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# TAXATION

## FINANCE ACT 2016

ALAN MELVILLE

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# Taxation

## Finance Act 2016

Twenty-second edition

Alan Melville
FCA, BSc, Cert. Ed.

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# Preface

The main aim of this book is to describe the UK taxation system in sufficient depth and with sufficient clarity to meet the needs of those undertaking a first course of study in taxation. The book has not been written with any specific syllabus in mind but should be useful to anyone who is studying taxation as part of a university or college course in accounting, finance or business studies. The book should also be of value to students who are preparing for the taxation examinations of the professional accounting bodies. A list of relevant examinations is given on the back cover of the book.

Every effort has been made to explain the tax system as clearly as possible. There are numerous worked examples and each chapter (except Chapter 1) concludes with a set of exercises which thoroughly test the reader's grasp of the new topics introduced in that chapter. The book also contains four sets of review questions, drawn mainly from the past examination papers of the professional accounting bodies. The solutions to most of these exercises and questions are located at the back of the book but solutions to those exercises and questions marked with an asterisk (*) are provided in a separate Instructor's Manual.

This twenty-second edition incorporates the provisions of Finance Act 2016, which is based upon the March 2016 Budget proposals. However, it is important to point out that the passage of this year's Finance Bill through Parliament has been delayed (because of the EU referendum) and, in consequence, the Finance Act may not receive Royal Assent until October. Although it is unlikely that there will be major amendments to the Finance Bill before it is enacted, the situation is fluid and readers are advised to monitor the progress of the Bill on website http://services.parliament.uk/bills/2016-17/finance.html.

A further complication is the prospect of another Budget in the Autumn. A summary of this Budget (should it occur) together with any significant amendments to the current Finance Bill will appear in the "updates" section of the website which accompanies this book. The website address is www.pearsoned.co.uk/melville.

*Alan Melville*
*June 2016*

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I would like to thank the following accounting bodies for granting me permission to use their past examination questions:

- Association of Chartered Certified Accountants (ACCA)
- Chartered Institute of Public Finance and Accountancy (CIPFA)
- Association of Accounting Technicians (AAT).

I must emphasise that the answers provided to these questions are entirely my own and are not the responsibility of the accounting body concerned. I should also point out that the questions which are printed in this textbook have been amended in some cases so as to reflect changes in taxation law which have occurred since those questions were originally published by the accounting body concerned.

I would also like to thank the Office for National Statistics for granting me permission to reproduce the table of Retail Price Indices given in Chapter 24.

Please note that, unless material is specifically cited with a source, any company names used within this text have been created by me and are intended to be fictitious.

*Alan Melville*
*June 2016*

# Summary of Tax Data

## Income Tax

| | *2016-17* | *2015-16* |
|---|---|---|
| **TAX RATES AND BANDS** | | |
| Basic rate | 20% | 20% |
| Higher rate | 40% | 40% |
| Additional rate | 45% | 45% |
| Basic rate limit | £32,000 | £31,785 |
| Higher rate limit | £150,000 | £150,000 |
| Starting rate for savings | 0% | 0% |
| Starting rate limit for savings | £5,000 | £5,000 |
| Personal savings allowance (maximum) | £1,000 | - |
| Dividend allowance | £5,000† | - |

† *Rates of tax on dividends in 2016-17 are 7.5%, 32.5% and 38.1%*

| **ALLOWANCES** | £ | £ |
|---|---|---|
| Personal allowance | 11,000 | 10,600† |
| Marriage allowance | 1,100 | 1,060 |
| Blind person's allowance | 2,290 | 2,290 |
| Married couple's allowance: | | |
| Born before 6 April 1935 | 8,355 | 8,355 |
| Minimum amount | 3,220 | 3,220 |
| Income limit for basic personal allowance | 100,000 | 100,000 |
| Income limit for married couple's allowance | 27,700 | 27,700 |

