incurred on software or consumable items on or after a day to be appointed.
7. Subsection (5) provides that new paragraph 6 of Schedule 20 FA 2000 has effect for expenditure incurred on or after 1 April 2004 in the application of paragraph 6 for the purposes of Schedule 12 FA 2002.
8. Subsection (6) provides that the Treasury may by order appoint a day for the commencement of the provisions at subsection (4), and that different days may be appointed for different provisions or purposes.

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9. Subsection (7) provides that the days that may be appointed under subsection (6) may include days earlier than the day on which the Finance Act 2004 is passed, but not earlier than 1 April 2004.

New paragraph 6 of Schedule 20 FA 2000

10. The existing paragraph 6 of Schedule 20 FA 2000 “Expenditure on consumable stores” is replaced by a new paragraph 6 “Expenditure on software or consumable items”.
11. Sub-paragraph (1) defines references to expenditure on “software or consumable items” within Schedule 20 as meaning expenditure on computer software or consumable or transformable materials.
12. Sub-paragraph (2) provides that for the purposes of Schedule 20 consumable or transformable materials includes water, fuel and power.
13. Sub-paragraph (3) provides that expenditure on software or consumable items is attributable to relevant R&D if the software or consumable items are employed directly in the R&D.
14. Sub-paragraph (4) provides that where software or consumable items are partly employed directly in relevant R&D, then an appropriate portion of the expenditure is treated as attributable to relevant R&D.
15. Sub-paragraph (5) provides that, for the purposes of sub-paragraphs (3) and (4) software or consumable items are not treated as directly employed in other activities if they are employed in the provision of services in support of those other activities.

BACKGROUND NOTE

16. The Government introduced an R&D tax credit for companies that are SMEs in Budget 2000 (at Schedule 20 FA 2000).
17. After consultation, an R&D tax credit for all companies was introduced in FA 2002 (at Schedule 12). At the same time, an additional new relief was introduced for companies carrying out R&D into drugs and vaccines to treat or prevent TB, malaria and AIDS/HIV - the so called killer diseases of the developing world.
18. The Government announced in the Pre-Budget Report 2003 its willingness to consider improvements to all three tax credits, and a package of improvements was announced in Budget 2004. The present legislation implements an element of that package.

EXPLANATORY NOTE

**CLAUSE 132: TEMPORARY INCREASE IN AMOUNT OF
FIRST-YEAR ALLOWANCES FOR SMALL ENTERPRISES**

SUMMARY

1. This clause increases for one year the rate of first-year capital allowances for spending by small businesses on most plant and machinery. The rate is increased from 40 per cent to 50 per cent. The increased allowances apply to spending on or after 1 April 2004 for businesses within the charge to corporation tax and on or after 6 April 2004 for businesses within the charge to income tax.

DETAILS OF THE CLAUSE

2. Subsection (1) provides for the substitution of “50%” for “40%” in the Table in section 52(3) of the Capital Allowance Act 2001, as the rate for expenditure qualifying under section 44 of that Act, but only in the case of expenditure to which this subsection applies.
3. Subsection (2) then defines which of the expenditure qualifying under section 44 is expenditure to which subsection (1) applies. It provides that the expenditure must be incurred by a small enterprise in the period of 12 months beginning with – (a) 1st April 2004, if the small enterprise is within the charge to corporation tax, or (b) 6th April 2004, if the small enterprise is within the charge to income tax.
4. Subsection (3) inserts a “signpost” or “second sentence” in section 52(3) of the Act, following the Table, which is intended simply to steer a small enterprise to this clause for the year in which it is to be in force.

BACKGROUND NOTE

5. Capital allowances allow the cost of capital assets to be written off against a business’s taxable profits. They take the place of commercial depreciation charged in commercial accounts. The main rate of capital allowances for general spending on plant and machinery is 25 per cent a year on the reducing balance basis. First-year allowances (FYAs) bring forward the time that tax relief is available for capital spending and

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allow a greater proportion of the cost of an investment to qualify for tax relief against a business's taxable profits of the period during which the investment is made.

6. Small and medium-sized enterprises can claim 40 per cent FYAs on their investments in most plant and machinery. There are some exceptions, including spending on long-life assets, cars and assets for leasing.
7. This measure will increase the FYAs for small enterprises only, from 40 per cent to 50 per cent for a period of one year, providing an increased cash-flow benefit for small businesses' investment in plant and machinery. The rate of FYAs for medium-sized enterprises remains unchanged at 40 per cent.

EXPLANATORY NOTE

**CLAUSE 133: DEDUCTION FOR EXPENDITURE BY
LANDLORDS ON ENERGY-SAVING ITEMS**

SUMMARY

1. This clause inserts two sections in the Income and Corporation Taxes Act 1988. These sections enable landlords who pay income tax to claim a deduction for expenditure to install loft insulation and cavity wall insulation in let residential property.

DETAILS OF THE CLAUSE

2. Subsection (1) of the clause inserts new sections 31A and 31B into the Income and Corporation Taxes Act 1988.
3. New sections 31A(1) and (2) provide for a deduction for certain expenditure when computing the profits of a business taxable under Schedule A if that business includes letting a dwelling house, the expenditure meets the qualifying conditions introduced by section 31A(3) subject to any regulations made under section 31A(13).
4. New section 31A(3) provides that the deduction can only be made in respect of expenditure which satisfies the nine qualifying conditions set out in new sections 31A(4) to (12). Condition 1 requires the expenditure to be incurred in installing qualifying energy-saving items in the dwelling house. Condition 2 specifies the period (from 6 April 2004 to 5 April 2009) in which expenditure which qualifies for the deduction may be incurred. Condition 3 requires the expenditure to be incurred wholly and exclusively for the purposes of the Schedule A business. Conditions 4 to 6 prevent the deduction being made in respect of expenditure for which a deduction may already be made under existing law when computing Schedule A profits. Condition 7 prevents the deduction being made in respect of expenditure in property which is being acquired or constructed. Condition 8 prevents the deduction being made in respect of expenditure in property let as furnished holiday accommodation. Condition 9 prevents the deduction being made for expenditure in property which is let by a landlord who is entitled to relief under the "rent a room" scheme in Schedule 10 to the Finance (No. 2) Act 1992.

