

EXPLANATORY NOTE

CLAUSE 88 AND SCHEDULE 18: ENTERPRISE INVESTMENT SCHEME

SUMMARY

1. Clause 88 and Schedule 18 make a number of amendments to the Enterprise Investment Scheme (EIS).
2. For the tax year 2004/2005 onwards the maximum amount invested in qualifying companies for which an individual can claim income tax relief under the EIS is increased from £150,000 to £200,000 per tax year.
3. The “same day” rule is relaxed so that investors will not be prevented from obtaining EIS reliefs where shares of the same class issued on the same day to other investors were subscribed for otherwise than wholly in cash.
4. The “active company” requirement is removed so the company that carries on the trade or research and development for whose purpose the money raised through an EIS share issue is used can change during the relevant period.
5. The rules relating to subsidiaries are relaxed so that a company can be a qualifying subsidiary of an EIS company if it is a 51% subsidiary (except a property management subsidiary or a subsidiary which carries on the trade or research and development in question – these have to be 90% subsidiaries).
6. The rules relating to the repayment of loans are relaxed to make it easier for investors to make short-term loans to EIS companies without thereby making themselves ineligible for income tax relief on subsequent qualifying investments in shares in the company.
7. Most of the changes take effect in relation to shares issued on or after 17 March 2004.

DETAILS OF THE CLAUSE

8. Clause 88 gives effect to Schedule 18, which amends a number of EIS provisions.

DETAILS OF THE SCHEDULE

Part 1 – Income tax relief

9. Paragraph 1(1) is introductory. It provides for amendments to be made to section 289 of the Income and Corporation Taxes Act 1988 (ICTA) which have effect in relation to shares issued on or after 17 March 2004.
10. Paragraph 1(2) amends paragraphs (a) to (c) of subsection (1) of section 289 and inserts a new paragraph, paragraph (aza), in that subsection. The main effect of the changes is that individuals who subscribe wholly in cash for qualifying shares will not be prevented from obtaining EIS income tax relief because the company also issues bonus shares of the same class to them on the same day, or because any other subscribers for the company's shares which are of the same share class and which are issued on the same day do not subscribe for them wholly in cash.
11. Paragraph 1(3) replaces the existing subsections (1A) to (1D) of section 289 with new subsections (1A) to (1E). The principal effect of the new provisions is that any qualifying activity for which the money raised by an EIS share issue is employed must be carried on during the relevant period (usually the three years following the date of the share issue) by the company which issued the shares ("the qualifying company") or a "qualifying 90% subsidiary" of that qualifying company, but not necessarily by the same company at all times. This replaces the "active company" provisions which required that the identity of the company that carried on any particular qualifying activity remained unchanged throughout the relevant period.
12. New section 289(1A) provides that at no time in the relevant period must "the relevant qualifying trade", "relevant preparatory work" or "relevant research and development" be carried on by any person other than the qualifying company or a qualifying 90% subsidiary of that company. The meanings of these expressions are set out in new section 289(1E).
13. New section 289(1B) provides that where the qualifying company or any of its qualifying 90% subsidiaries is preparing to carry on an existing qualifying trade which is being carried on by a company other than the qualifying company or one of its subsidiaries, then any carrying on of that trade by the other company before the qualifying company (or one of its qualifying 90% subsidiaries) carries it on is disregarded for the purposes of the new subsection (1A).
14. New section 289(1C) provides that the requirements of subsection (1A) do not fail to be met in certain circumstances where the trade in question ceases at some time during the relevant period to be carried on by the qualifying company (or one of its qualifying 90% subsidiaries) and is subsequently carried on in that period by another person. The circumstances are where this happens solely in consequence of a company being in administration or receivership, or being wound up, or

being dissolved without winding up. The person who takes over the carrying on of the trade must not at any time in “the period of restriction” (this begins one year before the shares were issued and ends at the same time as the relevant period ends) be connected with the qualifying company. New subsection (1D) of section 289 provides that the entry into administration or receivership and everything done in consequence or, as the case may be, the winding up or dissolution, must be for bona fide commercial reasons and not for any tax avoidance purpose.

15. New section 289(1E) contains definitions.
16. Paragraph 1(4) makes some changes to subsection (2) of section 289 which are needed to secure that where money is raised through the EIS for the purposes of a qualifying business activity, the identity of the company which carries on the activity in question can change during the relevant period. This is provided that the company carrying it on at any given time in that period is either the qualifying company or a qualifying 90% subsidiary of that company. In particular, the changes make it possible for a qualifying company to raise money through the EIS for the purpose of preparing to carry on a qualifying trade which is then to be carried on by a qualifying 90% subsidiary which was not a subsidiary of the company at the time the shares were issued.
17. Paragraph 1(5) makes a consequential change to subsection (3) of section 289.
18. Paragraph 1(6) inserts a new subsection, subsection (3A), in section 289. This determines the question as to when a company (“company A”) which is a qualifying 90% subsidiary of another company (“company B”) begins to carry on the qualifying trade or research and development which is the subject of a qualifying business activity which consists in preparing to carry on a qualifying trade, or in carrying on research and development which is begun to be carried on immediately after the date on which the shares were issued. Subsection (3A) provides that any carrying on by company A of the trade or research and development in question before it became a qualifying 90% subsidiary of company B is to be disregarded.
19. Paragraph 1(7) inserts a new subsection, subsection (8A), into section 289. This provides interpretation for the condition in subsection (1)(aa), which refers to shares being “fully paid up” at the time they are issued. Subsection (8A) provides that shares are not fully paid up if there is any undertaking to pay cash to any person at a future date in respect of their acquisition.
20. Paragraph 1(8) replaces subsection (9) of section 289 with new subsections (9) to (13). The new subsection (9) provides the definition of a “qualifying 90% subsidiary” of a company.
21. New subsections (10) and (11) of section 289 provide that subsections (3), (3A) and (4) of section 308 apply in relation to section 289(9) as

they apply in relation to section 308(2), but in a modified form. These provisions relate to windings up, administration and receivership, and arrangements for the disposal of the subsidiary.

22. New subsections (12) and (13) of section 289 provide that for the purposes of new subsection (9) the persons who are equity holders of a subsidiary and the percentage of its assets to which they would be entitled are to be determined in accordance with paragraphs 1 and 3 of Schedule 18 of ICTA. An equity holder is any person who holds ordinary shares in the company or is a loan creditor in respect of a loan that is not a commercial loan. But the application of paragraphs 1 and 3 of Schedule 18 to ICTA is modified for the purposes of section 289 so that the references to winding up in paragraph 3 Schedule 18 are to be read as including references to any other circumstances in which assets of the subsidiary are available for distribution to its equity holders.
23. Paragraph 2(1) is introductory. It provides for amendments to be made to section 289A ICTA which have effect in relation to shares issued on or after 17th March 2004.
24. Paragraph 2(2) and (3) amend subsections (6) and (7) of section 289A in consequence of the changes made to section 289. The revised provisions have the effect that where money is raised through an issue of EIS shares wholly for the purpose of carrying on a qualifying trade or of preparing to carry on a qualifying trade, the trade has to be carried on by no person other than the qualifying company or a qualifying 90% subsidiary of that company for a minimum of 4 months before any claim for EIS tax reliefs may be made. Corresponding provision is made where any part of the money is raised for carrying on research and development. The effect of these changes is that the trade or research and development in question need not be carried on at all times in the four month period by the same company. For example, it could be carried on for part of that period by the qualifying company and for the remainder by qualifying 90% subsidiary of that company.
25. Paragraph 2(4) and (5) amend section 289A(8) and (8A). The effect of the revised provisions is to relax the four month condition mentioned above in circumstances where the trade or research and development in question is carried on for a period shorter than four months solely in consequence of a company being in administration or receivership, or being wound up, or being dissolved without winding up. The entry into administration or receivership and everything done in consequence or, as the case may be, the winding up or dissolution, must be for bona fide commercial reasons and not for any tax avoidance purpose.
26. Paragraph 3 amends section 289B(4) ICTA which provides the meaning of references in the EIS income tax relief legislation to an “issue of eligible shares” in provisions which refer to shares issued to an individual. Section 289B(4) provides that this means all the shares of the share class in question in the company concerned which are issued to the individual on the day in question. The effect of the amendment is to provide for this meaning not to apply in section 289A(6) and (7).

Instead, the meaning which applies in those provisions is that given by section 312(4A) ICTA – that is, *all* the shares of that class which are issued by the company on the day concerned. This is needed because the amendments made to section 289A(6) and (7) insert references to share issues in provisions dealing with claims for relief made by an individual in respect of his investment in shares. The amendment has effect in relation to shares issued on or after 17th March 2004.

27. Paragraph 4(1) and (2) amend section 290(2) ICTA. The effect of the amendment is to raise the upper investment limit in respect of which an individual can obtain EIS income tax relief in a tax year from £150,000 to £200,000 with effect for the tax year 2004/05 and subsequent tax years. The limit is applied to the total amount subscribed for shares in respect of which relief is claimed for the tax year in question.
28. Paragraph 5(1) is introductory. It provides for amendments to be made to section 293 ICTA which have effect in relation to shares issued on or after 17 March 2004.
29. Paragraph 5(2) and (3) amend section 293(4A) and (4B), so that they provide, in certain circumstances, for a company not to fail to be a qualifying company by reason solely of anything done as a consequence of it or any of its subsidiaries being in administration or receivership.
30. Paragraph 5(4) and (5) amend section 293(5) and (6). The effect of these revised provisions is that a company will not be a qualifying company if, before the end of the relevant period, a resolution is passed, or an order is made, for it or any of its subsidiaries to be wound up, or if the company or any of its subsidiaries is dissolved without winding up. This does not apply, however, if a company would not be a qualifying company solely by reason of the company or any subsidiary being wound up or dissolved without winding up and the winding up or dissolution is for bona fide commercial reasons and not for any tax avoidance purpose.
31. Paragraph 5(6) inserts three new subsections, subsections (6ZA), (6ZB) and (6ZC), into section 293. New section 293(6ZA) provides that a company is not a qualifying company if at any time in the relevant period it has a property managing subsidiary which is not a qualifying 90% subsidiary of the qualifying company. New section 293(6ZB) and (6ZC) provide interpretation.
32. Paragraph 6(1) amends section 300(2)(b) ICTA. This currently provides that an individual is treated for EIS income tax relief purposes as receiving value from a company which issues shares to him if, at any time in the period of restriction (see paragraph 14 above), the company (or any connected person) repays any debt owed to the individual or any associate of his. (This does not apply to debts incurred by the company on or after the date on which the individual subscribed for the shares provided that the debt in question is not a replacement for any debt incurred before that date.) The amendment makes two changes to this provision. First, the repayment is to be treated as a receipt of value only

if it is made in pursuance of any arrangements for, or in connection with, the acquisition of the shares. Second, the reference to the date of the subscription for the shares is changed to the date on which the shares were issued.

33. Paragraph 6(2) and (3) provide that, subject to a transitional provision, the revised section 300(2)(b) applies to shares issued on or after 17th March 2004. The transitional provision applies in any case where shares which were subscribed for before 17th March 2004 are issued on or after that date and the repayment in question is of a debt incurred on or after the date of the subscription. In such circumstances the amendment made to section 300(2)(b) does not have effect.
34. Paragraph 7(1) and (2) provide that, in relation to any “repayment” (within the meaning which applies for the purposes of section 303A ICTA) made on or after 17th March 2004, the definition of “subsidiary” which applies for the purposes of sections 303 and 303AA ICTA will apply also for the purposes of section 303A. Paragraph 8(1) and (2) make a consequential amendment to section 303A, which also applies in relation to any such repayment made on or after 17th March 2004.
35. Paragraph 9 makes a number of amendments to the conditions in section 308 ICTA which must be met in relation to subsidiaries of qualifying companies. The amendments have effect in relation to shares issued on or after 17th March 2004. The main change is that the existing 75% ownership and entitlement requirements are replaced by the requirement that the qualifying company must directly or indirectly own more than 50% of the ordinary share capital of each subsidiary. (Interpretation for this requirement is provided by a new subsection, subsection (5B), of section 308.)
36. Section 308(3) is relaxed so that it has effect in relation not only to circumstances where the qualifying company or subsidiary concerned is wound up or dissolved without winding up, but also to circumstances where any other company is wound up or dissolved without winding up. The requirement in section 308(3)(b) relating to the distribution of assets is removed.
37. A new subsection, subsection (3A), is inserted in section 308 to provide that the conditions which must be met in relation to a subsidiary do not fail to be satisfied by reason only of anything done as a consequence of any company being in administration or receivership. It is necessary that the entry into administration or receivership and everything done in consequence of the company concerned being in administration or receivership is for bona fide commercial reasons and not for any tax avoidance purpose.
38. Subsection (4) of section 308 is amended so that it provides that the existence of arrangements for the disposal by the qualifying company (or another of its subsidiaries) of all its interest in a subsidiary does not of itself cause the qualifying conditions to fail to be met provided that

the disposal is to be for bona fide commercial reasons and not for any tax avoidance purpose.

39. Subsection (5) of section 308 is removed, as it is no longer required on account of the changes made to the requirements which must be met.
40. Paragraph 10(1)(a) to (c) amend the information provisions in section 310 ICTA. In relation to shares issued on or after 17th March 2004 the scope of section 310(5) is extended so that an inspector having reason to believe that there is any scheme or arrangements involving tax avoidance that could cause a company to cease to be a qualifying company, a qualifying 90% subsidiary, or a qualifying subsidiary can by notice require the persons specified in section 310(6) to provide information. No notice provided for by these amendments may be given until after the Finance Act 2004 is passed.
41. Paragraph 11(1) makes some consequential changes to the interpretation section of the EIS provisions at section 312 ICTA, in particular inserting definitions of “bonus shares” and “qualifying 90% subsidiary”, and amending, and providing interpretation in relation to, the definition of “termination date” to take account of the changes made to section 289. These changes have effect in relation to shares issued on or after 17th March 2004.

Part 2 – Deferral relief

42. Paragraph 12 is introductory. It provides for Schedule 5B to the Taxation of Chargeable Gains Act 1992 (TCGA) to be amended as provided for by paragraphs 12 to 20 of the Schedule, in accordance with the commencement provision given by paragraph 21 of the Schedule.
43. Paragraph 13 amends paragraph 1 of Schedule 5B in order to keep the rules for EIS deferral relief in line with the changes made to section 289 ICTA for EIS income tax relief. The amendments have effect in relation to shares issued on or after 17th March 2004.
44. Paragraph 14 makes a number of changes to paragraph 1A of Schedule 5B in consequence of the changes made to paragraph 1 of Schedule 5B. The amendments have effect in relation to shares issued on or after 17th March 2004.
45. Paragraph 15 amends paragraph 10 of Schedule 5B. It removes a redundant word from sub-paragraph (1) of that paragraph and inserts a new sub-paragraph, sub-paragraph (4), which provides the definition of “group of companies” which applies for the purposes of paragraph 10. The meaning of “group of companies” is the same as that which applied in relation to reinvestment relief, which was superseded by EIS deferral relief in 1998. The commencement provisions are set out in sub-paragraphs (2) and (3) of paragraph 15. Separate provision is made in relation to the application of the definition of “group of companies” to the provisions in sub-paragraphs (1) and (2) of paragraph 10 of Schedule 5B.

46. Paragraph 16 amends the rule in paragraph 13(2)(b)(i) of Schedule 5B which treats an investor as receiving value from the company in certain circumstances where the company (or any connected person) repays a debt owed to him (or any of his associates). The amendment provides that the exception to the rule applies in relation to the repayment of a debt incurred on or after the date of issue of the shares in question rather than the date on which the investor subscribed for them. The effect of the change is to align the provision made by 13(2)(b)(i) of Schedule 5B with the corresponding provision made by section 300(2)(b) ICTA, as amended by Part 1 of this Schedule (see paragraph 32 above).
47. Paragraph 16(2) and (3) provide that the amendment made by paragraph 16(1) applies in relation to shares issued on or after 17th March 2004 except that it does not apply in relation to the repayment of any debt incurred before 17th March 2004 if the shares were subscribed for before that date, and the debt was incurred on or after the date on which the shares were subscribed for.
48. Paragraph 17(1) & (2) provide that, in relation to any “repayment” (within the meaning which applies for the purposes of paragraph 14 of Schedule 5B) made on or after 17th March 2004, the definition of “subsidiary” which applies for the purposes of paragraphs 14 and 14AA of Schedule 5B will apply also for the purposes of paragraph 14A of Schedule 5B. Paragraph 18(1) & (2) make a consequential amendment to paragraph 14A of Schedule 5B. This amendment also applies in relation to any such repayment made on or after 17th March 2004.
49. Paragraph 19(1)(a) to (c) amend the information provisions in paragraph 16 of Schedule 5B. In relation to shares issued on or after 17th March 2004 the scope of paragraph 16(6) is extended so that an inspector having reason to believe that there is any scheme or arrangements involving tax avoidance that could cause a company to cease to be a qualifying company, a qualifying 90% subsidiary, or a qualifying subsidiary can by notice require the persons specified in paragraph 16(7) to provide information. No notice provided for by these amendments may be given until after the Finance Act 2004 is passed.
50. Paragraph 20 inserts definitions for “51 per cent subsidiary” and “bonus shares” in paragraph 19(1) of Schedule 5B. These definitions have effect in relation to shares issued on or after 17th March 2004, except in respect of the reference to “51 per cent subsidiaries” in the definition of “group of companies” inserted by paragraph 15(1) of this Schedule (see paragraph 45 above), where the definition of “51 per cent subsidiary” takes effect in accordance with the commencement provision for that definition.