† *The personal allowance was £10,660 in 2015-16 for those born before 6 April 1938*

| **CAR AND FUEL BENEFIT** | | |
|---|---|---|
| Not exceeding 50g/km | 7% | 5% |
| 51g/km to 75g/km | 11% | 9% |
| 76g/km to 94g/km | 15% | 13% |
| 95g/km | 16% | 14% |
| Each additional 5g/km | +1% | +1% |
| Maximum charge | 37% | 37% |
| Amount used in car fuel benefit calculation | £22,200 | £22,100 |

| **PENSION SCHEMES** | £ | £ |
|---|---|---|
| Annual allowance | 40,000 | 40,000 |
| Lifetime allowance | 1,000,000 | 1,250,000 |

## Capital Allowances

| | |
|---|---|
| Writing Down Allowance (WDA) | |
| Main pool of plant and machinery | 18% |
| Special rate pool of plant and machinery | 8% |
| Annual Investment Allowance (AIA) | |
| AIA annual limit from 1 January 2016† | £200,000 |
| AIA rate | 100% |
| First Year Allowance (FYA) on qualifying plant and machinery | |
| Very low emission cars | 100% |
| Gas refuelling equipment | 100% |
| Energy saving or water efficient technology | 100% |
| Zero-emission goods vehicles | 100% |

† *The AIA annual limit was £500,000 between 6 April 2014 (1 April 2014 for companies) and 31 December 2015*

## National Insurance Contributions

| | *2016-17* | *2015-16* |
|---|---|---|
| **CLASS 1** | | |
| Lower earnings limit (weekly) | £112 | £112 |
| Primary threshold (weekly) | £155 | £155 |
| Upper earnings limit (weekly) | £827 | £815 |
| Secondary threshold (weekly) | £156 | £156 |
| Upper secondary threshold (weekly) | £827 | £815 |
| Employee contributions | | |
| Rate on earnings between primary threshold and UEL | 12% | 12% |
| Rate on earnings beyond UEL | 2% | 2% |
| Employer contributions | | |
| Rate on earnings beyond secondary threshold | 13.8% | 13.8% |
| **CLASS 1A** | | |
| Rate | 13.8% | 13.8% |
| **CLASS 2** | | |
| Weekly contribution | £2.80 | £2.80 |
| Small profits threshold | £5,965 | £5,965 |
| **CLASS 3** | | |
| Weekly contribution | £14.10 | £14.10 |
| **CLASS 4** | | |
| Lower profits limit | £8,060 | £8,060 |
| Upper profits limit | £43,000 | £42,385 |
| Rate on profits between lower and upper limit | 9% | 9% |
| Rate on profits beyond upper limit | 2% | 2% |

## Capital Gains Tax

| | *2016-17* | *2015-16* |
|---|---|---|
| Standard rate† | 10% | 18% |
| Higher rate† | 20% | 28% |
| Entrepreneurs' relief rate | 10% | 10% |
| Entrepreneurs' relief lifetime limit | £10,000,000 | £10,000,000 |
| Annual exempt amount | £11,100 | £11,100 |

† *Taxable gains on the disposal of residential property in 2016-17 are taxed at 18% and 28%*

## Corporation Tax

| *Financial Year* | *FY2016* | *FY2015* | *FY2014* | *FY2013* |
|---|---|---|---|---|
| Main rate | 20% | 20% | 21% | 23% |
| Small profits rate | - | - | 20% | 20% |
| Lower limit | - | - | £300,000 | £300,000 |
| Upper limit | - | - | £1,500,000 | £1,500,000 |
| Marginal relief fraction | - | - | 1/400 | 3/400 |

*Note*:
The main rate for FY2017 is 19%.

## Inheritance Tax

| *Date of transfer* | *0% Band* | *Rate on life-time transfers* | *Rate on death* | *Lower rate* |
|---|---|---|---|---|
| 6 April 2006 to 5 April 2007 | 0 - £285,000 | 20% | 40% | - |
| 6 April 2007 to 5 April 2008 | 0 - £300,000 | 20% | 40% | - |
| 6 April 2008 to 5 April 2009 | 0 - £312,000 | 20% | 40% | - |
| 6 April 2009 to 5 April 2010 | 0 - £325,000 | 20% | 40% | - |
| 6 April 2010 to 5 April 2011 | 0 - £325,000 | 20% | 40% | - |
| 6 April 2011 to 5 April 2012 | 0 - £325,000 | 20% | 40% | - |
| 6 April 2012 to 5 April 2017 | 0 - £325,000 | 20% | 40% | 36% |