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5. New section 31A(13) provides a power for the Treasury to make regulations to restrict the amount of expenditure which may be claimed, to exclude specified kinds of claim, to determine which person may claim the deduction when more than one person has an interest in the property in respect of which the deduction is made or for apportioning the deduction when more than one person owns that property.
6. New section 31A(14) provides a link to section 31B.
7. New section 31B(1) introduces the supplementary provisions in section 31B.
8. New section 31B(2) prevents the deduction being claimed by corporation tax payers.
9. New section 31B(3) requires that the deduction cannot be made unless a claim is made.
10. New section 31B(4) enables the deduction to be made in respect of an appropriate part of any expenditure which meets the qualifying conditions if the whole of that expenditure does not meet the qualifying conditions.
11. New section 31B(5) enables the deduction to be made in respect of expenditure incurred up to six months before the Schedule A business is commenced (provided the expenditure is incurred on or after 6 April 2004).
12. New section 31B(6) defines qualifying energy-saving items in respect of which the deduction may be made.
13. New section 31B(7) provides a power for the Treasury to make regulations to add further descriptions of items, and to remove or vary the definitions of qualifying energy-saving items. New section 31B(8) allows those regulations to include conditions which must be satisfied if an item is to be a qualifying energy-saving item. New section 31B(9) allows the regulations to include conditions which refer to guidance or other material issued by another organisation. New section 31B(10) ensures that the regulations have effect in relation to expenditure incurred before they are made provided they are made on or before 31 December 2004.
14. New section 31B(11) provides for the meaning of the expression "provision of a qualifying energy-saving item".
15. Subsection (2) of the clause provides for the start date and expiry of the new provisions.

BACKGROUND NOTE

16. Provision for a deduction for certain energy-saving expenditure ("Landlord's Energy Saving Allowance") was announced in Budget 2004. The deduction is intended to provide encouragement for private landlords who pay income tax to install cavity wall and loft insulation in the residential property which they let. Expenditure on these items cannot normally be deducted when calculating taxable profits and it is not eligible for capital allowances under the Capital Allowances Act 2001. Regulations made under the new powers will restrict the maximum deduction which can be made to £1,500 per property. The provisions are to have a limited life and the deduction will not be available for expenditure incurred after 5 April 2009.

EXPLANATORY NOTE

CLAUSE 134 AND SCHEDULE 25: LLOYD'S NAMES: CONVERSION TO LIMITED LIABILITY UNDERWRITING

SUMMARY

1. This Clause and Schedule 25 allow individual Lloyd's underwriters who convert under Lloyd's rules to underwriting through a company or a limited partnership to carry forward unused trading losses, and, where the conversion is to a company, to defer charges to capital gains tax ("CGT"). This is provided certain qualifying conditions are met. The new relief for trading losses is available where the conversion takes place on or after 6 April 2004. The CGT relief is available where assets are transferred to the successor company on or after that date.

DETAILS OF THE CLAUSE

2. The Clause gives effect to the Schedule, which makes provision for certain reliefs to be available where a member of Lloyd's converts to limited liability underwriting.

DETAILS OF THE SCHEDULE

3. Paragraphs 1, 2, and 3 amend the Finance Act 1993, inserting a new section (section 179B) and a new Schedule (Schedule 20A) in that Act. The new section and schedule have effect where a member converts to limited liability underwriting. This means underwriting through a member of Lloyd's which is a company or a Scottish Limited Partnership ("SLP").

Schedule 20A to Finance Act 1993

4. Part 1 of Schedule 20A deals with conversion to underwriting through successor companies. A successor company is a corporate member of Lloyd's. The reliefs which apply in this situation are set out in paragraphs 1 to 5 of the Schedule.
5. Paragraph 1 sets out the conditions which must be satisfied for the reliefs to be available.

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- Condition 1 is that the member must resign as an underwriting member of Lloyd's, must not withdraw that resignation, and must not underwrite new business at Lloyd's after the end of the "the member's last underwriting year". This expression is defined in sub-paragraph (7).
 - Condition 2 is that the member must dispose of all "outstanding syndicate capacity" under a "conversion arrangement" to a "successor company" with effect from the beginning of the next underwriting year. The terms "conversion arrangement", "outstanding syndicate capacity" and "successor company" are defined, respectively, in paragraph 10, paragraph 1(8) and paragraph 5.
 - Condition 3 is that immediately before the disposal of syndicate capacity the member must control the successor company and hold the majority of its ordinary share capital.
 - Condition 4 requires that disposal to be made solely in return for an issue of shares in the company to the member.
 - Condition 5 requires the successor company to start its underwriting in the year which immediately follows the member's last underwriting year. This is referred to as "the successor member's first underwriting year".
6. Paragraph 2 allows the member's trading losses from his underwriting business as a member of Lloyd's to be carried forward and set off against his income from the successor company.
7. Sub-paragraph (1) applies where the member's total income for a year of assessment includes income derived from the successor company. The requirements about control and ownership of ordinary share capital (see the third condition set out above in paragraph 5 of this note) must continue to apply until the end of that year of assessment.
8. Sub-paragraph (2) provides for the "carry forward provision" to apply as if the income were trading profits for tax purposes. The carry forward provision is defined in sub-paragraph (4) and means section 385 of the Income and Corporation Taxes Act 1988. This provision allows trading losses to be carried forward and set off against subsequent profits of the same trade.
9. Sub-paragraph (3) states that losses are to be set first against income on which the member is directly assessed for income tax purposes, for example, remuneration.
10. Paragraphs 3 and 4 allow the member to claim new CGT roll-over reliefs where chargeable gains arise on the disposal by a member of certain assets to the company. Paragraph 3 applies to the disposal of syndicate capacity to the company. Paragraph 4 applies to the disposal

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of assets used as security for the member's underwriting business (assets forming part of a member's Ancillary Trust Fund – "ATF assets").