Part 3 – Commencement

51. Paragraph 21 makes commencement provision.

BACKGROUND NOTE

52. The EIS is designed to help small, unquoted higher-risk trading companies raise start-up and expansion finance by issuing full-risk ordinary shares. Individuals who are previously unconnected with companies in which they invest may obtain various income tax and capital gains tax reliefs:
- income tax relief (at 20 per cent) on the amount invested on investments of up to £150,000 per tax year (increased by Schedule 18 to £200,000 from 2004/05), and relief from capital gains tax on disposal of the shares, provided that the shares are held for a specified minimum period;
 - relief for most allowable losses on the disposal of shares (net of any income tax relief remaining after the disposal) against income if they are not set off against chargeable gains; and
 - deferral of capital gains tax on a chargeable gain from the disposal of any asset where the gain is reinvested in EIS shares.
53. Deferral relief can also be obtained by individuals who have a prior connection with the company and by the trustees of certain trusts.
54. Venture capital loss relief against income was introduced in the early 1980s. It provides for investment companies and individuals to set capital losses arising on disposals of certain ordinary shares in qualifying trading companies against income (if they are not deducted from chargeable gains). The shares must have been acquired by subscription and the companies in which an investment is made must satisfy certain qualifying conditions. For shares issued on or after 6th April 1998 these conditions are broadly comparable to those which apply for companies in which investments are made through the EIS. Some of the rules applying to companies whose shares qualify for venture capital loss relief feed directly into the EIS conditions for qualifying companies. In particular, the changes made by paragraphs 5 and 9 of Schedule 18 will have effect to make corresponding amendments to the venture capital loss relief rules in relation to shares issued on or after 17th March 2004.

EXPLANATORY NOTE

CLAUSE 89 AND SCHEDULE 19: VENTURE CAPITAL TRUSTS

SUMMARY

1. This Clause and Schedule make a number of amendments to the Venture Capital Trust (VCT) scheme.
2. For shares issued by VCTs on or after 6th April 2004 (but before 6th April 2006) the rate of income tax relief available increases from the lower rate (20%) to the higher rate (40%).
3. For the tax year 2004/2005 onwards the maximum amount invested for which tax reliefs can be obtained is increased from £100,000 to £200,000 per tax year.
4. It will no longer be possible to defer capital gains tax by reinvesting gains in VCT shares unless the shares were issued before 6 April 2004.
5. The “trader company” requirement is changed so that where a VCT invests in a company, the trade or research and development which benefits from the VCT investment must be carried on either by the relevant company or a 90% subsidiary, but not necessarily by the same company at all times.
6. The rules relating to qualifying subsidiaries are relaxed so that a company can be a subsidiary of a qualifying company in which a VCT invests if it is a 51% subsidiary of that company. But a subsidiary of a qualifying company which is a property managing subsidiary or a subsidiary which carries on the trade for the purpose of which the money invested by the VCT is employed, must be a 90% subsidiary of the qualifying company.

DETAILS OF THE CLAUSE

7. Clause 89(1) provides that income tax relief for qualifying investments in VCT shares is increased from the lower rate (20%) to the higher rate (40%) where the shares are issued on or after 6th April 2004 but before 6th April 2006.

8. Clause 89(2) provides that where income tax relief has been given at the higher rate and there is a loss of income tax relief, that relief is to be recovered at the higher rate.
9. Clause 89(3) gives effect to Schedule 19, which amends a number of VCT provisions.

DETAILS OF THE SCHEDULE

Part 1 – Increase in relief on investments and distributions

10. Paragraph 1 provides that the maximum amount of investment in qualifying VCT shares issued to an individual in a tax year in respect of which income tax relief can be claimed is raised from £100,000 to £200,000 for the tax year 2004/2005 and subsequently.
11. Paragraph 2 increases the annual investment limit for investment in VCT shares which qualify for dividend relief and the capital gains tax (CGT) exemption from £100,000 to £200,000.
12. Paragraph 3 provides that the amendments made by paragraphs 1 and 2 have effect for the tax year 2004/05 and subsequent tax years.

Part 2 – Abolition of deferral relief

13. Paragraphs 4 and 5 provide that CGT deferral relief for gains reinvested in VCT shares for which income tax relief is obtained will cease to apply.
14. Paragraph 6 makes a consequential amendment.
15. Paragraph 7 provides for the abolition of deferral relief to have effect in relation to VCT shares issued on or after 6th April 2004. But this does not affect the continuing operation of a provision in section 151B of the Taxation of Chargeable Gains Act 1992 which has a continuing need to refer to some provisions contained in the rules for deferral relief

Part 3 - Miscellaneous

16. Paragraph 8 is introductory. It provides for Schedule 28B to the Income and Corporation Taxes Act 1988 (ICTA) (referred to as “Schedule 28B” in these notes) to be amended as provided for by paragraphs 9 to 15 of the Schedule, in accordance with the commencement provision given by paragraph 16 of the Schedule.
17. Paragraph 9 makes a number of amendments to paragraph 3 of Schedule 28B, as a consequence of the changes to paragraph 6 and paragraph 10.

It concerns the requirement which must be met in relation to “the relevant company” (that is, the company in which a VCT makes a qualifying investment). The main effect of paragraph 3 is that if the relevant company is the parent company of a group, and does not itself exist wholly (disregarding any incidental purposes) for the purpose of carrying on a qualifying trade, and is not carrying on such a trade or preparing to do so, then those criteria must be fulfilled by a relevant qualifying subsidiary of the company (see paragraph 18 below).

18. Paragraph 10 inserts a new paragraph, paragraph 5A, into Schedule 28B. This provides the new meaning of “relevant qualifying subsidiary” – it is a 90% subsidiary of the relevant company.
19. Paragraph 11 removes the “trader company” provisions of the VCT scheme in paragraph 6 of Schedule 28B and replaces them with new provisions which are broadly in step with the corresponding changes made to the Enterprise Investment Scheme (EIS) under Schedule 18 to this Bill. (See paragraphs 11 to 14 of the Explanatory Note on Clause 88 and Schedule 18.)
20. Paragraph 12 amends the rules relating to qualifying subsidiaries in paragraph 10 of Schedule 28B. The new rules are in line with those for the EIS following the revisions made under Schedule 18 to this Bill. (See paragraphs 35 to 39 of the Explanatory Note on Clause 88 and Schedule 18.)
21. Paragraph 13 inserts into Schedule 28B a new paragraph, paragraph 10ZA, which imposes a new requirement regarding property managing subsidiaries. Paragraph 10ZA(1) provides that any property managing subsidiary of the relevant company must be a relevant qualifying subsidiary of that company. Paragraph 10ZA(2) and (3) provide interpretation.
22. Paragraphs 14 and 15 make some minor amendments to paragraphs 11 and 11A of Schedule 28B, which make provision in relation to windings up, administration and receivership.
23. Paragraph 16 provides that the amendments made by Part 3 of the Schedule have effect for the purpose of determining whether shares or securities issued on or after 17th March 2004 are, for the purposes of section 842AA ICTA, to be regarded as comprised in a company’s qualifying holdings.

BACKGROUND NOTE

24. VCTs are companies listed on the Stock Exchange, which specialise in investing in small higher-risk unquoted trading companies of the same kind as those which qualify under the EIS. By investing in a VCT, individuals are able to spread the risk over a number of such qualifying companies. The investor is entitled to various income tax and capital gains tax reliefs, including:
- income tax relief at 20 per cent (increased by Clause 89 to 40 per cent for shares issued in 2004/05 and 2005/06) up to an annual limit of £100,000 in any tax year (increased in Schedule 19 to £200,000 for shares issued in the tax year 2004/05 onwards) on the amount invested in new ordinary shares provided that they are retained for at least 3 years;
 - exemption from capital gains tax for gains on the disposal of any ordinary shares and from income tax on dividends on ordinary shares on acquisitions of VCT shares up to £100,000 per tax year (increased by Schedule 19 to £200,000 for shares acquired in the tax year 2004/05 onwards).

EXPLANATORY NOTE

CLAUSE 90 AND SCHEDULE 20: CORPORATE VENTURING SCHEME

SUMMARY

1. Clause 90 and Schedule 20 make amendments to the Corporate Venturing Scheme (CVS). The rules in relation to the subsidiaries of an issuing company are amended so that a company can be a qualifying subsidiary if it is a 51% subsidiary of the CVS company. This does not apply in relation to property managing subsidiaries and subsidiaries whose activities benefit from the money raised through the CVS – such subsidiaries have to be 90% subsidiaries. The activities for whose purpose the money raised is used must be carried on by the company that issued the shares, or a 90% subsidiary of that company.

DETAILS OF THE CLAUSE

2. Clause 90 gives effect to Schedule 20, which amends a number of CVS provisions.

DETAILS OF THE SCHEDULE

3. Paragraph 1 is introductory. It provides for the amendments provided for by paragraphs 2 to 15 of the Schedule to be made to Schedule 15 to Finance Act 2000 (referred to in this note as “Schedule 15”).
4. Paragraph 2 makes an amendment to the definition of “the qualification period” in paragraph 3 of Schedule 15 which is consequential on the introduction of the requirement that if the qualifying trade (or qualifying research and development) for which money is raised through the CVS is not carried on by the company which issued the shares (“the issuing company”), it must be carried on by a “qualifying 90% subsidiary” of that company.
5. Paragraph 3 inserts a cross-reference in paragraph 15 of Schedule 15 to the new paragraph 21A (introduced by paragraph 6 of this Schedule) which imposes the new “property managing subsidiary requirement”.

6. Paragraph 4 clarifies the “qualifying subsidiaries requirement” in paragraph 20 of Schedule 15. It does not make any substantive change to this requirement.
7. Paragraph 5 makes a number of amendments to the conditions in paragraph 21 of Schedule 15 which must be met in relation to subsidiaries of an issuing company if that company is to be a “qualifying issuing company” for CVS purposes. The main change is that the existing 75% ownership and entitlement requirements are replaced by the requirement that the subsidiary must be a 51% subsidiary of the issuing company.
8. Paragraph 6 inserts a new paragraph, paragraph 21A, into Schedule 15. This imposes a new requirement regarding property management subsidiaries which must be met in relation to an issuing company if it is to be a qualifying issuing company. Sub-paragraph (1) provides that any property managing subsidiary must be a qualifying 90% subsidiary of the issuing company. Sub-paragraphs (2) and (3) provide interpretation.
9. Paragraph 7 makes a number of amendments to paragraph 23 of Schedule 15, which imposes the trading activities requirement which must be met in relation to the issuing company if it is to be a qualifying issuing company. The main effect of the changes is that if the issuing company is the parent company of a group, and does not itself exist wholly (disregarding any incidental purposes) for the purpose of carrying on a qualifying trade and is not carrying on such a trade or preparing to do so, then those criteria must be fulfilled by a qualifying 90% subsidiary of the company.
10. The inserted sub-paragraph (10) of paragraph 23 of Schedule 15 provides the meaning of “qualifying 90% subsidiary”, and the inserted sub-paragraph (11)(a) provides for sub-paragraphs (3) and (4) of paragraph 21 of Schedule 15 to apply in relation to sub-paragraph (10) of paragraph 23 as they apply in relation to paragraph 21(2). These provisions relate to windings up, administration and receivership. Sub-paragraph (11)(b) provides that the existence of arrangements for the disposal by the issuing company of all its interest in a subsidiary does not of itself cause the qualifying conditions to fail to be met provided that the disposal is to be for bona fide commercial reasons and not for any tax avoidance purpose.
11. Paragraph 8 amends paragraph 24 Schedule 15, which applies where the issuing company or any of its qualifying subsidiaries are in administration or receivership, or a resolution is passed, or an order is made, for the winding up of such a company, or such a company is dissolved without winding up. Paragraph 24 provides that, if certain conditions are met, the trading activities requirement does not fail to be met in relation to the issuing company by reason of anything done as a

consequence of the company concerned being in administration or receivership, or being wound up, or being dissolved without winding up. The main effect of the amendments is to insert the word “only” after “by reason” here.

12. Paragraph 9 amends paragraph 25 of Schedule 15, which defines the meaning of the expression “qualifying trade” for CVS purposes. It provides for the carrying on of research and development to be treated as the carrying on of a qualifying trade if it is intended that a “connected qualifying trade” will be derived from the research and development, or that the research and development will benefit such a trade. At present, a “connected qualifying trade” is a qualifying trade which is carried on either by the company carrying on the research and development or, if it is a member of a group, by the issuing company or any of its 51% subsidiaries. The effect of the amendment is that the trade cannot be carried on by a subsidiary of the issuing company unless it is a qualifying 90% subsidiary of that company.
13. Paragraph 10 amends the provision which provides interpretation for the condition in paragraph 35(2)(c) of Schedule 15 that requires shares to be fully paid up at the time they are issued if they are to qualify for CVS investment relief. The revised provision secures that shares are not treated as being fully paid up at the time they are issued if there is any undertaking to pay cash to any person at a future date in respect of the acquisition of the shares.
14. Paragraph 11 amends the requirements which must be met in relation to the use of money raised through the CVS. It secures that the money must be employed for the purposes of a trade carried on by the qualifying company or one of its qualifying 90% subsidiaries. Reference to carrying on a trade here includes preparing to carry it on, and also includes carrying on qualifying research and development.
15. Paragraph 12 amends the provisions of paragraph 40 Schedule 15, which require the funded trade to have been carried on for at least four months before a claim for investment relief can be made. The amended provision enables the trade to be carried on successively during that period by different members of the group of which the issuing company is the parent, provided that at all times when it is not carried on by the issuing company, it is being carried on by a qualifying 90% subsidiary of that company. The scope of the provisions which allow a period shorter than four months to count in certain circumstances where the issuing company or subsidiary concerned is in administration or receivership, or is being wound up, or is dissolved without winding up, is extended. The reference to the issuing company or subsidiary concerned is, in effect, replaced by a reference to any company.

16. Paragraph 13 inserts a new sub-paragraph, sub-paragraph (8), into paragraph 102 of Schedule 15. It provides interpretation which determines the question as to when a company which is a qualifying 90% subsidiary of the issuing company is treated as beginning to carry on a trade. This is of relevance to certain CVS requirements which must be met if the issuing company is to be a qualifying issuing company.
17. Paragraph 14 inserts a reference to the term “qualifying 90% subsidiary”, as defined in paragraph 23 (10) and (11) Schedule 15, in the index of defined expressions in paragraph 103 of Schedule 15.
18. Paragraph 15 provides that the amendments made by the Schedule have effect in relation to shares issued on or after 17th March 2004.

BACKGROUND NOTE

19. The Corporate Venturing Scheme (CVS) was introduced in Finance Act 2000. It is designed to encourage established companies to invest in small higher-risk, unquoted trading companies and, through this, to encourage the two companies to form mutually beneficial corporate venturing relationships. Companies investing through the CVS may obtain various reliefs from corporation tax:
 - relief (at 20 per cent) – investment relief - on the amount invested provided the shares are held throughout the qualification period (usually three years);
 - relief for most allowable losses on the disposal of CVS shares (net of any investment relief remaining after the disposal) against either income or chargeable gains; and
 - deferral of corporation tax in respect of chargeable gains on gains arising from the disposal of shares for which investment relief has been obtained where that gain is reinvested in a new CVS investment.

EXPLANATORY NOTE

CLAUSE 91: ENTERPRISE MANAGEMENT INCENTIVES: SUBSIDIARIES

SUMMARY

1. This Clause amends “the 75% qualifying subsidiary” rule within Schedule 5 of the Income Tax (Earnings and Pensions) Act 2003 which provides the rules for Enterprise Management Incentives (EMI) share options.

DETAILS OF THE CLAUSE

2. Subsection (1) introduces amendments to Schedule 5 of the Income Tax (Earnings and Pensions) Act 2003 (enterprise management incentives).
3. Subsection (2) inserts in paragraph 8 of Schedule 5 a new requirement that has to be satisfied by a company if it has property managing subsidiaries and is to be a qualifying company for EMI purposes. The requirements are explained in new paragraphs 11A and 11B to Schedule 5.
4. Subsection (3) clarifies that the section 416 (2) to (6) of Income and Corporation Taxes Act 1988 (ICTA) definition of “control” in the context of close companies operates for the purposes of paragraph 10.
5. Subsection (4) removes the requirement in paragraph 11(2) that to be a qualifying subsidiary of the qualifying company, the subsidiary must be a 75% subsidiary. For EMI share options granted on or after 17th March 2004 new sub-paragraph (ca) in paragraph 11(2) requires a qualifying subsidiary to be a 51% subsidiary as defined by section 838 ICTA.
6. New sub-paragraphs 8 to 10 of paragraph 11 provide that the conditions in relation to a subsidiary shall not be regarded as ceasing to be satisfied by reason only of anything done as a consequence of the subsidiary or any other company being in administration or receivership. This is provided that the administration or receivership or anything done as a consequence is for commercial reasons and not for any tax avoidance purpose.
7. Subsection (5) inserts two new paragraphs 11A and 11B.

8. Paragraph 11A provides that a company is not a qualifying company if it has a property managing subsidiary which is not a qualifying 90% subsidiary as defined in new Paragraph 11B. A “property managing subsidiary” is defined as a company whose business consists wholly or mainly in the holding or managing of land or any property deriving its value from land. For these purposes the meaning of “land” and “property deriving its value from land” are the same as those in section 776 of ICTA.
9. Paragraph 11B sets out a definition of what comprises a qualifying 90% subsidiary. It provides that in order to be a qualifying 90% subsidiary of the holding company, the following conditions must be met:
 - the qualifying company must possess not less than 90% of the issued share capital and not less than 90% of the voting power in the relevant subsidiary;
 - in the event of a winding up or in any other circumstances the qualifying company must be beneficially entitled to receive not less than 90% of the assets of the relevant subsidiary available for distribution;
 - the qualifying company must be beneficially entitled to not less than 90% of any profits of the relevant subsidiary;
 - no person other than the qualifying company has control of the relevant subsidiary; and
 - no arrangements are in place which could cause any of the above conditions not to be met.
10. Sub-paragraph 3 of 11B provides that sub-paragraphs 4 to 10 (but not sub-paragraph (6)(b)) of paragraph 11 apply in relation to paragraph 11B as they apply in relation to paragraph 11. These provisions relate to winding up, administration and receivership and arrangements for disposal of the subsidiary.
11. Subsection (6) provides that the changes made by this section will apply to any EMI share options granted on or after the 17 March 2004.