## Value Added Tax

| | | |
|---|---|---|
| Standard rate† | 20% | (from 4 January 2011) |
| Reduced rate | 5% | |
| Registration threshold | £83,000 | (from 1 April 2016) |
| Deregistration threshold | £81,000 | (from 1 April 2016) |

†*Standard rate 17.5% prior to 4 January 2011*

Part 1

# INCOME TAX AND NATIONAL INSURANCE

Chapter 1

# Introduction to the UK tax system

## Introduction

The purpose of this first chapter is to provide an overview of the UK tax system. The principal UK taxes are introduced and classified and the main sources of taxation law are explained. This chapter also deals with:

(a) the structure and functions of Her Majesty's Revenue and Customs (HMRC) which is the organisation responsible for the administration of the UK tax system

(b) the annual procedure which is used to determine the tax liability of an individual.

The chapter concludes by distinguishing between tax avoidance and tax evasion.

## UK taxes

The UK taxation system is composed of a number of different taxes, some of which are *direct* taxes and some of which are *indirect* taxes:

(a) Direct taxes are charged on income, profits or other gains and are either deducted at source or paid directly to the tax authorities. The main direct taxes which are payable by individuals are income tax, capital gains tax and inheritance tax. The main direct tax payable by companies is corporation tax. All of these taxes are administered by HM Revenue and Customs (HMRC), which was formed in April 2005 when the Inland Revenue and HM Customs and Excise were merged. National Insurance contributions, which can also be looked upon as a form of direct taxation, are administered by the National Insurance Contributions Office (NICO) of HMRC.

(b) Indirect taxes are taxes on spending. They are charged when a taxpayer buys an item and are paid to the vendor as part of the purchase price of the item. It is then the vendor's duty to pass the tax on to the tax authorities. Indirect taxes include value added tax (VAT), stamp duty, customs duties and the excise duties levied on alcohol, tobacco and petrol. The only indirect tax considered in this book is VAT, which is also administered by HM Revenue and Customs.

## Sources of tax law

There is no single source of UK tax law. The basic rules are laid down in Acts of Parliament but it is left to the courts to interpret these Acts and to provide much of the detail of the tax system. In addition, HMRC issues a variety of statements, notices and leaflets which explain how the law is implemented in practice. These statements have no legal backing but they explain the tax authorities' interpretation of the law and will be adhered to unless successfully challenged in the courts.

### *Statute law*

The basic rules of the UK tax system are embodied in a number of tax *statutes* or Acts of Parliament. The main statutes currently in force for each tax are as follows:

| *Tax* | *Statute* | *Abbreviation* |
|---|---|---|
| Income tax | Capital Allowances Act 2001 | CAA 2001 |
| | Income Tax (Earnings and Pensions) Act 2003 | ITEPA 2003 |
| | Income Tax (Trading and Other Income) Act 2005 | ITTOIA 2005 |
| | Income Tax Act 2007 | ITA 2007 |
| National Insurance | Social Security Contributions and Benefits Act 1992 | SSCBA 1992 |
| Capital gains tax | Taxation of Chargeable Gains Act 1992 | TCGA 1992 |
| Inheritance tax | Inheritance Tax Act 1984 | IHTA 1984 |
| Corporation tax | Taxation of Chargeable Gains Act 1992 | TCGA 1992 |
| | Capital Allowances Act 2001 | CAA 2001 |
| | Corporation Tax Act 2009 | CTA 2009 |
| | Corporation Tax Act 2010 | CTA 2010 |
| Overseas aspects of tax | Taxation (International and Other Provisions) Act 2010 | TIOPA 2010 |
| Value added tax | Value Added Tax Act 1994 | VATA 1994 |
| Administration of } | Taxes Management Act 1970 | TMA 1970 |
| the tax system } | Customs and Excise Management Act 1979 | CEMA 1979 |

These statutes are amended each year by the annual Finance Act, which is based upon the Budget proposals put forward by the Chancellor of the Exchequer. Some of the tax statutes provide for the making of detailed regulations by *statutory instrument.* A statutory instrument (SI) is a document which is laid before Parliament and then automatically becomes law within a stated period unless any objections are raised to it.