11. Paragraph 3 allows the member to claim a new roll-over relief where a chargeable gain arises on the disposal by a member of syndicate capacity to a successor company.
12. Sub-paragraph (1) states that paragraph 3 applies where there is an excess of chargeable gains over allowable losses where syndicate capacity is disposed of to the company, and a claim is made to an officer of the Board. Sub-paragraph (2) defines the amount by which the gains exceed the losses as the "amount of the syndicate capacity gain" and provides that this gain is reduced for CGT purposes by the amount of the "rolled-over gain". The rolled-over gain is defined in sub-paragraph (4) as the lesser of the amount of the syndicate capacity gain and the amount which the member would be entitled to deduct as the acquisition cost of "the issued shares" in working out, for CGT purposes, any gain or loss arising on a disposal of them. The "issued shares" are defined in sub-paragraph (5) as the shares issued to the member in consideration for the syndicate capacity.
13. Sub-paragraph (3) requires the rolled-over gain to be apportioned between the "issued shares" as a whole and the acquisition cost, for CGT purposes, of those shares to be reduced by the amount apportioned to them. Where the issued shares comprise shares of more than one class, the apportionment is made by reference to the respective market values of the different shares issued. Reducing the cost of the shares in this way has the effect of increasing the amount of any chargeable gain arising on any later disposal of them by the amount rolled-over. (It can also have the effect of reducing the amount of any loss arising in such circumstances, or of converting a loss into a chargeable gain.) This "rolling over" of the gain enables the relief given on the transfer of syndicate capacity to be recovered on later disposal of the shares. An appropriate adjustment to the CGT acquisition cost is made where that disposal is of any asset derived from any of the issued shares.
14. Paragraph 4 allows the member to claim a new CGT roll-over relief where a chargeable gain arises on a disposal by a member of ATF assets to the company.
15. Sub-paragraph (1) sets out the circumstances in which the relief may apply. These are that, either at or after the time of the syndicate capacity disposal, the member transfers ATF assets to the successor company, and there is a net chargeable gain on the disposal of those assets (that is, the total of the chargeable gains on the disposal of ATF assets to the successor company exceeds the total allowable losses). In addition, the member must continue to control the company and hold the majority of

its ordinary share capital from the time of the syndicate capacity disposal until the disposal of the ATF assets in question. The disposal of the ATF assets to the successor company must be in consideration solely for an issue of shares (the “issued shares”) in the company, and a claim must be made to an officer of the Board.

16. Sub-paragraph (2) provides that a claim to roll-over relief in respect of ATF assets may be made only if the member makes, or has already made, a claim under paragraph 3 of the Schedule in relation to the syndicate capacity disposal. This requirement does not apply where it is not possible for such a claim be made either because the syndicate capacity disposal took place before 6 April 2004, the date from which the provisions in Schedule 20A have effect, or because there was no aggregate chargeable gain on the syndicate capacity disposal for which relief could be claimed.
17. Sub-paragraph (3) provides that the net chargeable gains on the disposal of the ATF assets to the company (referred to as the “amount of the ATF assets gain”) shall be reduced for CGT purposes by the amount of the “rolled-over gain”. The rolled-over gain is defined in sub-paragraph (5) to mean the lesser of the amount of the ATF assets gain and the amount which the member would be entitled to deduct as the acquisition cost of the issued shares in working out, for CGT purposes, any gain or loss arising on a disposal of them.
18. Sub-paragraph (4) requires the rolled-over gain to be apportioned between the issued shares as a whole and the acquisition cost, for CGT purposes, of those shares to be reduced by the amount apportioned to them. Where the issued shares comprise shares of more than one class, the apportionment is made by reference to the respective values of the different shares issued. This relief therefore works in the same way as the roll-over relief for syndicate capacity (see paragraph 13 of this note).
19. Sub-paragraph (6) provides that if the value of the ATF assets disposed of to the successor company exceeds an amount, referred to as “the amount of the ATF assets required”, only a fraction of the ATF assets gain can be rolled-over. This fraction is the amount of the ATF assets required divided by the value of ATF assets disposed of to the successor company. Sub-paragraph (7) defines “the amount of the ATF assets required” as the lesser of the amount of security required in respect of the member’s last underwriting year and the amount required in respect of the successor company’s first underwriting year.
20. Sub-paragraph (8) provides that a claim to the CGT roll-over relief for the disposal of ATF assets may be made in respect only of the first occasion after 5 April 2004 on which such assets are disposed of to the successor company.

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21. Sub-paragraph (9) provides that if a claim is made in respect of CGT relief on the disposal of syndicate capacity and then revoked, paragraph 4 shall apply as if that claim had never been made.
22. Paragraph 5 provides definitions of terms used in Part 1 of the Schedule.
23. Part 2 of Schedule 20A applies to members who convert to underwriting through “successor partnerships”. “Successor partnership” here means a Scottish Limited Partnership which is a member of Lloyd’s.
24. Paragraph 6 sets out the conditions for relief under this part of the Schedule to be available.
 - Condition 1 is that the member must resign as an underwriting member of Lloyd’s, must not withdraw that resignation, and must not underwrite new business at Lloyd’s after the end of “the member’s last underwriting year”. This term is defined in paragraph 6(6), and has the same meaning as in paragraph 1(7).
 - Condition 2 is that the member must dispose of all “outstanding syndicate capacity” under a “conversion arrangement”, to a “successor partnership” with effect from the beginning of the next underwriting year. The terms “conversion arrangement”, “outstanding syndicate capacity” and “successor partnership” are defined, respectively, in paragraph 10, paragraph 6(7) and paragraph 8.
 - Condition 3 is that the member is the only person who disposes of syndicate capacity under a conversion arrangement to the partnership.
 - Condition 4 is that the successor partnership must start its underwriting in the year which immediately follows the member’s last underwriting year. This is referred to as the successor member’s first underwriting year.
25. Paragraph 7 allows the member’s trading losses from his underwriting business as a member of Lloyd’s to be carried forward and set off against profits of the underwriting business carried on by the successor partnership.
26. Sub-paragraph (1) applies where the member’s total income for a year of assessment includes profits of the successor partnership’s underwriting business. The member must be beneficially entitled to more than 50% of the profits of that business throughout the period from the time of the syndicate capacity disposal up to the end of that year of assessment.
27. Sub-paragraph (2), together with sub-paragraph (3), provides for section 385 Income and Corporation Taxes Act 1988 (see paragraph 8 of this note) to apply so that losses carried forward in respect of the member’s old underwriting business can be set off against the profits of the

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successor partnership's underwriting business to which he is beneficially entitled.