BACKGROUND NOTE

12. Enterprise Management Incentives (EMI) was introduced in Finance Act 2000. It is aimed at smaller, higher risk companies to help them recruit and retain key workers.
13. It allows companies to award share options up to the value of £100,000 to any number of employees up to a total value of £3m for each company.
14. The proposed change to the ‘75% subsidiaries rule’ follows the change being made for the Venture Capital Schemes and responds to requests from business to relax this rule.

EXPLANATORY NOTE

**CLAUSES 92 TO 101: EXEMPTION FROM INCOME TAX
FOR CERTAIN INTEREST AND ROYALTY PAYMENTS**

SUMMARY

1. These Clauses implement the EU Interest and Royalties Directive (Council Directive 2003/49/EC of 3 June 2003 – ‘the Directive’) into UK law. The terms of the Directive have effect from 1 January 2004. It provides for the elimination of source state taxation on interest and royalty payments between associated companies in different Member States of the European Union.

DETAILS OF THE CLAUSES

CLAUSE 92: INTRODUCTORY

2. Subsection (1) - The Chapter implements the EU Interest and Royalties Directive (Council Directive 2003/49/EC of 3rd June 2003 – ‘the Directive’) into UK law.
3. Subsection (2) is an interpretation provision.
4. Subsections (3)–(4) allows the Treasury to amend the current legislation where that is appropriate for implementing any amendment to, or replacement of, the Directive. Such amendments will be subject to the approval of Parliament under the negative resolution procedure.
5. Subsections (5)–(6) are the commencement provisions. In general the chapter has effect in relation to interest or royalty payments made on or after 1 January 2004. As from 8 April 2004, an anti-avoidance rule has effect (see Clause 8).

**CLAUSE 93: EXEMPTION FROM INCOME TAX FOR CERTAIN
INTEREST AND ROYALTY PAYMENTS**

6. Clause 93 provides an exemption from tax where the beneficial owner of interest or royalty payments is a company of another Member State, or a permanent establishment in a Member State of such a company, as provided by Article 1 of the Directive.

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CLAUSES 92 TO 101

7. Subsection (1) exempts affected payments from income tax only, and not corporation tax. This is because non-resident companies are only within the charge to corporation tax on such payments if they trade in the United Kingdom through a permanent establishment here and that interest or royalty is effectively connected with the permanent establishment.
8. Subsections (2)–(5) set out the various conditions that must be fulfilled for the exemption to apply. (2)–(4) apply generally, (5) is specific to payments of interest.
 - a. (2) ensures that the payment is one which arises in the UK, as determined in Article 1.2 of the Directive.
 - b. (3) ensures that the beneficial owner is an EU company (or permanent establishment of such a company) that is entitled to benefit from the Directive.
 - c. (4) limits the type of associated companies that are entitled to benefit from the Directive. Further detail is given in Clause 91(4).
 - d. (5) applies only to payments of interest. The exemption for such payments is only available where the Board have issued an exemption notice. The procedures for obtaining an exemption notice are set out in draft Regulations accompanying the draft legislation. The procedures largely mirror the existing procedures for obtaining benefits due under Double Taxation Treaties for similar payments of interest. They follow the procedures set out in Articles 1.11 to 1.14 of the Directive.
9. Subsection (6) makes the exemption subject to the provision concerning interest and royalty payments that are excessive due to a special relationship between the parties, and the anti-avoidance rule where arrangements have been created specifically to take advantage of the exemption.

CLAUSE 94: PERMANENT ESTABLISHMENTS AND “25% ASSOCIATES”

10. Subsection (1) sets out in detail some of the requirements of Conditions 1 – 3 set out in clause 93.
11. Subsection (2) ensures that where a payment of interest or royalties is made by a permanent establishment, it will only qualify for exemption if the payment is directly connected with the business carried on by the permanent establishment. It implements Article 1.3 of the directive.
12. Subsection (3) determines when a permanent establishment is treated as the beneficial owner of the interest or royalties. The recipient must be taxable on the payment in the State where it is situated. It implements Article 1.5 of the Directive.

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13. Subsection (4) addresses the question of when companies are treated as associated for the purposes of implementing the Directive. The subsection implements Article 3(b) of the Directive by allowing direct holdings of either voting rights or capital to count when establishing whether companies are associated.

CLAUSE 95: INTEREST PAYMENTS: EXEMPTION NOTICES

14. This section implements the measures that Member States may require before allowing exemption under the Directive, as set out in Article 1.11 to 1.14. It applies only to interest payments, and not to royalties. This largely mirrors the present treatment of cross-border interest payments where some measure of relief from UK taxation is afforded to the recipient under a Double Taxation Treaty.
15. Subsection (1) authorises the Board to make regulations detailing the procedures governing the issue of exemption notices.
16. Subsection (2) provides specific authority for the matters to be covered by the regulations. These cover:
- a. (a) who should apply for a notice,
 - b. (b)–(c) what their application must contain, including a certification that Conditions 1 to 3 of clause 93 are satisfied, and that the anti-avoidance rule does not apply,
 - c. (d) who will receive copies of the exemption notice,
 - d. (e) matters that can be specified in an exemption notice, detailing the interest to which it applies,
 - e. (f) setting a time limit for the issue of a notice that will apply from the receipt of all necessary details,
 - f. (g) when parties are required to notify changes that will affect the validity of an exemption notice after its issue,
 - g. (h)–(i) conditions for the cancellation or lapse of notices once issued,
 - h. (j) the making of appeals in relation to exemption notices, for example against the refusal to grant a notice, or cancellation of a notice,
 - i. (j) authorising the recovery of tax in appropriate circumstances where it is found the exemption does not apply after the issue of an exemption notice.

CLAUSE 96: PAYMENT OF ROYALTIES WITHOUT DEDUCTION AT SOURCE

17. Subsection (1) This subsection provides a mechanism whereby a person paying royalties that are covered by the exemption in clause 93(1) can pay them without deducting tax if he has a reasonable belief that the recipient will be entitled to the exemption. No advance approval needs to be obtained from the Inland Revenue. It is closely modelled on

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section 349E of the Income and Corporation Taxes Act 1988, which provides a similar system where full or partial relief from tax is due under a Double Taxation Treaty.

18. Subsection (2) ensures that where the payer's reasonable belief turns out to be mistaken, then the Inland Revenue can recover the tax that should have been deducted.
19. Subsections (3) to (4) allows the Inland Revenue to direct a payer of royalties to deduct tax where they are not satisfied that the recipient is entitled to exemption under the Directive. Such a direction can be varied or revoked at a later date if new facts emerge.
20. Subsection (5) places a duty on the recipient of royalty payments to notify the Board and the payer of any changes affecting its entitlement to the exemption.
21. Subsection (6) enables the Inland Revenue to request information in a corporation tax return about the royalty payments made by a company where it has adopted the procedures set out in this section.
22. Subsection (7) applies a maximum penalty of £3000 to errors in information provided in a corporation tax return about royalty payments where the Directive has been relied upon to provide exemption from tax.
23. Subsections (6) and (7) apply only in relation to matters arising after Royal Assent.

**CLAUSE 97: CLAIM FOR TAX DEDUCTED AT SOURCE FROM
EXEMPT INTEREST OR ROYALTY PAYMENTS**

24. Where a person entitled to exemption from tax on interest or royalty payments receives them under deduction of tax, he can claim repayment of the tax deducted. A claim should include information to show that the conditions 1 to 3 set out in clause 93 are fulfilled.

CLAUSE 98: SPECIAL RELATIONSHIPS

25. Subsection (1) This subsection implements Article 4.2 of the Directive, which makes it clear that the Directive only applies to exempt interest or royalties from tax to the extent that they would have been paid between independent parties acting at arm's length.
26. Subsections (2) to (3) ensures that the special relationships rule is construed in the same way as similar rules in double taxation treaties.
27. Subsection (4) ensures that where a claim to relief under a double taxation treaty would provide greater relief from tax than is available

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CLAUSES 92 TO 101

under the terms of the Directive, a company can still choose to claim relief under the treaty.

CLAUSE 99: ANTI-AVOIDANCE

28. This section implements Article 5.2 of the Directive allowing Member States to withdraw, or refuse to apply, the exemption in the case of transactions where the principal purpose, or one of the principal purposes is tax evasion, tax avoidance or abuse. The conditions are derived from similar provisions found in our double taxation treaties, often known as 'treaty shopping' provisions.
29. Subsection (1) removes the exemption that would otherwise be granted by clause 93 where either of the conditions set out in (2) or (3) are satisfied.
30. The condition in subsection (2) relates to payments of interest. It will apply where the benefit of the exemption would otherwise be given in respect of interest payments made indirectly to a person not entitled to the exemption. One example would be where a UK company borrows money from an associated company within the EU with that associate itself borrowing the funds from a company outside the EU when, had the UK company's borrowing been directly from the company outside the EU, interest payments would not have been exempt from UK tax. The background to such an arrangement would need to be considered and the anti-avoidance clause will be invoked only where obtaining the tax exemption was the main purpose of the creation or assignment of the debt-claim in question.
31. The condition in subsection (3) is an equivalent measure relating to payments of royalties.

CLAUSE 100: CONSEQUENTIAL AMENDMENTS

32. Subsections (1) to (3) apply the penalty provisions where a company makes a payment of royalties without deducting tax, purporting to do so in accordance with clause 94 above, but did not, or could not reasonably have believed that the exemption provided by the Directive was in fact due. These penalty provisions will apply in respect of matters occurring after the legislation has received Royal Assent.
33. Subsections (4) and (5) provide signposts to this legislation elsewhere in the Taxes Act 1988.

CLAUSE 101 – TRANSITIONAL PROVISION

34. This section ensures that the benefits available under the Directive can be enjoyed from 1 January 2004, even though the relevant legislation will not become law until after the passing of the Finance Act 2004, and,

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CLAUSES 92 TO 101

where appropriate, the coming into force of the Regulations governing the issue of exemption notices for interest payments.

35. Clause 99, the anti-avoidance rule, only applies from 8 April 2004, the date of the publication of the Finance Bill and revised draft Regulations. This rule was not included in the draft material issued on 10 December 2004.

BACKGROUND NOTE

36. The EU Interest and Royalties Directive was published by the Council of the European Union on 3 June 2003. Its text can be found in the Official Journal of the European Union L157 of 26 June 2003, and on the internet at:

http://europa.eu.int/eur-lex/en/archive/2003/l_15720030626en.html

EXPLANATORY NOTE

**CLAUSE 102: SAVINGS INCOME: DOUBLE TAXATION
ARISING FROM WITHHOLDING TAX: INTRODUCTORY**

SUMMARY

1. Clause 102 provides introductory material and definitions used in Chapter 7 of Part 3 of the Finance Bill (clauses 102 to 110). This chapter ensures that persons who receive savings income from abroad do not suffer double taxation where special withholding tax may be levied on the income.
2. This chapter completes the implementation in the UK of the EU Savings Directive and related international arrangements with other jurisdictions. UK persons will receive relief from any special withholding tax levied on their savings income by set-off against their income tax or capital gains tax liabilities. Any excess will be repaid. Alternatively, they will be able to apply to the Inland Revenue for a certificate which they can present to their paying agent so that their income is paid without deduction of special withholding tax.

DETAILS OF THE CLAUSE

3. Subsection (1) explains the purpose of the chapter.
4. Subsection (2) provides that relief from double taxation is given as a set-off against income tax or capital gains tax, and any excess is repaid.
5. Subsections (3) and (4) define “special withholding tax” and “international arrangements”.
6. Subsection (5) provides that relief for special withholding tax is not also available under existing double taxation provisions.
7. Subsection (6) refers to the provision made by clauses 108 and 109 for the Inland Revenue to issue certificates to avoid the levy of special withholding tax in certain circumstances.
8. Subsection (7) provides definitions for the chapter.
9. Subsection (8) provides that terms used in the chapter in relation to capital gains tax have the same meaning as in the Taxation of Chargeable Gains Act 1992.

BACKGROUND NOTE

10. The Government is committed to fostering co-operation between tax authorities and using exchange of information as widely as possible to counter cross-border tax evasion on savings income. The principle is the basis of the EU Savings Directive (Directive 2003/48/EC on taxation of savings income in the form of interest payments), which was adopted on 3 June 2003, and related international arrangements with certain third countries and dependent and associated territories.
11. Under the Directive, UK businesses and public bodies that pay interest or other savings income to, or collect savings income for, individuals resident in the EU or the other jurisdictions, will have to report details of the payments and the payees to the Inland Revenue. The Inland Revenue will then provide this information to the tax authority of the payees.
12. Similarly, tax authorities in other jurisdictions will provide the Inland Revenue with information on UK resident payees who receive savings income from paying agents established in their jurisdictions.
13. As an alternative to exchanging information about cross-border payments, three EU countries (Austria, Belgium and Luxembourg) and certain other jurisdictions will, for a transitional period, impose a withholding tax. This “special withholding tax” will be levied at 15% for the first three years, 20% for the next three years and 35% thereafter. Paying agents in these jurisdictions will levy it on savings income they pay to individuals resident in other jurisdictions.
14. Jurisdictions will retain 25% of the tax withheld. The remaining 75% will be passed to the country of residence of the payee.
15. Article 14 of the Directive requires that credit is given for the special withholding tax levied. Where the credit exceeds the individual’s income tax and capital gains tax liability, the excess is to be repaid.
16. UK persons receiving interest from these jurisdictions may request that tax is not withheld by either:
 - authorising the paying agent to report information about the savings income payments made; or
 - presenting the paying agent with a certificate drawn up by the Inland Revenue.
17. Special withholding tax will not be levied before the Directive takes effect. This will not be before 1 January 2005. This date is subject to the condition that agreements with certain third countries and arrangements with relevant dependent and associated territories of Member States are in place and take effect from the same date.

**BOARD OF INLAND REVENUE
RESOLUTIONS:
PROCEDURE (SAVINGS
INCOME)
FINANCE (MONEY) (a)**

**FINANCE BILL 2004
CLAUSE 103**

EXPLANATORY NOTE

**CLAUSE 103: INCOME TAX CREDIT ETC FOR SPECIAL
WITHHOLDING TAX**

SUMMARY

1. Clause 103 ensures credit can be given against income tax when double taxation is suffered as a result of special withholding tax. Those affected will be able to set the tax withheld against their income tax liability. Any excess will be set against capital gains tax, and any remaining balance will be repaid.

DETAILS OF THE CLAUSE

2. Subsection (1) explains where the section applies. This is where a payment of savings income to a person has suffered special withholding tax, the person is chargeable to income tax and is resident for tax purposes in the UK.
3. Subsection (2) provides that income tax equal to the amount of special withholding tax levied is treated as having been paid by the person and deducted at source for the purposes of particular provisions of the Taxes Management Act 1970.
4. Subsection (3) lists the provisions mentioned in subsection (2).
5. Subsection (4) allows for any excess over the amount of income tax liability to be set against the person's capital gains tax liability, and for any remaining balance to be repaid.
6. Subsection (5) prevents credit or repayment where a person has obtained relief for the special withholding tax in another jurisdiction, and was resident there, or treated as being resident there under a double taxation arrangement.

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RESOLUTIONS: CLAUSE 103
PROCEDURE (SAVINGS
INCOME)
FINANCE (MONEY) (a)

BACKGROUND NOTE

7. The EU Savings Directive requires Member States to operate automatic exchange of information about cross-border payments of savings income to individuals. It provides that three Member States may, during a transitional period, levy a withholding tax rather than automatic exchange of information. Some of the other jurisdictions applying the same or equivalent measures as the Directive will do the same.
8. Article 14 of the Directive requires that credit is given for the special withholding tax levied. Where the credit exceeds the individual's income tax and capital gains tax liability, the excess is to be repaid.

EXPLANATORY NOTE

CLAUSE 104: CAPITAL GAINS TAX CREDIT ETC FOR SPECIAL WITHHOLDING TAX

SUMMARY

1. Clause 104 ensures credit can be given against capital gains tax when double taxation is suffered as a result of special withholding tax. Those affected will be able to set the tax withheld against their capital gains tax liability. Any excess will be set against income tax, and any remaining balance will be repaid.

DETAILS OF THE CLAUSE

2. Subsection (1) explains the circumstances in which the section applies. These are that a person chargeable to capital gains tax has made a disposal, where consideration includes savings income which has suffered special withholding tax. The person must be resident in the UK for tax purposes.
3. Subsection (2) disregards, for the purposes of determining whether the person would be chargeable to capital gains tax in respect of any chargeable gain arising on the disposal in question,
 - the annual exempt amount and any deduction of allowable losses, which could result in no capital gains tax being charged, and
 - section 77(1) of the Taxation of Chargeable Gains Act 1992, under which the trustees of certain settlements are not chargeable to tax in respect of chargeable gains arising to them.
4. Subsection (3) provides that capital gains tax equal to the amount of special withholding tax levied is treated as having been paid by the person.
5. Subsection (4) provides that, for the purposes of certain provisions of the Taxes Management Act 1970, income tax deducted at source should be taken to include the amount of tax deemed to have been paid.

**BOARD OF INLAND REVENUE
RESOLUTIONS:
PROCEDURE (SAVINGS
INCOME)
FINANCE (MONEY) (a)**

**FINANCE BILL 2004
CLAUSE 104**

6. Subsection (5) provides for any excess over the amount of capital gains tax to be set against the person's income tax liability, and for any remaining balance to be repaid.
7. Subsection (6) prevents credit or repayment where a person has obtained relief for the special withholding tax in another jurisdiction, and was resident there, or treated as being resident there under a double taxation arrangement.
8. Subsection (7) excludes any special withholding tax that has already been credited under clause 103.