### *European Union law*

Membership of the European Union (EU) involves adherence to EU law[†]. Member states are not required to adopt a common system of taxation but some parts of the UK system are nonetheless influenced by EU requirements. At present, the main impact is on VAT, where the prevailing legislation takes the form of EU Directives. These are binding on the UK and dictate the results which the internal legislation of the UK must bring about.

Additionally, EU "State aid" approval must sometimes be sought for amendments to UK tax-advantaged schemes such as the Enterprise Investment Scheme (see Chapter 6) or the R&D tax credits scheme (see Chapter 23). Furthermore, decisions made in the European courts may trigger changes to UK tax law, as occurred in relation to the tax treatment of the losses of overseas subsidiary companies (see Chapter 32).

† *In view of the Referendum result on 23 June 2016, it seems safe to say that EU influence over the UK tax system will eventually cease to exist.*

### Case law

Over the years, taxpayers and the tax authorities have frequently disagreed over the interpretation of the tax Acts. As a result, many thousands of tax cases have been brought before the courts. The decisions made by judges in these cases form an important part of the tax law of the UK and some of the more significant cases are referred to in this book.

### Statements made by the tax authorities

The main statements and other documents produced by HM Revenue and Customs as a guide to the law on taxation are as follows:

(a) **Statements of Practice**. A Statement of Practice (SP) sets out the HMRC interpretation of tax legislation and clarifies the way in which the law will be applied in practice. For example, SP 4/97 (the fourth SP issued in 1997) deals with the taxation treatment of commissions, cashbacks and discounts.

(b) **Extra-Statutory Concessions**. An Extra-Statutory Concession (ESC) consists of a relaxation which gives taxpayers a reduction in liability to which they are not entitled under the strict letter of the law. In general, concessions are made so as to resolve anomalies or relieve hardship. For example, ESC A91 deals with the taxation treatment of living accommodation provided by reason of employment.

    A process of giving statutory effect to certain ESCs is currently underway. This is generally being done by means of statutory instruments.

(c) **Announcements**. Announcements (and other notices and documents) are issued by HMRC throughout the year on a wide variety of tax-related subjects. Of especial interest are the documents which are issued on Budget day and which provide a detailed explanation of the Budget proposals.

(d) **Internal Guidance Manuals**. HMRC produces a comprehensive set of internal tax manuals for the guidance of its own officers. These manuals may be accessed on the HMRC website (see below).

(e) **Explanatory publications**. Leaflets, factsheets and booklets are aimed at the general public and explain the tax system in non-technical language. These can usually be accessed online, though some are still available in printed form.

Most of the above information is now available on the HMRC website, the address of which is www.gov.uk/government/organisations/hm-revenue-customs.

## The tax year

The changes to the tax system that are proposed in the annual Budget speech are usually intended to take effect as from the start of the next *tax year*. Tax years for individuals and for companies are identified as follows:

(a) For individuals, a tax year runs from 6 April to the following 5 April. For instance, tax year 2015-16 began on 6 April 2015 and ended on 5 April 2016. Tax years are also referred to as *fiscal years* or *years of assessment*.

(b) For companies, a corporation tax *financial year* runs from 1 April to the following 31 March and is identified by the year in which it begins. For instance, the financial year referred to as FY2015 began on 1 April 2015 and ended on 31 March 2016.

This book takes into account the provisions of Finance Act 2016 (which is based on the March 2016 Budget) and describes the UK taxation system for fiscal year 2016-17 and corporation tax financial year FY2016.

## Structure of HM Revenue and Customs

Her Majesty's Revenue and Customs (HMRC) consists of a large body of civil servants headed by the *Commissioners for Revenue and Customs*. The Commissioners are appointed by Her Majesty The Queen in accordance with recommendations made by the *Treasury*. This Government department has overall responsibility for the public finances of the UK and is managed by the *Chancellor of the Exchequer*. The main duties of the Commissioners for Revenue and Customs are as follows:

(a) to implement the law relating to direct and indirect taxation
(b) to provide advice to the Chancellor of the Exchequer on taxation matters
(c) to administer the divisions and offices into which HMRC is organised.