28. Paragraph 8 provides definitions of terms used in Part 2 of the Schedule.
29. Part 3 of the Schedule contains supplementary provisions.
30. Paragraph 9 provides that a member who has made a claim to relief under this Schedule must notify an officer of the Board if he withdraws the notice of his resignation from membership of Lloyd's. The member must notify the Inland Revenue in writing within six months of such a withdrawal. Any necessary adjustments will be made to the tax liabilities of the member where a notice of resignation is withdrawn. Subsection 5 applies if a member fraudulently or negligently fails to comply with the requirement to notify the Inland Revenue. Under these circumstances, the member may be subject to a penalty under Section 95 Taxes Management Act 1970 as if he had fraudulently or negligently made an incorrect return, statement or declaration in connection with his claim for relief.
31. Paragraph 10 defines certain expressions used in the Schedule.
32. Paragraph 11 makes commencement provision. Claims to relief under paragraph 2 and paragraph 7 (carry forward of trading losses), and paragraph 3 (CGT relief on disposal of syndicate capacity), may be made in relation to syndicate capacity disposals on or after 6 April 2004. Claims to relief under paragraph 4 (CGT relief in respect of ATF assets) may be made in relation to conversions to limited liability underwriting entered into at any time, provided the assets for which relief is claimed are disposed of on or after 6 April 2004.

BACKGROUND NOTE

33. In most circumstances, tax rules allow unincorporated traders to carry forward unused trading losses and offset them against income derived from the company, and to defer charges to CGT when they transfer a business to a company in return for shares issued by the company. Where an unincorporated business is transferred to a partnership, it is normally treated as continuing for tax purposes, and depending on the terms on which the business is transferred, no charge to CGT may arise. However, these rules do not currently apply to individual underwriting members of the Lloyd's insurance market (known as "Names"). This is because the tax rules outlined above require the trader to transfer the entire business as a going concern. Under Lloyd's regulations and system of accounting, the transfer of underwriting has to take place over

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an extended period of time, and the conditions for the current tax reliefs are not capable of being satisfied.

34. Subject to a number of conditions, the new rules will allow a Name to transfer his underwriting to a “successor member” of Lloyd’s without losing the benefit of unused trading losses, or incurring an immediate liability to CGT. The new rules broadly replicate the tax reliefs to which other unincorporated traders are entitled when they convert to a company or a partnership. Currently the only type of partnership which can be a member of Lloyd’s is a Scottish Limited Partnership.
35. One condition for relief is that the transfer of underwriting must be under a Lloyd’s “conversion arrangement”. In most cases this refers to arrangements under which the assets which provide security for the underwriting business (known as the assets of the “Ancillary Trust Fund” or “ATF”) are used to support both the Name’s final underwriting year and the first few underwriting years of the successor member.
36. The successor member must be either a company of which the Name owns more than 50% of the ordinary share capital and which the Name controls, or a Scottish Limited Partnership in which the Name is beneficially entitled to more than 50% of the underwriting profits.
37. In most cases where relief is due the successor member will underwrite for the first time for the 2005 or a later underwriting year. For example, where the successor member underwrites on the 2005 underwriting year, any profits from underwriting will arise for tax purposes in 2008. Such profits (in the case of a partnership), or income derived from the profits (such as remuneration or dividends from a company), will normally form part of the Name’s income for the 2008-09 income tax year. If the Name has income tax losses arising from the 2004 or earlier underwriting years which have not been used in some other way, it will now be possible to set such losses against this income.
38. Where the transfer of the underwriting business is to a company, liability to CGT would normally arise on gains made on disposals of assets to the company as part of the transfer. Under the new rules it will be possible to roll over such gains against the cost (for CGT purposes) of the shares issued in return for the assets. Gains rolled over in this way will, therefore, be deferred until the shares in question are disposed of.
39. The CGT roll-over relief is available both for gains on syndicate capacity which is transferred to the company at the start of its first underwriting year, and for gains on assets which are used as security for the underwriting business (known as “Funds at Lloyd’s” or the “ancillary trust fund” or “ATF”) which are usually transferred to the company some time later. The roll-over relief for ATF assets applies in

respect of assets transferred to new companies, and to existing companies which satisfy the conditions for the other reliefs. But this relief is restricted to the first transfer of ATF assets after 6 April 2004 only. The amount of relief will also be restricted to the lower of the value of ATF assets needed to support either the member's last underwriting year or the successor company's first underwriting year.

40. An illustration of how the new CGT roll-over relief works is as follows.
41. An individual Name converts to underwriting via a successor company with effect from the 2005 underwriting year. The Name transfers syndicate capacity to the company. A chargeable gain of £100 (before any roll-over relief) accrues for CGT purposes on the disposal by the Name to the company. The Name receives shares with a cost (for CGT purposes, and before any roll-over relief) of £250 as consideration for the transfer of syndicate capacity. All relevant conditions for relief are met and the Name makes a claim to relief.
42. The effect of the relief is that –
 - The chargeable gain of £100 is reduced to nil, eliminating any possible liability to CGT on the disposal of syndicate capacity.
 - The gain of £100 is “rolled over” onto the consideration shares and the Name is treated as acquiring them at a reduced cost of £250-£100=£150.
 - If the Name sells the shares at a later date for, say, £425 the gain on sale will be £425-£150=£275 (and not £425-£250=£175, as it would have been if no roll-over relief had been claimed).