BACKGROUND NOTE

9. The EU Savings Directive requires Member States to operate automatic exchange of information about cross-border payments of savings income to individuals. It provides that three Member States may, during a transitional period, levy a withholding tax rather than automatic exchange of information. Some of the other jurisdictions applying the same or equivalent measures as the Directive will do the same.
10. Article 14 of the Directive requires that credit is given for the special withholding tax levied. Where the credit exceeds the individual's income tax and capital gains tax liability, the excess is to be repaid.

**BOARD OF INLAND REVENUE
RESOLUTIONS:
PROCEDURE (SAVINGS
INCOME)
FINANCE (MONEY) (a)**

**FINANCE BILL 2004
CLAUSE 105**

EXPLANATORY NOTE

**CLAUSE 105: CREDIT UNDER PART 18 OF TAXES ACT
1988 TO BE ALLOWED FIRST**

SUMMARY

1. Clause 105 ensures that credit is given first for any foreign tax suffered before giving credit for special withholding tax. This ensures foreign tax credits are not wasted unnecessarily.

DETAILS OF THE CLAUSE

2. Subsection (1) states that any credit for foreign tax allowed under Chapters 1 and 2 of Part 18 of the Income and Corporation Taxes Act 1988 should be given before credit for special withholding tax under clauses 103 or 104.
3. Subsection (2) defines “foreign tax” for this purpose.

BACKGROUND NOTE

4. The EU Savings Directive requires Member States to operate automatic exchange of information about cross-border payments of savings income to individuals. It provides that three Member States may, during a transitional period, levy a withholding tax rather than automatic exchange of information. Some of the other jurisdictions applying the same or equivalent measures as the Directive will do the same.
5. Article 14 of the Directive requires that credit is given for the special withholding tax levied. Where the credit exceeds the individual’s income tax and capital gains tax liability, the excess is to be repaid.
6. Credit for special withholding tax is to be given in addition to credit for any foreign tax paid. Credit for foreign tax is to be given first. This ensures that the individual gets maximum relief, since foreign tax is not repayable if it exceeds the individual’s income tax and capital gains tax liability.

EXPLANATORY NOTE

**CLAUSE 106: COMPUTATION OF INCOME ETC
SUBJECT TO SPECIAL WITHHOLDING TAX ONLY**

SUMMARY

1. Clause 106 explains how income and gains are to be computed for income tax purposes, and capital gains are to be computed for capital gains tax purposes, where a person has suffered special withholding tax, but no foreign tax.

DETAILS OF THE CLAUSE

2. Subsections (1) – (3) set out the conditions under which the clause applies. A person must be chargeable to income tax or capital gains tax in respect of savings income which has suffered special withholding tax but not foreign tax.
3. Subsection (4) requires an amount of special withholding tax to be added to the person's income if he is chargeable to income tax on income remitted to the UK.
4. Subsection (5) requires an amount of special withholding tax to be added to the person's capital gains if he is chargeable to capital gains tax on the chargeable gains remitted to the UK.
5. Subsection (6) provides that, if subsections (4) or (5) do not apply, no amount of special withholding tax should be deducted from the amount of income or gains for the purposes of income tax or chargeable gains for the purposes of capital gains tax.
6. Subsection (7) defines references in the clause to "special withholding tax".

BACKGROUND NOTE

7. The EU Savings Directive requires Member States to operate automatic exchange of information about cross-border payments of savings income to individuals. It provides that three Member States may, during a transitional period, levy a withholding tax rather than automatic

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CLAUSE 106

exchange of information. Some of the other jurisdictions applying the same or equivalent measures as the Directive will do the same.

8. Article 14 of the Directive requires that credit is given for the special withholding tax levied. Where the credit exceeds the individual's income tax and capital gains tax liability, the excess is to be repaid.

EXPLANATORY NOTE

**CLAUSE 107: COMPUTATION OF INCOME ETC
SUBJECT TO FOREIGN TAX AND SPECIAL
WITHHOLDING TAX**

SUMMARY

1. Clause 107 determines how income and capital gains should be computed for the purposes of giving relief for foreign tax where a person has suffered both special withholding tax and foreign tax.

DETAILS OF THE CLAUSE

2. Subsections (1) – (4) amend section 795 of the Income and Corporation Taxes Act 1988 to ensure that the provisions which give income tax relief for foreign tax work correctly where special withholding tax has been levied.
3. Subsection (2) amends subsection (1) of section 795 so that amounts received in the UK are increased by special withholding tax levied in respect of them.
4. Subsection (3) amends subsection (2)(a) of section 795 to ensure that no deduction is given for special withholding tax for the purposes of that subsection.
5. Subsection (4) inserts a new subsection (5) in section 795 which defines what is meant by special withholding tax.
6. Subsections (5) and (6) amend section 277 of the Taxation of Chargeable Gains Act 1992 to ensure that the provisions which give capital gains tax relief for foreign tax work correctly where special withholding tax has been levied.
7. Subsection (6) inserts new subsections (1A) – (1C) in section 277.
8. New subsection (1A) provides that subsection (1B) applies where a person has made a chargeable gain, the disposal proceeds include savings income, and special withholding tax has been levied.

EXPLANATORY NOTE

CLAUSE 108: ISSUE OF CERTIFICATE

SUMMARY

1. Clause 108 provides for the arrangements under which a person may apply to the Inland Revenue for a certificate. It specifies the information that the applicant must provide, and the information that the certificate must contain. The applicant can send the certificate to their paying agent so that he will not levy special withholding tax on payments of savings income he makes to him.
2. This clause implements in the UK Article 13(2) of the EU Savings Directive, and the corresponding provision of certain international arrangements.

DETAILS OF THE CLAUSE

3. Subsection (1) sets out that the clause enables the Inland Revenue to issue certificates for the purposes of the EU Savings Directive or corresponding international arrangements.
4. Subsection (2) states that the Inland Revenue will issue a certificate if satisfied that the applicant has provided the required information and documents needed to verify it.
5. Subsection (3) defines the information required, namely:
 - The applicant's name and address
 - His National Insurance number or, if he does not have one, his date of birth and the town and country of his birth
 - His account number or some other information which identifies his investment
 - The name and address of his paying agent
 - The period for which the certificate is to be valid (with a maximum of three years).
6. Subsection (4) sets out that the certificate must be in writing and what it must contain.
7. Subsection (5) provides for the time limit within which the certificate must be issued.

EXPLANATORY NOTE

**CLAUSE 109: REFUSAL TO ISSUE CERTIFICATE AND
APPEAL AGAINST REFUSAL**

SUMMARY

1. Clause 109 provides for a person to appeal against a decision by the Inland Revenue to refuse to issue a certificate requested under clause 108.

DETAILS OF THE CLAUSE

2. Subsection (1) sets out that the clause applies if the Inland Revenue refuse to issue a certificate under clause 108.
3. Subsection (2) states that the Inland Revenue must issue a written notice – a refusal notice – if it refuses to issue a certificate.
4. Subsection (3) provides that the refusal notice must set out the reasons for the refusal to issue a certificate.
5. Subsection (4) gives the applicant the right to appeal, in writing, to the Special Commissioners.
6. Subsection (5) allows the applicant 30 days in which to lodge their appeal with the Inland Revenue.
7. Subsection (6) applies Part 5 of the Taxes Management Act 1970 to the appeal.
8. Subsection (7) provides that the Special Commissioners may either confirm the refusal notice, or quash it and require the Inland Revenue to issue a certificate.

BACKGROUND NOTE

9. The EU Savings Directive requires Member States to operate automatic exchange of information about cross-border payments of savings income to individuals. It provides that three Member States may, during a transitional period, levy a withholding tax rather than automatic

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exchange of information. Some of the other jurisdictions applying the same or equivalent measures as the Directive will do the same.

10. Article 13 of the Directive provides that Member States levying a withholding tax must provide at least one of two procedures whereby overseas individuals can opt to receive savings income without the levy.
11. Under the second procedure, individuals may apply to their own tax authority for a certificate showing their details, their paying agent's name and address, details to identify their investment and the period of validity (with a maximum of three years). When they present the certificate to their paying agent, the latter will not levy withholding tax or exchange information about them.

EXPLANATORY NOTE

CLAUSE 110: SUPPLEMENTARY

SUMMARY

1. Clause 110 contains supplementary provisions to ensure that Chapter 7 of Part 3 of the Finance Bill functions as intended. This chapter completes the implementation in the UK of the EU Savings Directive and related international arrangements with other jurisdictions.

DETAILS OF THE CLAUSE

2. Subsection (1) amends the definition of “foreign tax” in section 792 of the Income and Corporation Taxes Act 1988 to exclude special withholding tax.
3. Subsections (2) and (3) amend section 811 of the Income and Corporation Taxes Act and section 278 of the Taxation of Chargeable Gains Act 1992 to ensure that they operate subject to clause 105.
4. Subsection (4) construes section 10 of the Exchequer and Audit Departments Act 1866 to allow for the funding of repayments of special withholding tax.

BACKGROUND NOTE

5. The EU Savings Directive requires Member States to operate automatic exchange of information about cross-border payments of savings income to individuals. It provides that three Member States may, during a transitional period, levy a withholding tax rather than automatic exchange of information. Some of the other jurisdictions applying the same or equivalent measures as the Directive will do the same.
6. Article 14 of the directive requires that credit is given for the special withholding tax levied. Where the credit exceeds the individual’s income tax and capital gains tax liability, the excess is to be repaid.

EXPLANATORY NOTE

**CLAUSE 111 AND SCHEDULE 21: RESTRICTION OF
GIFTS RELIEF ETC.**

SUMMARY

1. This Clause and Schedule counter tax avoidance schemes which rely on the availability of capital gains tax (CGT) gifts relief on the disposal of assets to the trustees of trusts which are settlements in which a settlor has an interest. The new provisions will prevent gifts relief being available in relation to such disposals made on or after 10th December 2003.
2. Gifts relief has effect to postpone tax on chargeable gains in certain cases where assets standing at a gain are transferred from one person to another otherwise than by way of a bargain at arm's length. The relief applies not only in the case of outright gifts, but also where consideration is given for an asset of an amount or value which is less than the current market value of the asset.
3. The Schedule introduces a number of new provisions into the Taxation of Chargeable Gains Act 1992 (TCGA) which prevent gifts relief under section 165 or section 260 of that Act being available in respect of disposals of assets to the trustees of trusts in which a settlor has an interest. Such trusts are referred to as "settlor-interested settlements" in this note, and, for this purpose, a "settlor" is an individual who has transferred any property to the settlement.
4. The provisions will also claw back any gifts relief which has been obtained, or prevent such relief being obtained if it has not yet been obtained, in relation to disposals made on or after 10th December 2003 to trusts which become settlor-interested settlements within a certain time period. This period begins immediately after the disposal and ends immediately before the sixth anniversary of the start of the tax year next following that in which the disposal was made.
5. Disposals of assets to certain settlements which benefit disabled persons, or which provide income for maintenance funds for historic buildings are excluded from these new provisions.
6. The Schedule also restores a provision denying gifts relief on the transfer of shares or securities to companies which was introduced by Finance Act 2000 and inadvertently repealed with effect for disposals on or after 6th April 2003. The restored provision will have effect for

disposals on or after 21st October 2003, as explained in the Inland Revenue News Release (reference 86/03) published on that date.

7. In addition, the Schedule makes a number of consequential and minor amendments to existing provisions in the TCGA which are concerned with gifts relief or settlements. These amendments have various commencement dates.

DETAILS OF THE CLAUSE

8. The clause gives effect to the Schedule.

DETAILS OF THE SCHEDULE

9. In the notes which follow, any reference to a numbered section or Schedule are to that section or Schedule of the TCGA unless indicated otherwise.
10. Paragraph 1 amends section 98 of the Taxes Management Act 1970, which provides for penalties to be imposed in certain circumstances. In particular, it imposes penalties on persons who fail to comply with notices requiring them to provide information to the Inland Revenue which are issued in accordance with any of the provisions listed in the first column of the Table contained in section 98.
11. Sub-paragraph (2) of paragraph 1 inserts a reference to section 169G(2) of the TCGA in the first column of this table. The amendment is consequential on the introduction of sections 169B to 169G into the TCGA (see paragraph 21 below), and takes effect in relation to notices given in respect of the tax year 2003-04 or any subsequent tax year, but only if the notice in question is given after the passing of the Finance Act 2004. Paragraph 60 below gives details of the information provision in section 169G(2).
12. Paragraph 2 amends section 79, which contains a number of provisions relating to sections 77 and 78. Section 77 provides for chargeable gains arising to the trustees of certain settlements on the disposal of assets not to be chargeable to tax. Instead, the person who provided the assets to the settlement is treated as though chargeable gains of an amount equal to the amount of those gains (after deducting any available allowable losses) arise to him. Section 78 makes provision for people who have paid tax on such gains to recover the amount of that tax from the trustees.
13. Sub-paragraph (2) of paragraph 2 inserts a new subsection, subsection (5A), into section 79. Its purpose is to define the meaning of the references to “arrangements” in subsection (5). This definition has

effect in relation to property provided to settlements on or after 10th December 2003. The change is being made to achieve consistency with the corresponding provision in the new section 169E(3), for which the definition of “arrangements” is provided by section 169G(1). (See paragraphs 50 and 59 below.)

14. The effect of the amendment made by sub-paragraph (3) of paragraph 2 is to modify a provision which enables the Inland Revenue to obtain information from relevant persons for the purposes of the application of sections 77 to 79 in relation to a settlement. At present, the information must be requested by notice given by an inspector of taxes. Notices relating to the tax year 2004-05 or any later year may be given by any officer of the Board of Inland Revenue.
15. Paragraph 3 amends section 165, which makes provision for gifts relief in the case of disposals of business assets.
16. The amendment made by sub-paragraph (2) of paragraph 3 is consequential on the introduction of sections 169B and 169C into the TCGA (see paragraph 21 below), and takes effect on their introduction. The effect of the amendment is to make the provision of relief under section 165 subject to those sections.
17. Sub-paragraph (3) of paragraph 3 inserts a new paragraph, paragraph (ba), into section 165(3). Its effect is to prevent relief being obtained under section 165 in respect of any disposal of shares or securities to a company. This provision was formerly included in paragraph (b) of section 165(3). But that paragraph, which was primarily concerned with the interaction of gifts relief and capital gains tax retirement relief, was repealed with effect for the tax year 2003-04 onwards by a prospective repeal made in Finance Act 1998 as part of the phasing-out of retirement relief over the period from 6th April 1998 to 5th April 2003. The existence of the repeal was inadvertently overlooked when paragraph (b) was amended in Finance Act 2000 to include the provision that has now been restored. The new paragraph takes effect in relation to disposals on or after 21st October 2003.
18. Sub-paragraphs (4) and (5) of paragraph 3 make amendments which clarify existing provisions in section 165 without making any change of substance.
19. The cross-references in section 165(8) to Schedule A1 (which makes provision for CGT taper relief) in the definitions of certain expressions used in section 165 which have the same meanings as they have for taper relief are updated with effect for the tax year 2004-05 onwards.
20. In addition, a reference in section 165(10) to a claim having been made under section 165 in respect of a disposal is replaced with a reference to subsection (4) applying in relation to that disposal. The significance of the reference to subsection (4) is that it is that subsection which provides

for the chargeable gain arising on the disposal to be postponed. This amendment applies in relation to disposals on or after 10th December 2003.

21. Paragraph 4 inserts six new sections, sections 169B to 169G, into the TCGA after section 169A. These make provision for gifts relief under section 165 or 260 not to be available on disposals of assets to settlor-interested settlements, subject to certain exceptions. Details of these new sections are given in paragraphs 22 to 63 below. They take effect in relation to disposals made on or after 10th December 2003, except that where references appear in these provisions to “an earlier disposal”, that earlier disposal could have been made at any time.

Section 169B Gifts to settlor -interested settlements etc

22. Subsection (1) provides for gifts relief under section 165 or 260 not to be available in relation to a disposal made by a person (referred to in this section as “the transferor”) to the trustees of a settlement if either or both of two conditions is, or are, satisfied in respect of the disposal. (This disposal is referred to as “the relevant disposal” in this section.) The reference to “a person” here includes the trustees of a different settlement as well as an individual.
23. Subsection (2) sets out the first condition. It is satisfied if, immediately after the disposal, someone who is a “settlor” in relation to the settlement has an “interest in the settlement” (see paragraphs 52 to 58 below). It is also satisfied if there is an “arrangement” (see paragraph 59 below) in existence at that time under which someone who is a settlor in relation to the settlement will or may acquire such an interest. The definition of “settlor” wherever the term is used in sections 169A to 169G is explained in paragraphs 48 to 51 below: it targets only individuals. Note that the first condition can be satisfied in circumstances where the person who makes the disposal has no interest in the settlement. The reason for this is that if the condition were to focus solely on the interests which that person has in the settlement then there would be scope for gifts relief to be used in tax avoidance schemes which relied in part on arrangements to which two or more settlors of a settlor-interested settlement were party, but where the transferor of the asset does not himself have an interest in the settlement.
24. Subsection (3) sets out the second condition. It is satisfied if three requirements are met. These are—
- *first*, on the assumption that gifts relief is not available in relation to the relevant disposal, a chargeable gain would arise to the transferor on that disposal;
 - *second*, the amount of expenditure allowed as a deduction in the computation of the gain would be reduced to any extent on account of gifts relief obtained in respect of an earlier disposal made by an individual (it is immaterial whether the earlier disposal

in question was made on or after 10th December 2003 or before that date); and

- *third*, immediately after the relevant disposal, the individual concerned has an interest in the settlement, or there exists an arrangement under which he or she will or may acquire such an interest.

25. The second condition prevents the first condition being side-stepped by the use of a chain of transfers which interposes one or more intermediate settlements or individuals between an individual and a settlement of which he or she is a beneficiary, and to which he or she wishes to transfer an asset and obtain the benefit of gifts relief. In the absence of the second condition, the individual could be able to arrange matters so that gifts relief is obtained in respect of each transfer in the chain.
26. Subsection (4) makes section 169B subject to the exceptions provided by section 169D.

*Section 169C Clawback of relief if settlement becomes
settlor-interested etc*

27. Subsection (1) describes the circumstances in which section 169C applies in relation to a disposal. It is triggered where a person (referred to in this section as “the transferor”) makes a disposal to the trustees of a settlement, and two requirements are met in relation to the disposal (see paragraph 28 below). The disposal is referred to as “the relevant disposal” in this section. The reference to “a person” here includes the trustees of a different settlement as well as an individual. It is important to note that, as mentioned in paragraph 21 above, this section applies only where the relevant disposal is made on or after 10th December 2003. Section 169C has no effect in any case where the relevant disposal was made before that date.
28. The first requirement is that gifts relief is obtained in relation to the relevant disposal or would be so obtainable if nothing in this section were to prevent it from being obtained. The second requirement is that either or both of two conditions (see paragraphs 29 and 30 below) is, or are, satisfied in respect of the disposal.
29. Subsection (2) sets out the first condition. It is satisfied if there is a time during “the clawback period” (see paragraph 38 below) at which someone who is then a settlor in relation to the settlement has an interest in the settlement. It is also satisfied if, at some time in that period, an “arrangement” (see paragraph 59 below) exists under which someone who is then a settlor in relation to the settlement will or may acquire such an interest.
30. Subsection (3) sets out the second condition. It is satisfied if three requirements are met. These are—

- *first*, on the assumption that gifts relief is not available in relation to the relevant disposal, a chargeable gain would arise to the transferor on that disposal;
 - *second*, the amount of expenditure allowed as a deduction in the computation of the gain would be reduced to any extent on account of gifts relief obtained in relation to an earlier disposal made by an individual (it is immaterial whether the earlier disposal in question was made on or after 10th December 2003 or before that date); and
 - *third*, there is a time during the clawback period at which the individual concerned has an interest in the settlement, or at which there exists an arrangement under which he or she will or may acquire such an interest.
31. If either or both of these conditions is satisfied in relation to the relevant disposal, then subsection (12) provides for the earliest time at which either of them is satisfied to be called “the material time” in section 169C.
32. Subsection (4) provides for gifts relief under section 165 or 260 not to be available in relation to the relevant disposal in any case where the relief has not been claimed before the material time. It also applies where a claim made before the material time is subsequently revoked. This is because subsection (10) provides for section 169C to apply in relation to claims under section 165 or 260 that are revoked as if the claim had never been made.
33. Subsection (5) provides for subsections (7) to (9) to apply in any case where gifts relief is claimed in relation to the relevant disposal before the material time and the claim is not revoked. The effect of those subsections is to claw back the relief and make consequential adjustments. This is, however, subject to subsection (6) (see paragraph 34 below).
34. Subsection (6) prevents subsections (7) to (9) applying in any case where the transferor is an individual who has died before the material time.
35. Subsection (7) provides for a chargeable gain to arise to the transferor at the material time. The amount of the gain is equal to the amount of the gain that was held over in consequence of the gifts relief obtained in relation to the relevant disposal.
36. Subsection (8) provides for the chargeable gains and allowable losses of the trustees of the settlement for any tax year ending after the relevant disposal was made to be determined on the basis that no gifts relief was obtained in relation to that disposal. It also provides for the chargeable gains and allowable losses of any person to whom the trustees have transferred property to be determined on the same basis for any “chargeable period” ending after the relevant disposal was made. This

will be of relevance only where the person concerned disposes of an asset and the computation of the amount of any gain or loss arising on the disposal would need to take account of the gifts relief that had been obtained on the relevant disposal. The expression “chargeable period” is defined in section 288(1). In the case of a company within the charge to corporation tax in respect of chargeable gains, a chargeable period is an accounting period of the company. Otherwise it is a tax year.

37. Subsection (9) authorises the making of all adjustments, whether by way of reductions of liability to, or repayments of, CGT or corporation tax in respect of chargeable gains, the making of assessments or otherwise, which are necessary to give effect to the provision made by subsection (8).
38. Subsection (11) defines “the clawback period”. It begins immediately after the relevant disposal and ends immediately before the sixth anniversary of the start of the tax year next following that in which the relevant disposal was made.
39. Subsection (13) makes section 169C subject to the exceptions provided by section 169D.

Section 169D Exceptions to sections 169B and 169C

40. Subsection (1) prevents sections 169B and 169C applying in relation to any disposal to the trustees of a settlement which is made in a tax year in respect of which an election has been made by the trustees for income of the settlement (or of any part of the settlement) to be applied for the maintenance of an historic building.
41. Subsections (2) to (4) prevent sections 169B and 169C applying in relation to any disposal to the trustees of settlement if two or, in some cases, three requirements are met. (The description of those requirements in paragraphs 42 to 45 below does not use the expressions “interested settlor” and “disabled beneficiary” which appear in subsection (4), but takes account of the meanings given for them in subsections (5) and (6).)
42. The first requirement is that, immediately after the disposal, the settled property is held on trusts which secure that one of three alternative conditions relating to the application of that property and the income arising from it is met in respect of a “disabled person” (see paragraph 45 below). (Subsections (10) and (11) provide relevant interpretation.)
43. The second requirement is that, immediately after the disposal is made, every person who is then a settlor in relation to the settlement and who has an interest in it is—
 - a beneficiary under the settlement, and
 - a disabled person.

44. Both the requirements in paragraphs 42 and 43 above must be met if subsection (2) is to apply. A further requirement must also be met in order for subsection (2) to apply in any case where, immediately after the disposal is made, there exists an arrangement under which a person who is then a settlor in relation to the settlement, but who does not have an interest in it, will or may acquire such an interest. In such circumstances, the requirement is that—
- every such person must be a disabled person immediately after the disposal is made, and
 - each such person would be a beneficiary under the settlement if he or she were to have the interest in question.
45. For the purposes of the second and third requirements, the question as to whether an individual has an interest in the settlement or will or may acquire such an interest under any arrangement is determined without taking account of the existence of any benefit which is or will, or may, be derived in any way by his or her spouse. (See paragraphs 53 and 54 below.)
46. Subsection (7) explains what it means for a person to be a “disabled person” for the purposes of section 169D. There are two categories. The first consists of individuals who, by reason of a mental disorder, are incapable of administering their property or managing their affairs. The second consists of individuals who are in receipt of attendance allowance or of a disability living allowance by virtue of entitlement to the highest or middle rate care component.
47. Subsections (8) and (9) provide the meanings of “attendance allowance” and “disability living allowance”.

*Section 169E Meaning of “settlor” in sections 169B to
169D and 169G*

48. Subsection (1) provides the meaning of the term “settlor”, which is used in this section, sections 169B to 169D and section 169G. For this purpose, a person is a settlor in relation to a settlement if any of the settled property originates from him or her. References in these provisions to “settlor” are references only to individuals who are settlors in relation to settlements, and not to other persons.
49. Subsection (2) explains the meaning of the reference in subsection (1) to property originating from a settlor. It includes not only property which the settlor has provided directly or indirectly for the purposes of the settlement, but also property which to any extent represents that property (see paragraph 51 below) or any part of it.
50. Subsection (3) makes provision in relation to the references in subsection (2) to property which a settlor has directly or indirectly provided for the purposes of the settlement. The references are to include references to property which another person has so provided if

that provision was made in pursuance of reciprocal “arrangements” with the settlor in question. But the references are not to include references to property which that settlor has directly or indirectly provided for the purposes of the settlement if he or she provided it in pursuance of reciprocal arrangements with another person. The meaning of the word “arrangements” is given by section 169G(1) (see paragraph 59 below).

51. Subsection (4) provides for the reference in subsection (2) to property representing other property to include reference to property representing accumulated income from that other property.

*Section 169F Meaning of “interest in settlement” in
sections 169B to 169D*

52. Subsection (1) provides for there to be two ways in which an individual is regarded as having an interest in a settlement for the purposes of this section and sections 169B to 169D.
53. Subsection (2) provides the first way this can happen (subject to the exception described in paragraphs 56 and 57 below). An individual is regarded as having an interest in a settlement if—
- any property which may at any time be comprised in the settlement, or
 - any derived property (see paragraph 58 below),
- is payable to, or applicable for, the benefit of the individual or his spouse in any circumstances whatsoever. Cases where any such property will, or may, become so payable or applicable are also caught.
54. Subsection (3) provides the second way. An individual is regarded as having an interest in a settlement if he or his spouse enjoys a benefit which is derived directly or indirectly from—
- any property which is comprised in the settlement, or
 - any derived property.
55. Subsection (4) provides that the references in subsections (2) and (3) to “spouse” do not include reference to a spouse from whom the individual is separated, whether under a court order, a separation agreement, or in such circumstances where the separation is likely to become permanent. Nor do the references include the widow or widower of the individual.
56. Subsection (5) makes an exception to the way in which subsection (2) provides for an individual to be regarded as having an interest in a settlement.
57. The exception is made where the only circumstances in which property can become payable or applicable as described in paragraph 53 above are in the event of—
- in the case of a marriage settlement, the death of both parties to the marriage and of all or any of the children of the marriage, or

- the death of a child of the individual concerned, where the child had, at an age not exceeding 25, become beneficially entitled to the property comprised in the settlement, or to any derived property.
58. Subsection (6) defines the expression “derived property” for the purposes of section 169F. Property is derived property in relation to other property if it is—
- income from that other property,
 - property which directly or indirectly represents proceeds of that other property,
 - property which directly or indirectly represents proceeds of income from that other property, or
 - income from either of the two preceding categories of property.

Section 169G Meaning of “arrangement” in sections 169B to 169E and information power

59. Subsection (1) provides the meaning of the references in sections 169B to 169E to the words “arrangement” and “arrangements”.
60. Subsection (2) gives the Inland Revenue the power to require any person to whom subsection (3) or (4) applies to provide information relevant to the provisions made by sections 169B to 169F.
61. Subsection (3) applies to any person who is, or who has ever been—
- a trustee of a settlement
 - a beneficiary under a settlement, or
 - a settlor in relation to a settlement.
62. Subsection (4) applies to any person who is the spouse of a settlor in relation to a settlement, and subsection (5) provides interpretation for subsection (4). Where notice is given in connection with a disposal, information may also be required from anyone who, although no longer the spouse of such a settlor, was such a spouse at the time the disposal in question was made or at any later time.
63. The meaning of “settlor” which applies in subsections (3) and (4) is that given by section 169E (see paragraphs 48 to 51 above). The word “spouse” takes its normal meaning and is not subject to the exclusions made by section 169F(4) (see paragraph 55 above) for the purposes of references in section 169F(2) and (3).
64. Paragraph 5 of the Schedule makes some minor amendments to section 260, which makes provision for gifts relief in the case of disposals of assets in certain specified cases, including those which are chargeable transfers for inheritance tax purposes.
65. The amendment made by sub-paragraph (2) of paragraph 5 is consequential on the introduction of sections 169B and 169C into the TCGA (see paragraph 21 above), and takes effect on their introduction.

The effect of the amendment is to make the provision of relief under section 260 subject to those sections.

66. The amendments made by sub-paragraphs (3) and (4) of paragraph 5 remove subsections (6A) and (6B) of section 260. These subsections provide that section 260(3) does not apply in relation to a chargeable gain which arises on the occurrence of a chargeable event under Schedule 5B or 5C which is triggered by a disposal of shares.
67. Schedules 5B and 5C provide for chargeable gains to be postponed in certain circumstances where qualifying investments in shares are made under the Enterprise Investment Scheme or in a Venture Capital Trust. Where relief is claimed under Schedule 5B or 5C, the gains that are accordingly postponed are treated for CGT purposes as not having arisen. But if a chargeable event occurs in relation to any shares comprised in the qualifying investment, a chargeable gain equal in amount to the amount of the postponed gain or gains, or to an appropriate proportion of that amount, is treated as arising at the time of the event. In this note, such chargeable gains are referred to as “revived gains”. A chargeable event will occur if, for example, the shares comprised in the qualifying investment are disposed of (except where the disposal is from one spouse to another and the disposal is treated as one on which neither a gain nor a loss arises for CGT purposes). Another example of where a chargeable event occurs is where the company in which the shares subsist ceases to meet the requirements for the shares to be a qualifying investment.
68. Relief under section 260(3) is available only where the chargeable gain which is to be the subject of the claim is a gain which arose on the disposal of an asset. Chargeable gains which are revived gains under Schedule 5B or 5C are not, however, gains which arise on the disposal of assets. They are gains which arise on the occurrence of a chargeable event, and it makes no difference whether the trigger for the chargeable event is a disposal or some other event.
69. In view of this, it follows that the provisions made by subsections (6A) and (6B) of section 260 are unnecessary. They are being removed, with effect for gains arising on or after 6th April 2004, because the fact that section 165 does not contain corresponding provisions has been the source of some confusion.
70. Sub-paragraph (5) of paragraph 5 makes a minor amendment to subsection (7) of section 260 to make it clear that the computational adjustment for which it provides in relation to the calculation of any chargeable gain arising on the disposal of an asset has effect whether or not gifts relief under section 260 is obtained in relation to the transfer of that asset to the person now disposing of it. The purpose of subsection (7) is to take account of any inheritance tax chargeable in relation to that earlier transfer when determining the amount of the chargeable gain arising on the disposal. The significance of the reference to subsection

(3) in the amendment is that it is that subsection which provides for the chargeable gain arising on the earlier transfer to be held over to the subsequent disposal in any case where gifts relief is obtained. The amendment, which serves a purely clarificatory purpose, has effect in relation to disposals on or after 6th April 2004.

71. Paragraph 6 amends section 281. Section 281(2) makes provision for CGT to be paid in ten annual instalments where the whole or part of any asset falling within any of the categories described in section 281(3) is disposed of by way of gift and the donor is unable to benefit from gifts relief on any, or part, of the chargeable gain that arises on the disposal. Interest is charged. Section 281(7) provides for the instalment plan to be curtailed in certain circumstances. This will happen if the disposal was to a person connected with the donor, and the asset (or part of an asset) in question is subsequently disposed of for valuable consideration, whether or not the subsequent disposal in question was made by the person to whom the donor transferred the asset. Where the plan is curtailed, the amount of tax remaining unpaid becomes immediately due and payable together with interest charged to the date of payment.
72. Sub-paragraph (2) of paragraph 6 amends section 281(2). The effect of the amendment is that the person paying the tax will be able to give notice of his or her election to pay by instalments to an officer of the Board of Inland Revenue: this relaxes the present requirement that notice must be given to his or her tax inspector. This change will have effect in relation to any notice given in respect of the tax year 2004-05 or any subsequent tax year.
73. Sub-paragraph (3) of paragraph 6 adds two new subsections, subsections (8) and (9), after subsection (7) of section 281. This amendment is consequential on the introduction of sections 169B to 169G into the TCGA (see paragraph 21 above), and takes effect on their introduction.
74. Section 281(8) makes provision for section 281(2) to apply in certain cases in relation to chargeable gains which arise in accordance with the clawback provision in section 169C(7). This will happen if two conditions are met. The first condition is that “the relevant disposal” in question (see paragraph 27 above) must have been a disposal of the whole or part of any assets falling within any of the categories described in section 281(3). The second condition is that at “the material time” (see paragraph 31 above), no part of the subject matter of the relevant disposal in question has been subsequently disposed of for valuable consideration, whether or not that subsequent disposal was made by the trustees to whom the relevant disposal in question was made.
75. Section 281(9) applies in any case where section 281(2) applies to a chargeable gain by virtue of the provision made by section 281(8). The effect of section 281(9) is to provide for subsections (4) to (7) of section 281 to apply in relation to such gains, subject to a modification being made to subsection (7). The effect of the modification is to provide that

that where the instalment plan applies in relation to a chargeable gain that arose in accordance with the clawback provision in section 169C(7), the plan is curtailed if any part of the subject matter of the relevant disposal is subsequently disposed of for valuable consideration, whether or not that subsequent disposal is made by the trustees to whom the relevant disposal in question was made.

76. Paragraph 7 amends section 282. Section 282 applies in certain circumstances where an asset is transferred by one person (referred to as “the donor” in that section) to another person (“the donee”) by way of gift. (The reference to “gift” here includes any transaction made otherwise than a bargain at arm’s length where either no consideration is given for the asset or where the amount or value of any consideration given for the asset is less than its market value at the time of the transfer.) The circumstances arise where a chargeable gain arises to the donor on the disposal and the CGT for which he is accordingly liable remains unpaid 12 months after it becomes due. Where the section applies, its effect is to provide for the donee to be assessed and charged to CGT in the name of the donor, and for the donee then to recover from the donor a sum equal to the amount of tax paid.
77. Sub-paragraph (2) of paragraph 7 inserts two new subsections, subsections (5) and (6) into section 282. These provide for section 282 to apply in relation to any chargeable gain which arises in accordance with the clawback provision in section 169C(7) (see paragraph 35 above) to persons who claim gifts relief in respect of the transfer of assets to the trustees of settlements which later become settlor-interested settlements. (Such a person is referred to as a “transferor” in section 169C(7).) For this purpose, the chargeable gain is treated as though it accrued to a person on the disposal of an asset, the transferor is taken to be the donor, and the trustees are taken to be the donee. This has effect in any case where the relevant disposal (that is, the disposal of the asset to the trustees) is made on or after 10th December 2003.
78. Paragraph 8 amends Schedule A1, which contains provisions for CGT taper relief.
79. Sub-paragraph (2) of paragraph 8 inserts a reference to section 169C(7) in the list of provisions mentioned in paragraph 16(2) of Schedule A1. Paragraph 16 of that Schedule provides rules which determine how much taper relief can be applied to chargeable gains which arise in certain circumstances where gains have been postponed. The effect of the amendment is to provide that the chargeable gain which arises in accordance with section 169C(7) to “the transferor” (see paragraph 27 above) on account of the clawback provision in section 169C(5) is, for the purposes of determining how much taper relief is available, treated as though it arose on “the relevant disposal” (see paragraph 27 above). The amendment has effect in any case where the relevant disposal is made on or after 10th December 2003.