EXPLANATORY NOTE

CLAUSE 135 AND SCHEDULE 26: OFFSHORE FUNDS

SUMMARY

1. This clause and schedule amend the offshore funds regime. They change the rules that determine whether or not an offshore fund can be certified as a "distributing fund". This in turn determines the tax treatment of a UK investor. The new rules apply to the first account period of an offshore fund ending after Royal Assent, but existing funds will have the option to continue to apply some of the existing rules.
2. An offshore fund must satisfy certain conditions if it is to be certified as a "distributing fund". It must distribute at least 85% of its income annually and it must meet certain investment restrictions. Where an offshore fund consists of more than one sub-fund and/or class of interest, all the sub-funds and classes of interest must meet the qualifying conditions.
3. If an offshore fund is certified as a distributing fund, a UK investor will pay income tax or corporation tax on the annual distributions, and any gains on their shares or units are within the chargeable gains rules. If an offshore fund does not qualify, all gains realised by a UK investor are treated as income. This is to reflect the fact that the value of units or shares in a non-qualifying fund will usually include accumulated income.
4. The changes align the measure of income against which distributions are measured more closely to a measure of profits for the purposes of UK corporation tax, remove most of the investment restrictions, and allow each sub-fund or class of interest to qualify separately without affecting or being affected by other sub-funds or classes of interest. Consequential changes are also made to relevant capital gains legislation to accommodate the new structure involving sub-funds and classes of interest.

DETAILS OF THE CLAUSE

5. Subsection (1) introduces Schedule 26.
6. Subsection (2)(a) sets the commencement provisions. The new rules for determining distributing status apply to the first account period of an

offshore fund that ends on or after the date of Royal Assent. For example, if the fund accounts to 31st July and Royal Assent is on a date in July 2004, the new rules apply to the fund for its account period ending 31st July 2004. This is subject to existing funds' option to continue to apply certain of the existing rules.

7. Subsection (2)(b) provides that regulations made under these provisions may have effect for account periods of an offshore fund ending on or after the date of Royal Assent.

DETAILS OF THE SCHEDULE

8. Paragraph 1 amends the rules in Paragraph 5 Schedule 27 of the Income and Corporation Taxes Act 1988 (ICTA) by which "United Kingdom Equivalent Profits" (UKEP) are calculated. UKEP is important in giving a measure against which offshore funds must measure their distributions. An offshore fund must make distributions annually that are equal to at least 85% of its income measured by UKEP.
9. Under existing rules, UKEP is measured on the basis of what would be the measure of profits chargeable to UK corporation tax, with certain exceptions. One exception is that chargeable gains are omitted, reflecting the fact that investment schemes are not usually permitted to distribute capital as annual income. The other main exceptions are that income tax rules rather than corporation tax rules are used to measure profits from loan relationships (broadly, interest-bearing assets) and derivative contracts, such as futures and options.
10. The rules are now amended so that corporation tax rather than income tax rules will apply for the purposes of calculating income from loan relationships unless the manager of the offshore fund opts to continue with the current rules. Once the fund changes to the new rules then the new rules must apply for all subsequent account periods.
11. Paragraph 1(1) imports into UKEP the loan relationship rules for the treatment of interest and similar income. It applies the rules that are relevant to a UK Authorised Unit Trust. This means that the capital element of any loan relationship profits or losses are to be left out of UKEP.
12. Paragraph 1(2) deletes the current rule that calculates interest and similar income on an income tax basis for UKEP purposes.
13. Paragraph 1(3) qualifies the new rules so that they apply where the only where the fund chooses to apply them. This option is available only to funds established on or before the date of Royal Assent.

14. Paragraph 1(4) ensures that once the new rules are adopted they must be used for all subsequent account periods.
15. Paragraph 1(5) ensures that no amounts of income are brought into UKEP twice, and where an amount was left out of UKEP under the old rules it is now to be brought into UKEP in the first period to which the new rules apply.
16. Paragraph 1(6) imports necessary definitions
17. Paragraph 2 performs the same functions for income from derivative contracts as paragraph 1 of the Schedule does for income from loan relationships.
18. Paragraph 3 inserts new definitions into the offshore funds legislation. The purpose is to accommodate the changes to the rules that will allow sub-funds and classes of interest to qualify for "distributing status" separately. The overall impact is that the term "offshore fund" can apply to a fund, a sub-fund or a class of interest as is necessary or relevant in each case.
 - a. New section 756A ICTA adopts the definition of an offshore fund currently found in sections 759(1) and 759(1A) ICTA, but subject to the new sections 756B and 756C.
 - b. New section 756B ICTA defines an "umbrella fund" and a "sub-fund". The definitions are drawn from the definitions currently in use for UK funds in section 468 ICTA. Where this section applies, the umbrella fund of which the sub-fund is a part will not be regarded as an offshore fund. Where an offshore fund that is part of an umbrella fund does not satisfy section 756B(1)(b) then, subject to the specific terms of the fund, it is likely to be a separate fund in its own right and therefore fall within the new section 756A definition of an "offshore fund".
 - c. New section 756C ICTA defines the treatment of a class of interest. Where this section applies the fund or sub-fund of which the class of interest is a part will not be regarded as an offshore fund.
19. Where reference is made going forward to a sub-fund or class of interest, the historical link will be to the status of the fund of which these were a part before the new rules took effect. This is necessary because, in order for an investor to be subject to the tax treatment applicable to investment in a distributing fund, the fund must qualify as a "distributing fund" in every period in which the investor held the shares or units.

20. Paragraph 4 makes necessary changes to section 757 ICTA to accommodate the new structure. Sub-paragraphs (3) and (4) amend section 757(5) and (6) ICTA to reflect the changes in the definition of an offshore fund. Section 757(5) and (6) ICTA ensure that an offshore income gain will accrue to an investor who exchanges an investment in a non-qualifying fund for an investment in a distributing fund, even if certain provisions of the Taxation of Chargeable Gains Act 1992 (TCGA) would otherwise mean that there was no disposal of the original investment.
21. Paragraph 5 provides a regulatory power to enable necessary amendments to be made to section 758 ICTA to accommodate the new definitions of "offshore fund".
22. Paragraph 6 makes consequential amendments to section 759 ICTA.
23. Paragraph 7 makes consequential amendments to section 760 ICTA.
24. Paragraph 8 makes consequential amendments to Schedule 27 ICTA, and adds a new paragraph 21 to Schedule 27 ICTA. This provides for a regulatory power to deal with transitional and other issues arising from the new rules for funds or sub-funds involving more than one class of interest.
25. Paragraph 9 adds a new paragraph 9 to Schedule 28 ICTA. This provides for a regulatory power to deal with transitional and other issues arising from the new rules for funds or sub-funds involving more than one class of interest.
26. Paragraph 10 makes a consequential amendment to a definition in section 587B ICTA.
27. Paragraph 11 makes a consequential amendment to a definition in section 212 TCGA.
28. Paragraph 12 makes consequential amendments to paragraph 10 of Schedule 26 to the Finance Act 1996.
29. Paragraph 13 amends section 760 ICTA. This section currently contains certain investment restrictions that an offshore fund must meet in order to be certified as a distributing fund. All but one of those restrictions are abolished. The remaining restriction is that the offshore fund cannot be certified as a distributing fund if it invests more than 5% of its assets in other offshore funds (in aggregate). If it does exceed that threshold it may still be able to be certified, if it satisfies further conditions in part 2 of Schedule 27 ICTA. It must also have regard to the "excess income" test in part 2 of Schedule 27 ICTA.

30. Paragraph 14 makes consequential amendments to Part 2 Schedule 27 ICTA.
31. Paragraph 15 introduces changes made necessary by the new rules for treating separate classes of interest in an offshore fund as separate funds for the purposes of deciding whether any such separate fund can be certified as a distributing fund. Under the current rules, and providing certain conditions are satisfied, an exchange of one class of interest for another in the same offshore fund would fall to be treated as not giving rise to a disposal of the original interest. The broad effect of this treatment is that no liability to tax as income in respect of an offshore income gain arises at the time of the exchange, and the new class of interest stands in place of the original class of interest.
32. The current treatment has no particular implication for offshore funds as all classes of interest in the same fund have the same status as either non-qualifying or distributing. However, under the revised rules introduced this year, it will become possible for a person to exchange an interest of a non-qualifying class for an interest of a distributing class in the same fund. If the treatment described in the previous paragraph were to apply to such a transaction a gain arising on a future disposal of the interest would be taxable under the chargeable gains rules. As a result, an offshore income gain, accumulated up to the date of change, would not be charged to tax as income as intended, but would be included in the chargeable gain on the disposal.
33. The provision introduced by this paragraph provides that an exchange of an interest of a non-qualifying class for an interest of a distributing class in the same fund is treated as a disposal for the purposes of the offshore funds tax regime. The result is that an offshore income gain will be crystallised and charged to tax as income at the time of the exchange.
34. Paragraph 15 (1) inserts a new section 762A ICTA 1988.
 - a. Section 762A(1) sets out that the new rules in the section apply where an investor exchanges an interest of one class for an interest of another class in the same offshore fund.
 - b. Section 762A(2) provides that, where there is an exchange of an interest of a class that is treated as a non-qualifying fund for an interest of a class that is treated as a distributing fund, the fact that there may be no disposal for the purposes of tax in respect of chargeable gains does not prevent the exchange being a disposal for the purposes of the offshore funds regime.
 - c. Section 762A(3) deems the disposal to take place at the market value of the interest at the time of the disposal. As a result of the offshore funds rules, any gain arising on the disposal will be

charged to income tax or corporation tax as an offshore income gain.

- d. Section 762A(4) imports necessary definitions.
35. Paragraph 15(2) inserts a new subsection, subsection (6A), in section 763 ICTA. That section ensures that an investor is not charged tax in respect of both income and chargeable gains on the amount of an offshore income gain. It does this in most circumstances by deducting the amount of the offshore income gain from the disposal proceeds that would otherwise be taken into account for the purposes of computing a chargeable gain in respect of a disposal of the same interest.
36. Section 763(6A) treats the offshore income gain computed under section 762A as additional consideration given for the holding, which is, therefore, deductible in the computation of any chargeable gain arising in respect of a disposal of that holding.
37. Paragraph 16 amends section 763(6) ICTA to correct an incorrect reference to section 757(6) ICTA. This is a consequential amendment that was not followed through when sections 757(5) and 757(6) ICTA were amended in the Finance Act 1992. The correct references are deemed to have effect from the same date as the changes to sections 757(5) and 757(6).
38. Paragraph 17 is a transitional provision. There may be cases where, under the old rules, a sub-fund would satisfy the condition in section 760(3)(a) within the overall umbrella fund. However, on the changeover to the new rules it may now find that it fails that condition by reference to its own investments. The transitional rule allows the sub-fund to continue to have regard to the investments of the umbrella fund in those circumstances so that it may satisfy the conditions by reference to the investments of the umbrella fund, if necessary. This option applies to account periods ending no later than 31st December 2005

BACKGROUND NOTE

39. The offshore funds rules were introduced in 1984 in response to concerns that offshore funds were gaining an unfair competitive advantage by allowing their investors to accumulate income within a fund. This income was not charged annually to income tax, and without the offshore fund rules the accumulated income would have fallen within the more lightly taxed chargeable gains rules when the investor disposed of their shares or units in the fund.

40. The offshore funds rules redress that balance by imposing a charge to income tax on all gains realised by an investor from an offshore fund where the fund does not have "distributing" status.
41. In order to obtain distributing status a fund must be certified by the Board of Inland Revenue. In order to be certified it must meet certain restrictions on its investments and it must distribute at least 85% of its income. Where a fund is divided into separate sub-funds and/or classes of interest, each of those sub-funds and classes of interest must meet the requirements relating to distributions.
42. If the fund has distributing status throughout the time that a UK investor held a particular investment, then the disposal of that investment will fall to be taxed within the chargeable gains regime.
43. The Government issued a consultation document in 2002, putting forward options for reform. There was general agreement that reform was needed, but no overall agreement on what shape that reform should take.
44. In the light of this the legislation tackles some of the issues which fund managers agreed were causing them the most difficulty, either in applying the "distributing fund" tests or in designing and marketing their products in the light of the rules.