80. Paragraph 9 amends Schedule 7, which makes provision for gifts relief under section 160 to apply in certain circumstances where assets are disposed of by the trustees of a settlement.
81. The amendment made by sub-paragraph (2) of paragraph 9 is consequential on the introduction of sections 169B and 169C into the TCGA, and takes effect on their introduction. Its effect is to make provision of relief under section 165 subject to these sections.
82. Paragraph 10 contains all the various commencement provisions applicable to the amendments which are made by the Schedule. These have been recorded separately in relation to each amendment in earlier paragraphs in this note.

BACKGROUND NOTE

Gifts relief

83. Where an asset is transferred for no consideration, or for consideration of less than its market value, a chargeable gain or allowable loss will generally accrue to the transferor. The transferor is treated for CGT purposes as if he had sold the asset for a consideration of an amount equal to its market value at the time of the transfer. And on the future disposal of the asset by the transferee, any chargeable gain or allowable loss arising is calculated on the basis that that amount was given to acquire the asset.
84. “Gifts relief” may apply to defer a charge to tax on chargeable gains arising on the transfer of an asset which is not made by way of a bargain at arm’s length if the transferor is an individual or the trustees of a settlement provided that it falls into one of three types of case. The first case is that, broadly (and subject to certain exceptions), the asset is a “business asset”, which includes certain kinds of shares. The second is that the transfer is a chargeable transfer for inheritance tax (IHT) purposes, but is not a potentially exempt transfer for IHT purposes (a transfer where a charge can arise if the donor dies within seven years of the gift). The third is that it is not a chargeable transfer because it falls within one of certain specified IHT exemptions
85. Where the conditions for gifts relief are satisfied, the transferor and transferee may together make a claim for the relief. Where the transfer is to the trustees of a settlement, however, the transferor may make the claim unilaterally. The chargeable gain on which he would otherwise have to pay tax is then reduced by an amount of the “held-over gain”.
86. When the transferee comes to dispose of the asset, the amount he is entitled to deduct from the sale proceeds in computing any chargeable gain or loss is reduced by the amount of the held-over gain. The result is that the held-over gain becomes chargeable on the transferee.

Example 1

87. David makes a gift of a business asset to Kay in August 2001. The asset cost him £10,000 in June 1998, and its market value in August 2001 is £25,000. Kay sells the asset for £35,000 (net of expenses) in July 2003.
88. If David does not claim gifts relief, a chargeable gain (before any taper relief) of £15,000 (market value £25,000 less cost £10,000) will arise to him in the tax year 2001-02. And when Kay sells the asset, a chargeable gain (before any taper relief) of £10,000 (net sale proceeds £35,000 less market value at acquisition £25,000) will arise to her for the tax year 2003-04.
89. But if David and Kay jointly make a claim for gifts relief, the gain of £15,000 is held over and no chargeable gain accrues to David in 2001-02. But when Kay sells the asset, her allowable expenditure is reduced to £10,000 because the market value of the asset when she acquired it from David (£25,000) is reduced by the amount of the held-over gain (£15,000). As a result her chargeable gain (before any taper relief) for 2003-04 becomes £25,000 (net sale proceeds £35,000 less allowable expenditure £10,000).
90. So, in effect, David's held-over gain of £15,000 becomes chargeable on Kay when she disposes of the asset.

Exploitation of the relief for tax avoidance purposes

91. This facility to defer liability to tax on a gain has been widely exploited for tax avoidance purposes in schemes involving the transfer of assets to settlor-interested settlements. The trustees dispose of the transferred asset but, typically, arrange matters in such a way that the chargeable gain is eliminated or reduced.
92. This can, for example, be achieved by the trustees having or creating allowable losses that can be deducted from the chargeable gain. Or, as a further example, tax reliefs may be exploited by the trust to eliminate the chargeable gain. A simple example of this is given in Example 2 below, but a number of more complex avoidance schemes which have relied upon the obtaining of gifts relief in relation to the transfer of an asset pregnant with gain to a settlement have been used. A key feature of all these schemes is that because an individual who is a settlor in relation to the settlement has an interest in the settlement, he has access to the proceeds from the trustees' disposal of the transferred asset.

Example 2

93. Louise owns a house which is not her only or main residence. It has a market value of £250,000 and if she were to sell it a chargeable gain of £150,000 (before any taper relief) would arise to her on the disposal.

94. She transfers the house to the trustees of a settlement in which she has an interest. She claims gifts relief and the gain is held over.
95. The terms of the settlement permit the trustees to allow certain persons to occupy the house. The trustees allow Alan, Louise's son, to do so. Alan then occupies the house as his only residence.
96. After a few months, Alan ceases to occupy the house and the trustees sell it for a sum (net of expenses) of £250,000. A chargeable gain of £150,000 (effectively the held-over gain) accrues to them. However, this gain is not chargeable to CGT because of provisions that allow trustees to benefit from the relief for gains arising on the disposal of private residences if a house has been occupied, under the terms of the trust, by a beneficiary as that person's only or main residence.
97. The settlement is left with full proceeds of the sale. And Louise has access to those proceeds, because she has an interest in the settlement.

The effect of the new provisions

98. The new provisions will stop gifts relief from being available on transfers to the trustees of settlor-interested settlements. So in example 2, if Louise transferred the house to the settlement on or after 10th December 2003, she would not be able to claim gifts relief and a chargeable gain of £150,000 (less any available taper relief) would arise to her. And the disposal by the trustees would not give rise to any gain or loss, because the value of the property when they acquired it from Louise, £250,000, is deducted from the sale proceeds of £250,000 when computing any gain or loss on the disposal.
99. The second element of the new provisions prevents people circumventing the bar on gifts relief on transfers to settlor-interested settlements by transferring an asset to a settlement that was not a settlor-interested settlement at the time of the disposal, and subsequently acquiring an interest in that settlement. If gifts relief is obtained in relation to the transfer of an asset to a settlement, and at some future time no later than six years after the end of the tax year in which the gift was made the settlement becomes a settlor-interested settlement, the gifts relief is "clawed back".
100. The way the clawback provision works is as follows. A chargeable gain equal in amount to the amount of the held-over gain is treated, for CGT purposes, as arising to the transferor at the time the settlement becomes a settlor-interested settlement, and the trustees' allowable expenditure on the asset (for use in computing the gain or loss on any disposal the trustees make of it) is increased by the amount of the held-over gain.
101. If the trustees have disposed of the asset before the trust becomes a settlor-interested settlement, any chargeable gain or allowable loss arising on that disposal is recomputed as if the gifts relief had never been

claimed, and tax is discharged or repaid. Example 3 below demonstrates the operation of this provision.

Example 3

102. Harry has an asset that cost him £200,000 in 1999 and is now worth £500,000. In January 2004 he transfers it to the trustees of a trust which is not a settlor-interested settlement, and claims gifts relief. A chargeable gain of £300,000 is held over. For the trustees the allowable expenditure to be used in computing the gain on any subsequent disposal they make of the asset is £200,000 (market value £500,000 less held-over gain £300,000).
103. The trustees sell the asset in March 2004 for £502,000 and a chargeable gain of £302,000 (proceeds £502,000 less allowable expenditure £200,000) arises to them for the tax year 2003-04. However, the trustees have capital losses of £275,000 that can be set against the gain, so they are taxed only on a gain of £27,000. They pay the tax on 31 January 2005.
104. In March 2005 Harry acquires an interest in the settlement. The settlement is now a settlor-interested settlement.
105. A chargeable gain equal in amount to the held-over gain of £300,000 (before taper relief) becomes chargeable on Harry for the tax year 2004-05. He can benefit from the taper relief that would have applied if the gain had arisen to him on his disposal of the asset in January 2004.
106. The trustees' gain on disposal of the asset is recomputed on the basis that gifts relief was not due on Harry's transfer of the asset to them. So the chargeable gain arising to them on their disposal of the asset is reduced to £2,000 (disposal proceeds £502,000 less allowable acquisition value £500,000). This £2,000 is covered by part of their losses of £275,000, so no CGT is due. The CGT they paid in January 2005 is repaid, and the trustees have unused losses of £273,000 to carry forward to the tax year 2004-05.
107. If the trust had become a settlor-interested settlement before the trustees had disposed of the asset, the revised allowable expenditure of £500,000 would have been used in computing the chargeable gain arising to them when they disposed of the asset.

EXPLANATORY NOTE

**CLAUSE 112 AND SCHEDULE 22: PRIVATE RESIDENCE
RELIEF**

SUMMARY

1. This Clause and Schedule prevent exploitation of the interaction between private residence relief and gifts relief to avoid capital gains tax (CGT). Their effect is that private residence relief will not be available in certain circumstances where a disposal is made on or after 10th December 2003 by an individual or the trustees of a settlement. These circumstances arise where the computation of the amount of any gain arising on the disposal has to take account of gifts relief obtained in respect of an earlier disposal. This is subject to a transitional provision which will restrict the amount of private residence relief available in respect of the disposal if there has been no “earlier disposal” on or after 10 December 2003.
2. Private residence relief under sections 222 to 226 of the Taxation of Chargeable Gains Act 1992 (TCGA) has effect in most cases to provide that capital gains arising on the disposal of any property which is the owner’s only or main residence are not chargeable to CGT. The purpose of gifts relief under section 260 of the TCGA is to defer the charge to CGT in certain circumstances when assets standing at a gain are transferred at undervalue from one person to another. The main purpose of the new provisions introduced by this Clause and Schedule is to counter tax avoidance schemes which are designed to secure that gains arising on the disposal of other properties are able to benefit from private residence relief.
3. The new provisions will not apply in any case where the gain arising on the disposal is not in any way affected by a gifts relief claim under section 260 of the TCGA in respect of any earlier disposal.
4. The Schedule also makes a number of amendments to the existing private residence relief provisions. All but one of these are of minor significance. The exception is that the private residence relief which is available to the trustees of settlements when they dispose of property which has been occupied by a beneficiary under the settlement as that person’s only or main residence will be obtainable only where a claim for it is made by the trustees. This will apply for disposals on or after 10th December 2003. The minor amendments also take effect from that date.

5. In addition, the Schedule introduces a new provision into the TCGA which will give statutory effect to a long-standing extra-statutory concession (ESC D5) which allows private residence relief to be available in respect of certain disposals of property by the personal representatives of deceased persons. The relief will be obtainable under the new provision only where a claim for it is made by the personal representatives. The scope of the new provision will be slightly wider than that of the concession, and will supersede it with effect for disposals on or after 10th December 2003.
6. The new provisions largely complement the measures introduced in the Bill to prevent gifts relief under either section 165 or section 260 of the TCGA being available in respect of transfers of assets, including residential property, to the trustees of settlor-interested settlements if certain conditions are satisfied.

DETAILS OF THE CLAUSE

7. The clause gives effect to the Schedule.

DETAILS OF THE SCHEDULE

8. In the notes which follow, any reference to a numbered section or Schedule are to that section or Schedule of the TCGA unless indicated otherwise.
9. Paragraph 1 amends section 222, which contains provisions specifying which gains are eligible for private residence relief. The assets which potentially qualify for the relief are described in section 222(1). These include dwelling houses used as private residences, their gardens and grounds (up to a maximum permitted area as determined by section 222(2) to (4)), and interests in such houses and land. Gains arising on the disposal of a qualifying asset are eligible for the relief only if they arise to the individual who has occupied the property as his or her only or main residence. This is subject to section 225 (see paragraph 16 below) and section 226 (which provides for the relief to be obtainable in certain circumstances where the property has before 6th April 1988 been the only or main residence of a dependent relative of the owner). It is also subject to the new section, section 225A, which is inserted by paragraph 5 of this Schedule (see paragraphs 20 to 26 below).
10. Sub-paragraph (2) of paragraph 1 amends subsection (5)(a) of section 222. This makes provision for an individual who has two or more residences to settle the question as to which is to qualify as his or her main residence for any period for the purposes of the relief. This is achieved if the individual gives notice to his or her tax inspector within two years after the period starts. Such notices are subject to subsequent

variation if the individual gives further notice to the inspector in respect of a period beginning no earlier than two years before the further notice is given. The effect of the amendment is that any notices mentioned in subsection (5)(a) that are given on or after 10th December 2003 may be given to any officer of the Board of Inland Revenue.

11. Paragraph 2 amends section 223, which determines the extent to which any gains to which section 222 applies are chargeable gains. Sections 222 and 223 also have effect, owing to the provision in section 16(2), to determine the extent to which a capital loss arising on the disposal of an asset to which section 222(1) applies is an allowable loss. (The significance of a loss being an “allowable loss” for CGT purposes is that it is deductible from chargeable gains to reduce or eliminate the amount chargeable to CGT. Section 16(2) provides that, except where express contrary provision is made, all TCGA provisions which distinguish gains which are chargeable gains from those which are not also have effect to distinguish losses which are allowable losses from those which are not.)
12. Sub-paragraph (2) of paragraph 2 deletes some unnecessary words in subsection (4)(a) of section 223 with effect for disposals made on or after 10th December 2003. The words in question - “or those provisions as applied by section 225” - appear in the context of a reference to other subsections of section 223. They do no more than qualify the reference to those other subsections. But such qualification is unnecessary in view of section 20(2) of the Interpretation Act 1978, which provides that where an Act refers to an enactment, the reference, unless the contrary intention appears, includes a reference to that provision as applied by or under any other enactment, including any other provision of the same Act. The opportunity to remove these words has arisen owing to the introduction of section 225A (see paragraphs 20 to 26) below) because that new section also provides for section 223 to be applied for purposes for which it would not otherwise apply.
13. Sub-paragraph (3) of paragraph 2 inserts a new subsection, subsection (8), in section 223. The effect of this provision, which is to make it clear that section 223 is subject to section 226A (see paragraphs 28 to 35 below) as well as to section 224 (see paragraph 14 below), is consequential on the introduction of section 226A into the TCGA and applies accordingly. The commencement and transitional provisions relating to section 226A are described in paragraphs 27 and 41 to 51 below. Section 223 has always been subject to section 224, but there was previously no necessity for this to be mentioned in section 223 because of the adjacency of the two provisions. In view of the need, in the interests of clarification, to refer anyone reading section 223 to the existence of section 226A, reference to section 224 has also been included in subsection (8) to avoid any possible confusion.
14. Paragraph 3 amends section 224, which restricts, or prevents, the application of section 223 in certain circumstances.

15. The effect of sub-paragraph (2) of paragraph 3 is to change the words “accrues from the disposal” in section 224(1) to “accrues on the disposal”. This amendment, which is being made to achieve consistency with the drafting used in section 226A and generally elsewhere in the TCGA, takes effect in relation to disposals made on or after 10th December 2003.
16. Paragraph 4 amends section 225, which provides for sections 222 to 224 to apply in relation to assets comprised in settled property and occupied by a person under the terms of the settlement.
17. Sub-paragraph (2)(a) of paragraph 4 provides for the reference in the opening words of section 225 to “a trustee” (as the person to whom the gain arises on a disposal of settled property) to be changed to “the trustees of a settlement” for consistency with drafting used in section 226A and elsewhere in the TCGA. Sub-paragraphs (2)(b), (3) and (4)(b) make consequential amendments to later references in section 225. These amendments all have effect in relation to disposals on or after 10th December 2003.
18. Sub-paragraph (4)(a) of paragraph 4 makes an amendment which is consequential on that made by paragraph 1(2) of the Schedule (see paragraph 10 above) and accordingly has effect in relation to any notice given on or after 10th December 2003.
19. Sub-paragraph (5) inserts closing full-out words in section 225 after paragraph (b) of that section. The effect of the amendment is to provide for private residence relief under section 223 (as that section applies by virtue of section 225) to be available only on the making of a claim by the trustees.
20. Paragraph 5 introduces a new section, section 225A, into the TCGA after section 225. Details of this new section, which has effect in relation to disposals on or after 10th December 2003, are given in paragraphs 21 to 26 below.

*Section 225A Private residence held by personal
representatives*

21. Subsection (1) provides for sections 222 to 224 to apply, subject to the modifications made by subsections (5) and (6) (see paragraphs 25 and 26 below), in relation to gains arising to the personal representatives of a deceased person on the disposal of an asset falling within section 222(1) (see paragraph 9 above) if two conditions are satisfied (see paragraphs 22 and 23 below).
22. Subsection (2) sets out the first condition. It is that immediately before and immediately after the death of the deceased person referred to in subsection (1) one or more individuals have occupied the property concerned as their only or main residence.

23. Subsections (3) and (4) set out the second condition. This is that the individual or individuals mentioned in subsection (2) is or are between them entitled as legatee(s) of the deceased person in question to at least 75% of the net proceeds of disposal (see paragraph 24 below), or to an interest in possession in 75% or more of those proceeds. Where there is more than one individual who occupied the property as their only or main residence at the times prescribed in subsection (2), the 75% condition is tested by accumulating the separate interests of all the individuals concerned: it is not necessary for all the individuals in question to have such an interest for the condition to be met. Interpretation for the meaning of the word “legatee” is provided by section 64(2) and (3). It includes, in particular, any person whose entitlement results from the will or intestacy (or partial intestacy) of the deceased person.
24. For this purpose, the “net proceeds of disposal” are the proceeds of the disposal realised by the personal representatives, less any incidental costs of disposal allowable as a deduction under section 38(1)(c) in computing any capital gain arising to the personal representatives on that disposal. In testing whether the 75% condition is satisfied, the assumption is made that none of the proceeds of the disposal are applied to pay inheritance tax (IHT) or to meet any other liabilities of the deceased person’s estate.
25. Subsection (5) explains how the provisions of sections 222 to 224 are to be modified in applying section 225A. All references in those sections to the individual, other than references in relation to the occupation of the property in question by the individual, are to be read as references to the personal representatives. In addition, any notice given under section 222(5)(a) (see paragraph 10 above) must be given jointly by the personal representatives and the individual(s) entitled to occupy the property.
26. Subsection (6) provides that the personal representatives must make a claim if they wish to benefit from private residence relief in respect of any gain arising on the disposal of the property in question.
27. Paragraph 6 of the Schedule inserts two new sections, sections 226A and 226B, into the TCGA after section 226. These provide for private residence relief under section 223 (see paragraph 11 above) not to be available in most cases where the gain (or part of a gain) that would otherwise benefit from the relief to any extent represents a gain (or part of a gain) that has been postponed by virtue of gifts relief under section 260 in relation to an earlier disposal. This applies for gains or parts of gains arising on disposals (“later disposals” – see paragraph 29 below) made by individuals or the trustees of settlements on or after 10th December 2003, irrespective of the time at which any relevant earlier disposal was made. (A disposal is a “relevant earlier disposal” in relation to a later disposal if the condition described in paragraph 30 below is satisfied in relation to it.) This is subject to a transitional provision which applies where, and only where, the relevant earlier

disposal (or, if there was more than one such earlier disposal, every one of them) was made before that date (see paragraphs 41 to 51 below).

*Section 226A Private residence relief: cases where relief
obtained under section 260*

28. Subsection (1) provides for section 226A apply if two conditions are met.
29. The first condition is that section 223 applies in relation to a gain (or part of a gain) arising to an individual or the trustees of a settlement on a disposal, or would so apply in the absence of any provision made by section 226A. In section 226A, the person to whom the gain arises is called “the transferor” and the disposal in question is referred to as the “later disposal”.
30. The second condition is that, assuming that section 223 does not apply in relation to the gain (or part of a gain) in question, the amount of expenditure allowed as a deduction in the computation of the chargeable gain that would arise to the transferor on the later disposal would be to any extent reduced on account of gifts relief under section 260 being obtained in respect of any earlier disposal.
31. Subsection (2) (read with subsection (5)) provides that section 223 does not apply in relation to the gain (or part of a gain) mentioned in paragraph 29 above if a claim under section 260 is made in respect of any such earlier disposal before, or at the time of—
 - the later disposal, in any case where that disposal is made by an individual, or
 - the making of the claim for relief under section 223 in respect of that gain (or part of a gain), in any case where the later disposal is made by the trustees of a settlement (see paragraph 16 above).
32. Subsection (3) (read with subsection (5)) provides that it is to be assumed for CGT purposes that section 223 never applied in relation to the gain (or part of a gain) mentioned in paragraph 29 above in any case where no such claim under section 260 is made until after—
 - the later disposal, in any case where that disposal is made by an individual, or
 - the making of the claim for relief under section 223 in respect of that gain (or part of a gain), in any case where the later disposal is made by the trustees of a settlement.
33. Subsection (4) authorises the making of all adjustments, whether by way of reductions of liability to, or repayments of, CGT, the making of assessments or otherwise, which are needed in consequence of the application of subsection (3).
34. Subsection (6) provides that where a claim which is made under section 260 is subsequently revoked it is to be treated as never having been

made for the purposes of section 226A. This is needed because of the dependence in subsections (2) and (3) on the times at which events occur in an ordered sequence.

35. Subsection (7) provides for section 226A to be subject to the exception provided by section 226B (see paragraphs 36 to 38 below).

Section 226B Exception to section 226A

36. Subsection (1) prevents section 226A applying in relation to any “later disposal” (see paragraph 29 above) made by the trustees of a settlement if an election under section 691(2) of the Income and Corporation Taxes Act has been made by the trustees in relation to each tax year in which a “relevant earlier disposal” (see paragraph 37 below) was made. Such an election is for income of the settlement (or any part of the settlement) to be applied for the maintenance of an historic building.
37. Subsection (2) provides the meaning of the expression “relevant earlier disposal”. This is any earlier disposal in respect of which the condition described in paragraph 30 above is satisfied.
38. Subsection (3) provides for section 226B to be construed as one with section 226A. Because of this, any terms or expressions used in section 226B which are also used in section 226A have the same meaning as they have in that section.
39. There is no need for section 226B to make an exception in the case of the sorts of settlements for disabled persons which are excluded by section 169D(2) to (4) from the scope of sections 169B and 169C (see paragraphs 40 to 46 of the Explanatory Note for the measures restricting gifts relief on gifts to settlor-interested settlements.). The reason for this is that section 89 of the Inheritance Tax Act 1984 provides that a beneficiary of such a settlement has an interest in possession in the settled property. And this means that any transfer to the trustees of such a trust is a potentially exempt transfer for IHT purposes, and cannot, therefore, fall within the scope of section 260 of the TCGA.
40. Paragraph 7 of the Schedule provides all the commencement provisions applicable to the amendments which are made by the Schedule. These have been recorded separately in relation to each amendment in earlier paragraphs in this note. The amendments made by paragraphs 2(3) and 6 of the Schedule are subject to the transitional provision set out in paragraph 8 of the Schedule.
41. Paragraph 8 supplies the transitional provision referred to in paragraph 27 above.
42. Sub-paragraph (1) of paragraph 8 provides for paragraph 8 to have effect in any case where section 226A (see paragraphs 28 to 35 above) applies in circumstances where the “relevant earlier disposal” (or if there was more than such disposal, every one of them) was made before 10th

December 2003. The meaning of “relevant earlier disposal” is given by sub-paragraph (6) of paragraph (8). A disposal is a relevant earlier disposal in relation to a “later disposal” (see paragraph 29 above) if the condition described in paragraph 30 above is satisfied in relation to it.

43. Sub-paragraph (2) of paragraph 8 provides for section 226A to apply in a modified form in these circumstances. The modifications are described in paragraphs 44 to 49 below.
44. Sub-paragraph (3) of paragraph 8 modifies subsection (2) of section 226A. The effect of the modified subsection (2) (read with subsection (5) of section 226A) is to provide that section 223 applies (but in a modified way) in relation to the gain (or part of a gain) mentioned in paragraph 29 above if a claim under section 260 is made in respect of the relevant earlier disposal before, or at the time of—
 - the later disposal, in any case where that disposal is made by an individual, or
 - the making of the claim for relief under section 223 in respect of that gain (or part of a gain), in any case where the later disposal is made by the trustees of a settlement (see paragraph 16 above).
45. The modified way in section 223 applies in these circumstances is set out in subsections (2A) to (2C) of section 226A, which are inserted after subsection (2) by sub-paragraph (4) of paragraph 8. The effects of these subsections are described in paragraphs 46 to 48 below.
46. Subsection (2A) of section 226A stops section 223(1) applying in these circumstances. The effect of this is to prevent section 223 treating the whole of the gain (or part of a gain) in question as not being a chargeable gain. This means that section 223(2) applies, so that only a fraction of it will be treated as not being a chargeable gain.
47. Subsection (2B) of section 226A makes certain provisions that apply for the purposes of section 223(2)(a) and (3), which together determine the extent to which the property in question was occupied (or treated as occupied) as the only or main residence of the person concerned during the period of ownership. The effect of subsection (2B) is that no part of the “post-commencement period” counts as a period of such occupation. This includes any part of the last 36 months of the period of ownership which falls within the post-commencement period.
48. Subsection (2C) of section 226A defines “the post-commencement period”. It is the period beginning with 10th December 2003 and ending with the date of the “later disposal” (see paragraph 29 above). The combined effect of subsections (2A) to (2C) is, therefore, that no private residence relief is available in respect of that part of the period of ownership of the property which falls after 9th December 2003.
49. Sub-paragraph (5) of paragraph 8 of the Schedule modifies subsection (3) of section 226A. The effect of the modified subsection (3) (read

with subsection (5) of section 226A) is to provide that it is to be assumed for CGT purposes that section 223 applied in the modified way described in paragraphs 46 to 48 above in relation to the gain (or part of a gain) mentioned in paragraph 29 above in any case where no such claim under section 260 is made until after—

- the later disposal, in any case where that disposal is made by an individual, or
- the making of the claim for relief under section 223 in respect of that gain (or part of a gain), in any case where the later disposal is made by the trustees of a settlement.

50. Sub-paragraph (7) of paragraph 8 provides for paragraph 8 to be construed as one with section 226A. Because of this, any terms or expressions used in paragraph 8 which are also used in section 226A have the same meaning as they have in that section.
51. Sub-paragraph (8) of paragraph 8 provides for the scope of the power given to the Treasury by section 223(5) and (6) to amend the references to “36 months” in section 223(1) and (2)(a) by order to “24 months” (and to make a subsequent reversal by order) to include the corresponding references in subsection (2B)(b) of section 226A (see paragraph 49 above). All these references relate to the last 36 months of the period of ownership of the property in question.

BACKGROUND NOTE

Private residence relief

52. As outlined at paragraph 2 above, private residence relief broadly provides that capital gains arising on the disposal of any property which is the owner’s only or main residence are not chargeable to CGT. It also exempts gains arising from the sale of a part of a house, or the grounds of a house (up to a permitted area defined in section 222(2) to (4)), provided that the house has been the seller’s only or main residence. It also applies to gains on the sale of an interest in all or part of a house or its grounds.
53. If the house has been used partly as a residence and partly for business purposes, private residence relief can only cover the part of the gain that relates to the part of the house used as a residence. And if the house has been the seller’s only or main residence for only part of the time he has owned it, private residence relief can only cover the part of the gain that relates to the period when it was his only or main residence. However, in any case where private residence relief is available, the final 36 months of ownership will always qualify for relief under the current rules.
54. Where somebody at any time owns two houses, and uses each of them as his residence, he may elect which shall be treated as his main residence

(see paragraph 10 above). If the election is not made within the statutory time limit (see paragraph 10 above), it will be a question of fact, to be determined on the basis of the pattern of occupation of the houses, which house is the main residence. A married couple who are not separated can have only one main residence – they may not each elect for a different main residence.

55. An individual may qualify for private residence relief in respect of two houses at the same time in the three years leading up to the sale of one of those houses (see paragraph 53 above). This prevents him losing the benefit of private residence relief if he buys and moves into a new house before selling his old house.
56. Some simple examples of the operation of private residence relief are given below.

Example 1

57. George buys house number one and occupies it as his only residence for seven years. He sells it, and buys and occupies house number two. When he sells house number one he makes a gain of £50,000. For the seven years of his ownership of house number one, it was George's only residence. So the whole of the gain of £50,000 is covered by private residence relief, and George has no liability to capital gains tax on the sale of house number one.
58. If house number one was not sold until six months after George bought and moved into house number two, there would be a period of six months when George had two residences. He may elect for house number two to be treated as his main residence in this period. If he does not make this election, it is likely that an examination of the facts would conclude that house number two was his main residence. So for the last six months of his ownership of house number one, it was not his main residence. But as that period is part of the last three years of his ownership of house number one, private residence relief is due and once again George has no liability to capital gains tax on the sale of house number one.

Example 2

59. Mary and her husband Michael have a house which they have occupied as their only residence for ten years. They buy a holiday cottage, which they use at weekends and for occasional breaks. They do not make an election for one of the properties to be treated as their main residence. Three years after they buy the cottage they sell their house and move into the cottage. Their gain on the sale of the house is £80,000 (before any taper relief). Until they bought the cottage, the house was their only residence, and the way they have used the two properties since the purchase of the cottage indicates that the house continued to be their main residence. The whole of the gain of £80,000 is therefore covered

by private residence relief, and there is no capital gains tax payable as a result of the sale.

60. Five years later Mary and Michael sell the cottage, and buy and move into a flat. The sale of the cottage results in a gain of £60,000 (before any taper relief). They occupied the cottage as their only residence for five of their eight years of ownership, so five-eighths of the gain (£37,500) can be covered by private residence relief. The remaining £22,500 is potentially chargeable to capital gains tax. Taper relief will reduce the amount of the chargeable gain.
61. Private residence relief is also available in certain circumstances if the trustees of a settlement sell all or part of a house or its grounds. The relief is available if the terms of the settlement allowed the house to be occupied by one of the beneficiaries, and such a person occupied the house as his or her only or main residence. If these conditions are satisfied, the gain to the trustees may be wholly or partially covered by private residence relief. The relief is calculated in the same way as for individuals, comparing the period of occupation by the beneficiary with the period of ownership by the trustees.

Example 3

62. A settlement includes in its settled property a house. The acquisition cost of the house to the trustees, for capital gains tax purposes, is £60,000. For four years the trustees let the house. Then one of the beneficiaries of the settlement, who is entitled to occupy the house under the terms of the settlement, occupies it as her main residence for three years. She then moves out, the house is not occupied, and nine months later the trustees sell it for £140,000 (net of selling expenses). The trustees have a gain of £80,000 (before any taper relief). They owned the house for seven years nine months (93 months). The beneficiary occupied the house for three years, and private residence relief is also available in relation to the final nine months, because the house had previously been occupied by the beneficiary and therefore the final 36 months of ownership would be covered by private residence relief (see paragraph 53 above). So private residence relief can cover the portion of the gain relating to the three years of occupation by the beneficiary and the final nine months (45 months). The amount of private residence relief is therefore £38,710 ($£80,000 \times 45/93$). The trustees are left with a gain of £41,290, but the actual amount chargeable to capital gains tax will be reduced by taper relief.

Gifts relief

63. Where an asset is transferred for no consideration, or for consideration of an amount less than its market value, a chargeable gain or allowable loss will generally arise to the transferor. The transferor is treated for CGT purposes as if he had sold the asset for a consideration of an amount equal to its market value at the time of the transfer. And on the

future disposal of the asset by the transferee, any chargeable gain or allowable loss arising is calculated on the basis that that amount was given to acquire the asset.

64. "Gifts relief" may apply to defer a charge to tax on chargeable gains arising on the transfer of an asset which is not made by way of a bargain at arm's length if the transferor is an individual or the trustees of a settlement provided that it falls into one of three types of case. Only two of these cases are relevant to this legislation. The first of these is that the transfer is a chargeable transfer for IHT purposes, but is not a potentially exempt transfer for IHT purposes (a transfer where a charge can arise if the donor dies within seven years of the gift). The second is that it is not a chargeable transfer because it falls within one of certain specified IHT exemptions. The third case, which is not affected by these provisions, is that, broadly (and subject to certain exceptions), the asset is a "business asset", which includes certain kinds of shares. References in the remainder of this note to "gifts relief" do not include relief in respect of this third case because relief in such cases is given under section 165 rather than under section 260.
65. Where the conditions for gifts relief are satisfied, the transferor and transferee may together make a claim for the relief. Where the transfer is to the trustees of a settlement, however, the transferor may make the claim unilaterally. The chargeable gain on which he would otherwise have to pay tax is then reduced by an amount of the "held-over gain".
66. When the transferee comes to dispose of the asset, the amount he is entitled to deduct from the sale proceeds as costs of acquisition of the asset in computing any chargeable gain or loss is reduced by the amount of the held-over gain. The result is, in effect, that the held-over gain becomes chargeable on the transferee.

Example 4

67. John makes a gift of an asset to the trustees of a settlement in August 2001. The gift is a chargeable disposal for IHT purposes. The asset cost him £10,000 in June 1998, and its market value in August 2001 is £25,000. The trustees sell the asset for £35,000 (net of expenses) in July 2003.
68. If John does not claim gifts relief, a chargeable gain (before any taper relief) of £15,000 (market value £25,000 less cost £10,000) will arise to him in the tax year 2001-02. And when the trustees sell the asset, a chargeable gain (before any taper relief) of £10,000 (net sale proceeds £35,000 less market value at acquisition £25,000) will arise to them for the tax year 2003-04.
69. If John makes a claim for gifts relief, the gain of £15,000 is held over and no chargeable gain arises to John in the tax year 2001-02. But when the trustees sell the asset, their allowable expenditure is reduced to

£10,000, because in arriving at the price that they are deemed to have paid when they acquired it from John, the amount of the held-over gain (£15,000) is deducted from the market value of the asset (£25,000). As a result their chargeable gain (before any taper relief) for the tax year 2003-04 becomes £25,000 (net sale proceeds £35,000 less allowable expenditure £10,000).

70. So, in effect, John's held-over gain of £15,000 becomes chargeable on the trustees when they dispose of the asset.

Exploitation of the reliefs for tax avoidance purposes

71. The facility to defer liability to tax on a gain by using gifts has been widely exploited for tax avoidance purposes. Other measures in the Bill counter the use of gifts to the trustees of settlements in which the settlor has or acquires an interest ("settlor-interested settlements").
72. There are other avoidance schemes where the use of gifts relief is combined with the availability of the recipient of the gift to cover a subsequent gain with private residence relief. Unlike gifts to settlor-interested settlements, where the donor retains an interest in the gifted assets or the proceeds from their sale, these schemes can be used to sell assets and pass on the proceeds without paying capital gains tax on the gain realised on the sale of the assets. A simple example of such a scheme is outlined below.

Example 5

73. Jill owns a house which is not her only or main residence. It has a market value of £250,000 and if she were to sell it a chargeable gain of £150,000 (before any taper relief) would arise to her on the disposal. She wants to sell the house and give the proceeds to her children, Sandra and Paul.
74. She transfers the house to the trustees of a settlement. She claims gifts relief. If the settlement is a settlor-interested settlement, the new legislation preventing gifts relief on disposals to settlor-interested settlements would prevent her from claiming gifts relief. But the settlement is drawn up so that Jill does not have and may not acquire such an interest. The beneficiaries are Sandra and Paul. So Jill claims gifts relief and the gain is held over.
75. The terms of the settlement permit the trustees to allow certain persons to occupy the house. The trustees allow Paul to do so, and he occupies the house as his only residence.
76. After a few months, Paul vacates the house and the trustees sell it within a further few months for a sum (net of expenses) of £270,000. A chargeable gain of £170,000 (most of which is effectively the held-over gain) arises to them. However, this gain is not chargeable to CGT because of the provisions described at paragraph 61 above that allow

trustees to benefit from private residence relief. The trustees can then distribute the sale proceeds to Sandra and Paul.