EXPLANATORY NOTE

CLAUSE 136 AND SCHEDULES 27 AND 40: MEANING OF "OFFSHORE INSTALLATION"

SUMMARY

1. This Clause and schedule 27 provide a new definition of "offshore installation" for the purpose of the income tax deduction for seafarers (formerly known as the Foreign Earnings Deduction) and for certain other purposes of the Tax Acts. It also replaces certain references to "oil rigs" in those enactments with a reference to offshore installations.

DETAILS OF THE CLAUSE

2. The Clause introduces Schedule 27 which amends the definition of "offshore installation" and replaces certain references to "oil rigs" with "offshore installation".

DETAILS OF THE SCHEDULES

3. Part 1 of Schedule 27 provides the new definition of "offshore installation" to be inserted at section 837C of the Taxes Act. The new definition is largely based on the definition contained within the Mineral Workings (Offshore Installations) Act 1971, as amended by the Offshore Installations and Pipeline Works (Management and Administration) Regulations 1995.
4. Subsection 1 specifies that structures standing or stationed in or on water or the foreshore shall be an "offshore installation" if they are used for one of the purposes set out in subsection 2. Subsection 3 provides that a vessel will be an offshore installation until it changes use permanently. Subsection 4 clarifies that "structure" does include ship or other vessel. Subsection 5 provides a power for the Treasury to amend the meaning of "offshore installation" by regulation. Subsection 6 sets out the extent of any amendments to the new definition that may be made by regulation and in particular provides that amendments may be made to introduce different provisions for different purposes of the Tax Acts.
5. Paragraph 3 concerns the commencement provisions for the Schedule which shall be the 2004/05 tax year, except for the purposes of corporation tax when the commencement date is for accounting periods ending on or after 1 April 2004.

6. Part 2 concerns minor and consequential amendments as a result of the new definition. These amendments enable the new definition to apply for the purposes of the Foreign Earnings Deduction for seafarers, Tonnage Tax, mainland transfer expenses for oil/gas workers and certain aspects of Capital Allowances. They also enable the new definition to apply for the purposes of the Enterprise Investment Scheme (EIS), Venture Capital Trusts (VCT), the Corporate Venturing Scheme (CVS) and Enterprise Management Incentives (EMI). The change in the definition does not affect the operation of the EIS, VCT, CVS or venture capital loss relief rules in relation to shares or securities issued before the commencement date for the new definition, nor, in the case of EMI, in relation to rights to acquire shares granted before 6 April 2004.
7. Schedule 40 contains consequential repeals that are necessary as a result of the new definition.

BACKGROUND NOTE

8. An income tax deduction from earnings as a seafarer is provided to those seafarers who work on ships and satisfy certain conditions. The deduction (previously known as the Foreign Earnings Deduction under the Income and Corporation Taxes Act 1988) is not available to those working on offshore installations.
9. The definition of offshore installation is currently given by reference to legislation created for the purposes of Health and Safety, not for the Tax Acts. Changes to Health and Safety legislation have the potential to cause changes inadvertently to entitlements such as the deduction for seafarers intended to be available through the Tax Acts. In addition, some workers on offshore installations, mostly working abroad, are claiming the income tax deduction for seafarers despite the specific exclusion which removes them from entitlement. A free-standing definition is therefore being provided to give certainty and clarity. For this reason certain references to "oil rigs" will be replaced by "offshore installation" so that the same free-standing definition can be used.
10. The same types of vessel will continue to be categorised as offshore installations as now. These include vessels and other structures engaged in oil and gas exploration and exploitation or which provide accommodation for workers on offshore installations. For example, they include fixed and floating production platforms, Floating Production Storage and Offloading vessels, Floating Storage Units, Mobile Offshore Drilling Units such as semi-submersible and jack up drilling rigs, drill ships and floating accommodation units.

CLAUSE 137: IMMEDIATE NEEDS ANNUITIES

SUMMARY

1. This Clause provides for payments made to care providers under immediate needs annuities to be exempt from income tax in the hands of the policyholder. Immediate needs annuity business will be taxed as ‘other long-term business’ (that is according to the normal rules for taxing trading profits) in the hands of the insurance companies that provide this type of business.

DETAILS OF THE CLAUSE

2. Subsection (1) amends the Income and Corporation Taxes Act 1988 (ICTA) in accordance with the remaining paragraphs of the clause.
3. Subsection (2) amends the definition of ‘annuity business’ in section 431 ICTA to exclude the business of granting immediate needs annuities. This means that an insurance company’s profits from writing immediate needs annuity business will be taxed as ‘other long-term business’, and not according to the special rules that apply to life assurance business.
4. Subsection (3) inserts a new section 580C into ICTA. This provides relief from tax on payments made under immediate needs annuities. New section 580C(1) provides that no liability to income tax arises on payments made under an immediate needs annuity, if certain conditions are met. The conditions are that the payments in question must be ‘relevant annual payments’ and must be made to a care provider or to a Local Authority for care required by the person for whose benefit the immediate needs annuity is made. The term ‘relevant annual payments’ is defined in new section 580C(2).
5. New section 580C(3) defines ‘immediate needs annuity’ as a contract for a life annuity, the purpose (or one of the purposes) of which is to protect a person against the consequences of being unable, at the time the contract is made, to live independently because of mental or physical infirmity and which provides benefits in respect of the provision of care. The term ‘life annuity’ is itself defined at new section 580C (7).
6. New section 580C(4) defines ‘care provider’, for the purposes of this section, as a person who provides care as part of a business and who is registered or provides registered care under the ‘relevant enactment’ or

is subject to equivalent regulation if outside the UK. 'Relevant enactment' is in turn defined by new section 580C(5).