77. The full value of the house has thus been transferred from Jill to Sandra and Paul without any capital gains tax being paid.
78. The provisions introduced by Clause 111 and Schedule 22 counter schemes of this nature. Where house is transferred, either the transferor can benefit from gifts relief under section 260 *or* the recipient can benefit from private residence relief on a subsequent sale of the house. It will no longer be possible for both reliefs to apply.
79. So in Example 5 above, if Jill claimed gifts relief under section 260, the trustees' gain of £170,000 on the sale of the house would not be covered by gifts relief, and they would be liable to capital gains tax on that gain (as reduced by any taper relief due to them). Alternatively, if Jill did not claim gifts relief on the transfer of the house to the trustees, she would be chargeable to capital gains tax on her gain of £150,000 (as reduced by any taper relief). The trustees' gain on the sale of the house would be reduced to £20,000, which could be covered by private residence relief.
80. Because of the time limits for making claims, it is possible that the recipient of the transfer has sold the house and accounted for the gain before the claim for gifts relief is made. Suppose in Example 5 above that Jill did not make a claim for gifts relief before the trustees sold the house. As there had at that time been no claim for gifts relief, there would have been no held-over gain to affect the computation of the trustees gain, which would be £20,000 (proceeds £270,000 less acquisition value £250,000). They would be entitled to claim private residence relief and therefore would not be chargeable on that gain. But if Jill then made a claim for gifts relief within the statutory time limit, her claim would be valid and she would be entitled to the relief.
81. In that situation, the new legislation provides that the trustees' gain should be recomputed. Because of the claim to gifts relief, the trustees now have a gain of £170,000 (effectively including Jill's held-over gain of £150,000), and, because Jill had claimed hold-over relief, they would not be entitled to private residence relief. So they would be assessed on a gain of £170,000 (as reduced by any taper relief due to them).

Transitional rule

82. The new provisions apply where there is a disposal of a private residence on or after 10th December 2003. However, where all the claims for gifts relief under section 260 that affect the computation of the gain on that disposal relate to transfers made before 10th December 2003, the bar on private residence relief applies only to that part of the gain referable (on a time basis) to the period from 10th December 2003 to the date of disposal. An example of the operation of this transitional rule is given below.

Example 6

83. Geoffrey has a house that he has never occupied as a residence. On 31st January 2003 it was worth £300,000, and on a disposal for that sum he would have realised a gain (before any taper relief) of £200,000 for the purposes of capital gains tax.
84. On 31st January 2003 Geoffrey transferred the house to the trustees of a settlement that is not a settlor-interested settlement. He claimed gifts relief and the gain of £200,000 was held over.
85. The trustees allow Helen, Geoffrey's daughter, to occupy the house, under the terms of the settlement, as her only residence from 31st January 2003 to 31st August 2004. On 30th September 2004 they sell the house for £350,000 (net of incidental costs).
86. The trustees have a gain on the sale of £250,000 (sale proceeds £350,000 less allowable acquisition costs, net of held-over gain, of £100,000). Because their allowable expenditure was reduced as a result of Geoffrey's claim to gifts relief, they cannot cover the whole of the gain by private residence relief in respect of Helen's occupation of the house throughout their period of ownership.
87. But because the gifts relief related to a transfer before 10th December 2003, the transitional rule applies. Gifts relief is available to the trustees on the gain relating to the period from 31st January 2003 to 9th December 2003 (313 days).
88. Their total period of ownership was 609 days. So they are entitled to private residence relief of £128,490 ($£250,000 \times 313/609$). They remain chargeable on a gain of £121,510 (as reduced by any taper relief).
89. It should be noted that private residence relief is not available in respect of the 296 days from 10th December 2003 to 30th September 2004, even though that is part of the final three years of their ownership of the house. The transitional rule specifically prevents any period on or after 10th December 2003 from qualifying for relief as part of the final three years of ownership.

Legislation of Extra-Statutory Concession D5 (ESC D5)

90. ESC D5 was introduced in 1966 and extended private residence relief to disposals by personal representatives in certain circumstances. It addressed the sort of situation where a house-owner died and his widow and perhaps some children occupied the house. If the personal representatives sold the house, perhaps because funds were needed to pay debts of the estate or IHT, but the relatives occupying the house were entitled to substantially all the balance of the proceeds after those payments, the personal representatives would have been liable to capital gains tax in respect of any gain arising between the date of death and the sale of the house.

91. In such a case the ESC allowed the personal representatives to benefit from private residence relief in a manner analogous to the relief for trustees under section 225 (see paragraph 61 above).
92. The ESC was not wholly in step with sections 222 to 225. It referred only to the disposal by personal representatives of a house, not to a part of a house or grounds, or to the disposal of an interest in the house or grounds. And it was necessary for the Revenue to publish separately its view that “substantially the whole” of the proceeds meant at least 75%. In giving statutory force to the ESC, the opportunity has been taken to define the percentage entitlement to the proceeds required for the relief to be available, and to produce a provision that is consistent with the approach of sections 222 to 225, by including:
 - parts of a dwelling-house, grounds within the “permitted area”, and
 - disposals of interests in all or part of a house or its grounds.
93. So in a case of the type described at paragraph 90 above, if the people who occupied the house immediately before and after the death are together entitled to at least 75% of the net proceeds of disposal, the personal representatives will be able to claim that the chargeable gain on the disposal shall be reduced or eliminated by private residence relief. The amount of private residence relief will be determined by applying the rules in sections 222 to 224, and will depend upon the facts of each individual case.

EXPLANATORY NOTE

CLAUSE 113: AUTHORISED UNIT TRUSTS: TREATMENT OF UMBRELLA SCHEMES

SUMMARY

1. This clause is essentially clarificatory, amending the provisions of the Taxation of Chargeable Gains Act 1992 (TCGA) relating to authorised unit trusts (AUTs) to bring its treatment of “umbrella schemes” strictly into line with the Inland Revenue’s established interpretation of the current rules, and with the closely corresponding treatment of such schemes which applies for certain purposes of the Income and Corporation Taxes Act 1988 (ICTA). The clause makes no substantive changes to the effects of the TCGA provisions, and does not make any amendments to the rules for unit trust schemes which are not AUTs. The amendments take effect for chargeable periods beginning on or after 1st April 2004.
2. The TCGA treats a unit trust scheme as though it were a company and the units held by investors as though they were shares in that company. An “umbrella scheme” is an AUT whose investments are split into a number of separate sub-funds, usually having different investment strategies. The holders of units in the scheme have rights over individual sub-funds, and are entitled to switch their entitlements between different sub-funds.
3. The clause makes explicit provision for each sub-fund of an umbrella scheme to be treated for the purposes of the TCGA as though it were an AUT, and for the scheme itself not to be a unit trust scheme for such purposes. This accords with the ICTA treatment and with the Inland Revenue’s interpretation (which was published in a Tax Bulletin article in 1997) of the meaning of “authorised unit trust” which applies for TCGA purposes.

DETAILS OF THE CLAUSE

4. Subsection (1) introduces amendments to the TCGA, and subsection (5) provides that those amendments will apply for any year of assessment or accounting period commencing on or after 1 April 2004.

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5. Subsection (2) amends subsection (2) of section 99 of the TCGA, which provides definitions that apply for the purposes of that Act. It adds a definition of “unit holder”, and amends the definition of “authorised unit trust” so that it no longer cross-refers to the ICTA definition. It also makes the definitions in section 99(2) subject to new section 99A (see paragraphs 7 to 9 below).
6. Subsection (3) introduces section 99A into the TCGA.

Section 99A: Authorised unit trusts: treatment of umbrella schemes

7. Subsection (1) provides the definition of an “umbrella scheme”, and of “a part of an umbrella scheme”. An umbrella scheme is an AUT which:
 - provides arrangements for the contributions of participants, and the profits or income of the scheme, to be streamed into separate pools, and
 - allows participants to switch their rights in the scheme between pools.
8. The effect of subsections (2) and (3) is that the TCGA provisions will apply to each separate part (referred to in this note as a “sub-fund”) of an umbrella scheme as though it was a separate AUT, and the persons having rights in any sub-fund will be treated for such purposes as unit holders in that AUT. The umbrella scheme as a whole is to be regarded as not being an AUT or other collective investment scheme.
9. Subsection (4) secures that the treatment provided by subsections (2) and (3) does not prevent certain provisions of the TCGA (including the exemption for an AUT’s chargeable gains) applying as intended in relation to AUTs which are umbrella schemes.
10. Subsection (4) of the clause makes a consequential amendment to the definition of “collective investment scheme” and updates the list of definitions in section 288 of the TCGA.

BACKGROUND NOTE

11. For TCGA purposes, an AUT is a unit trust scheme in respect of which an order under section 243 of the Financial Services and Markets Act 2000 is in force. AUTs are regulated by the Financial Services Authority. The TCGA operates as though unit trust schemes are companies, and the unit holders are the shareholders in those companies.

EXPLANATORY NOTE

CLAUSE 114: INDIVIDUALS BENEFITED BY FILM RELIEF

SUMMARY

1. This clause, together with clauses 115 to 118 inclusive, is an anti-avoidance measure which applies to individuals who have carried on a trade, either alone or in partnership, which has computed its taxable profits or losses in accordance with the film tax reliefs at sections 40A to 40C and 41 to 43 Finance (No 2) Act 1992, and section 48 Finance (No 2) Act 1997. This measure tackles schemes, used by individuals who have benefited from these reliefs, which seek to convert a tax deferral into a permanent tax gain. The new rules will apply with effect from 10th December 2003. This particular clause sets out the necessary conditions for the measure to take effect, and raises a charge to income tax when those conditions are met.
2. The measure will apply to any individual who has claimed loss relief under sections 380 or 381 Income and Corporation Taxes Acts 1988 (ICTA), or section 72 Finance Act 1991 in respect of losses arising from such a trade. It raises a charge to income tax where there is a disposal, after 10 December 2003, of rights of an individual to profits from the trade, and where that disposal is accompanied by the individual either receiving non-taxable consideration, or the amount of his losses claimed becoming greater than his net contribution to the trade. The amount of the charge is set to remove the element of unfair tax advantage.

DETAILS OF THE CLAUSE

3. Subsection (1) sets out that the section applies to an individual who has claimed loss relief under sections 380 or 381 ICTA in respect of losses arising from a trade which made use of the film tax reliefs. The section only applies if there is a disposal after the 10 December 2003 of a right of the individual to profits arising from the trade, and when an "exit event" (defined in subsection (2)) occurs.
4. Subsection (2) defines an "exit event". The objective is to tackle the type of circumstance which seeks to convert a tax deferral into a permanent gain. An "exit event" can involve one of three sets of circumstances - where the individual receives non-taxable consideration

for a disposal of a right to income arising from the trade; or where the losses claimed from the trade become greater than the amount which the individual has contributed personally to the trade; or where there is an increase in the amount by which those losses exceed the contribution. An "exit event" can only involve an event of this type which occurs on or after 10th December 2003.

5. Subsection (3) defines when a chargeable event occurs. Three conditions are necessary. These are that the individual has made a claim to sideways loss relief arising from the trade, that there has been a disposal of rights to profits from the trade, and that an "exit event" has occurred. This subsection makes it clear that it does not matter in which order these conditions are met, but that the charge will arise when the last of these conditions is met.
6. Subsection (4) raises a charge to tax under Case VI of Schedule D, when all the conditions in sub-section (3) are met, in an amount defined by sub-section (5).
7. Subsection (5) defines the amount of the charge raised under subsection (4). This is the sum of any consideration received which is not otherwise chargeable to income tax and the amount by which sideways loss relief has been claimed that is in excess of the individual's capital contribution to the trade.
8. Subsection (6) makes it clear that, for the purposes of this charge it is immaterial when the claim to sideways loss relief was made. The claim can be before, on or after 10th December 2003.
9. Subsection (7) ensures that a charge can still arise if the trade is no longer being carried on either by the individual, or by anyone else, when the events leading to the charge occur.

BACKGROUND NOTE

10. Under the general scheme for computing business profits, expenditure on the production or purchase of a master version of a film would normally be classified as capital, not revenue, expenditure. As such, the expenditure would normally qualify for capital allowances written off at 25% per year on a reducing balance basis. The film tax legislation treats the expenditure as revenue expenditure, and sets rules for how this expenditure is to be deducted for tax purposes. For qualifying films, special reliefs allow the write-off of expenditure to be greatly accelerated.

11. In order to be a qualifying film, the film must have been certified as such by the Secretary of State for Culture Media and Sport under Schedule 1 to the Films Act 1985.
12. Expenditure which meets the necessary criteria may be deducted in equal amounts over three years under section 42 Finance (No 2) Act 1992, or at a slower rate if the claimant elects.
13. Where the expenditure meets the criteria, was incurred after 1st July 1997, and is expenditure on a qualifying film costing no more than £15m in total, the full amount of the expenditure may be deducted in the year in which it was incurred.
14. The accelerated deduction for expenditure, usually before any income of significance has arisen from the film, commonly gives rise to losses in the trade which the individuals can set off against their other income under sections 380 or 381 Income and Corporation Taxes Acts 1988, or against their chargeable gains under section 72 Finance Act 1991.
15. The film tax reliefs operate on a tax deferral basis. An individual is able to claim loss relief against his general income in the early years of a trade. As profits subsequently arise from the trade the individual pays tax on these profits. The overall effect is reduced tax bills in the early years of the trade, but with more tax in the later years. This produces a tax deferral, which is an incentive for individuals to invest in the British Film Industry. Avoidance schemes have been devised which seek to avoid the tax charge on income in later years, producing a permanent tax gain. This new measure tackles such schemes.

EXPLANATORY NOTE

CLAUSE 115: “DISPOSAL OF A RIGHT OF THE INDIVIDUAL TO PROFITS ARISING FROM THE TRADE”

SUMMARY

1. This clause is part of an anti-avoidance measure, introduced by clauses 114 to 118 inclusive, which tackles schemes used by individuals who have benefited from film tax relief from turning a tax deferral into a permanent tax advantage. This particular clause describes what is meant by “disposal of a right of the individual to profits arising from the trade” for the purposes of section 114.

DETAILS OF THE CLAUSE

2. Subsection (1) expands on the ordinary meaning of the word disposal by giving specific examples of what is meant by a disposal of a right of the individual to profits arising from the trade. These examples are not exhaustive.
3. Subsection (2) makes it clear that a disposal can be part of a larger disposal (such as a disposal of the whole business).
4. Subsection (3) requires that where there is an agreement which changes a person’s share of profits and losses from a trade then, for the purposes of subsection (1), the disposal of rights to income will be deemed to occur at the beginning of the period when the share of profits or losses changes.

EXPLANATORY NOTE

CLAUSE 116: “THE LOSSES CLAIMED” AND “THE INDIVIDUAL’S CAPITAL CONTRIBUTION TO THE TRADE”

SUMMARY

1. This clause is part of an anti-avoidance measure, introduced by clauses 114 to 118 inclusive, which tackles schemes used by individuals who have benefited from film tax relief from turning a tax deferral into a permanent tax advantage. This particular clause defines what is meant by “the losses claimed” and “the individual’s capital contribution to the trade” for the purposes of section 114.

DETAILS OF THE CLAUSE

2. Subsection (1) defines what is meant by "the losses claimed" for the purposes of section 114. The losses are "film-related losses" (defined in subsection (5)) for any year of assessment
3. Subsection (2) defines what is meant by an individual’s capital contribution to the trade. It includes all amounts contributed by the individual, but reduced by any amount which the individual receives back from the business, or which is reimbursed to him by somebody else.
4. Subsection (3) makes it clear that, where the trade is carried on by an individual through a Limited Liability Partnership, the reference to contribution to the trade should be read as the contribution to the Limited Liability Partnership.
5. Subsection (4) makes it clear that reimbursement or receiving back in subsection (2) includes situations where a liability of the individual is either assumed by someone else or met by someone else.
6. Subsection (5) makes it clear that subsection (4) should not be read so as to limit the meaning of reimbursement or receiving back in subsection (2).
7. Subsection (6) prevents any amount which is chargeable to income tax as profits from the trade from being treated as a withdrawal of a person’s

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capital contribution to the trade in subsections 2(a) and 2(b). This prevents a double charge arising where the tax treatment of a sum received can differ from the accountancy treatment. For example, lease rentals received under a finance lease are treated entirely as income for tax purposes, but may be treated as part income and part capital under Standard Accountancy Practice.

EXPLANATORY NOTE

CLAUSE 117: COMPUTING THE CHARGEABLE AMOUNT

SUMMARY

1. This clause is part of an anti-avoidance measure, introduced by clauses 114 to 118 inclusive, which tackles schemes used by individuals who have benefited from film tax relief from turning a tax deferral into a permanent tax advantage. This particular clause sets additional rules for computing the chargeable amount in section 114. It prevents any double charge from arising under that section, and also ensures that no costs paid out or borne by an individual, in order to arrange an exit, can be deducted in computing the amount of the charge.

DETAILS OF THE CLAUSE

2. Subsection (1) ensures that any amount which is treated as consideration brought into charge under section 114 cannot also be treated as reimbursement or paying back of an individual's capital contribution to the trade under that section.
3. Subsection (2) prevents double counting of any amounts which have already been brought into charge under section 114 if there is a subsequent chargeable event under that section.
4. Subsection (3) requires that the individual is charged to tax on the gross consideration that he or she receives for disposing of his or her right to income from the trade, without any deduction (this applies only where the consideration would be non-taxable without section 114). This prevents avoidance of any of the charge to tax where the individual agrees to allow part of the consideration to be paid to any other person, or retained by the payer; e.g., as a fee for arranging the exit.

EXPLANATORY NOTE

CLAUSE 118: “FILM-RELATED LOSSES” AND “NON-TAXABLE CONSIDERATION”

SUMMARY

1. This clause is part of an anti-avoidance measure, introduced by clauses 114 to 118 inclusive, which tackles schemes used by individuals who have benefited from film tax relief from turning a tax deferral into a permanent tax advantage. This particular clause defines the meaning of “film related losses” in section 114 and 116 and “non-taxable consideration” in section 114.

DETAILS OF THE CLAUSE

2. Subsection (1) defines the meaning of “film related loss” in section 114 and section 116.
3. Subsection (2) defines what is meant by non-taxable consideration in section 114.