7. New section 580C(6) defines the care that is provided as accommodation, goods or services which are necessary or desirable because of mental or physical infirmity of the person protected under the policy.
8. New section 580C(8) provides that the Treasury may by order amend the definition of 'immediate needs annuity' in subsection (3) and the definitions of 'care provider' and 'relevant enactment' in subsections (4) and (5) respectively.
9. Subsection (4) of the clause provides that the corporation tax treatment of immediate needs annuity business set out in subsection (2) will take effect in relation to accounting periods beginning on or after 1 January 2005.
10. Subsection (5) provides that, were a chargeable event gain to be treated as forming part of an individual's income on or after 1 January 2005 in connection with an immediate needs annuity taken out before that date, that individual shall continue to be treated as if lower rate tax had already been paid on the gain.
11. Subsection (6) provides that new section 580C ICTA has effect in relation to payments made on or after 1 October 2004. It has effect regardless of whether the immediate needs annuity contract under which the payment is made was taken out before, on, or after that date.

BACKGROUND NOTE

12. This clause is concerned with the treatment of 'immediate needs annuities' (INAs). INAs are a form of life annuity designed to fund part or all of the cost of a person's long term care.
13. Recent discussions with the insurance industry have shown that there was considerable uncertainty about the correct tax treatment of these policies. The view previously taken was that where payments were made under these policies directly to a care provider, then the payments were not to be treated as taxable annuity payments in the hands of the policyholder. However, recent developments in these products and in the funding arrangements for long term care have cast doubt on that view and led to the conclusion that legislation was needed if the previously agreed position was to be maintained.

14. The clause therefore provides that payments under immediate needs annuities which are made to a care provider under the circumstances set out in the clause will not be treated as taxable annuity payments. That is they will not be subject to income tax in the hands of the policyholder and will not be payable under deduction of tax.
15. The clause also makes provision for the corporation tax treatment of this product in the hands of the insurers that provide it. It ensures that INA business will be taxed under the normal rules for taxing trading profits and not under the special rules that apply to life assurance business. This means that insurers will be taxed on the profits they make from selling INAs on the same basis as applies to their permanent health insurance business.
16. Chargeable event gains can arise in connection with immediate needs annuities and other types of annuity contract under Chapter 2 of Part 13 ICTA. However, the nature of immediate needs annuities is such that in practice they give rise to few if any gains.

EXPLANATORY NOTE

CLAUSE 138: CORPORATION TAX: HEALTH SERVICE BODIES

SUMMARY

1. Clause 138 amends section 519A ICTA 1988 to give the Treasury power to make an order to disapply tax exemption and to specify the tax treatment of profits arising from non-health care activities of NHS foundation trusts to the extent these are not carried out in companies.

DETAILS OF THE CLAUSE

2. The clause adds new subsections to section 519A Income and Corporation Taxes Act 1988 which exempts health service bodies from income and corporation tax
3. New subsection (3) provides that a Treasury order may disapply the exemption from corporation tax for a specified activity or class of activity of an NHS foundation trust.
4. New subsection (4) states that an order made under subsection (3) will make provision for determining the amount of profits to be charged to corporation tax.
5. New subsection (5) provides that an order under subsection (3) may disregard particular profits on the basis of (a) the amount of the profits, (b) a specified part of profits, or (c) the amount of receipts or turnover.
6. New subsection (6) states that an order under subsection (3) may either apply or disapply provisions of the Tax Acts, may make a provision similar to a provision of the Tax Acts and may make provision generally or in relation to a specified body, for example, a particular NHS foundation trust, or a class of bodies.
7. New subsection (7) provides the conditions under which the Treasury may make an order.
8. (7)(a) specifies that it must appear to the Treasury that the activity or class of activity is of a commercial nature.

9. (7)(b) specifies that it must be for the purposes of avoiding, removing or reducing differences between the fiscal treatment of the body undertaking the activity and the fiscal treatment of a commercial body, for example, a private business, that undertakes or might undertake a similar activity.
10. 7(c) makes it clear that there needs to be House of Commons approval by resolution for any order.
11. New subsection (8) makes it clear that any activity authorised under section 14 (1) Health and Social Care (Community Health and Standards) Act 2003 will not be treated as an activity of a commercial nature. Section 14 (1) is the provision that allows the NHS foundation trusts to be authorised to carry on private or NHS healthcare activities.

BACKGROUND NOTE

12. The effect of the clause is to enable commercial trading profits of NHS foundation trusts that would otherwise be exempt from tax to be brought into charge to corporation tax by Treasury order.
13. The first NHS foundation trusts have become operational in April 2004.
14. Section 33 of the Health and Social Care (Community Health and Standards) Act 2003 gives NHS foundation trusts a general exemption from income and corporation tax, stamp duty and VAT. It does this for income and corporation tax purposes by including them within the exempt bodies listed in section 519A(2) ICTA 1988.
15. Subject to the approval of the independent Regulator, NHS foundation trusts will be free to carry out some commercial trading activities that could be in competition with private sector business. Where they carry on such activities within a limited company owned by the NHS foundation trust, any profits will be chargeable to corporation tax in the normal way.
16. However, there is no requirement for NHS foundation trusts to conduct such activities within a limited company. So absent any requirement to do so, it is entirely possible for such activities to be carried on by and within NHS foundation trusts themselves and any profits would be exempt from tax.
17. The carrying on of commercial activity with the benefit of tax exemption would mean that private sector businesses would be at a competitive disadvantage. It would therefore be necessary to remove the tax exemption in these circumstances.

18. A further reason for the removal of the tax exemption is the need to ensure that there is no risk of there being illegal State aid as defined in Article 87 of the Treaty establishing the European Community.
19. There is nothing unusual in this; the Government has been increasingly encouraging public sector bodies to carry on commercial activities. For instance the Local Government Act of 2003 enabled certain local authorities to undertake commercial profit making activities in competition with the private sector.
20. Consequently, section 96 Local Government Act 2003 provides that commercial trading activities conducted by local authorities must be conducted within companies so that any profits are chargeable to corporation tax.
21. The measures in the clause will address the situation where NHS foundation trusts carry on commercial trading activities other than through companies. They will be subject to Regulations that will ensure that any profits are subject to tax in the same way as if the activities had been carried on through a company.
22. We expect that in practice most if not all commercial trading activities conducted by NHS foundation trusts will be carried on within companies