The routine work of HMRC is carried out by officials known as *Officers of Revenue and Customs*. With regard to direct taxation, the main function of these officials is generally to check a taxpayer's own self-assessment of the tax liability (see below) and then to ensure that the correct amount of tax is paid. The functions of HMRC with regard to indirect taxation (and VAT in particular) are explained later in this book (see Chapter 30).

HMRC has specialist offices which deal with such matters as pension schemes, charities, trusts and so forth but most of the day-to-day work relating to direct taxation takes place in local area offices. These local offices are responsible for routine assessment and collection and for ensuring that taxpayers comply with tax regulations. At present, HMRC has 170 local offices but these are to be consolidated into 13 large regional centres by 2021.

Support for taxpayers who need help with their tax affairs is provided by means of specialist expert advice either given over the telephone or delivered by mobile advisors at convenient locations in the community or at a taxpayer's home or workplace.

## Administration of the tax system

The remainder of this chapter describes the administration system which is used to assess an individual's liability to income tax and capital gains tax in each tax year. This system is known as "Self Assessment". Under this system, the taxpayer (*not* HMRC) is primarily responsible for ensuring that:

(a) the tax liability for each tax year is properly assessed, and

(b) the correct amount of tax is paid on the due date or dates.

Later chapters of this book explain the administration systems which are used for the purposes of corporation tax, inheritance tax and VAT.

## Self Assessment

If an individual's tax liability for a tax year cannot be collected entirely by deduction at source (see Chapter 2) or via the PAYE system (see Chapter 7), then the liability must be formally assessed. The starting point in the assessment process is usually the completion of a *self assessment tax return*. The annual procedure is as follows:

(a) Tax returns†‡ are normally issued in April each year to those taxpayers who are likely to need them. Each tax return includes a formal notice requiring a return to be made and delivered to HMRC. Paper tax returns are not sent to taxpayers who submitted the previous year's return electronically (see below) but such taxpayers are still sent a notice requiring a return to be made and can request a paper tax return if they so wish. Returns can also be downloaded and printed from the HMRC website.

(b) The main paper tax return consists of a basic eight-page form. There are also several sets of supplementary pages, each dealing with a different type of income or gains (e.g. income from self-employment). Taxpayers are required to complete only those supplementary pages that are relevant to their circumstances.

(c) A short tax return (STR) is available for taxpayers with straightforward tax affairs.

(d) Rather than completing a paper tax return, taxpayers and their agents can file tax returns electronically by means of the internet and are encouraged to do so. Over 89% of the returns for tax year 2014-15 were in fact filed electronically.

† *As from tax year 2016-17, HMRC is empowered to make an assessment of an individual's income tax or capital gains tax liability without that person being first required to complete a tax return. This "simple assessment" procedure may be used where HMRC already has sufficient information about the individual to make the assessment.*

‡ *By 2020, the Government intends to replace tax returns with online "digital tax accounts" which will be pre-populated with information already held by HMRC (e.g. employment and pensions income). Most businesses will be required to use accounting software to keep records of their income and expenditure and to update their digital tax accounts at least quarterly.*

(e) The information requested in a tax return relates to the tax year just ended. For example, the tax returns issued in April 2016 required taxpayers to declare their income and gains for tax year 2015-16.

(f) A tax return must be completed in full. It is not permissible to omit figures or to make entries such as "see accounts" or "as submitted by employer". Unless asked to submit accounts or other supporting documentation with the return, a taxpayer is under no obligation to do so. However, it is necessary to retain all supporting documentation in case HMRC enquires into the accuracy of a return.

(g) If a main tax return is submitted on paper, the taxpayer has the option of calculating his or her own tax liability (using "tax calculation summary" pages) and submitting this calculation to HMRC as part of the return. HMRC will calculate the tax liability for taxpayers who do not take up this option or for those who submit the short tax return (which does not include a self-calculation facility). However, if a paper return is submitted late (see below), HMRC does not guarantee to advise the taxpayer of the liability in time for the correct amount of tax to be paid on the correct date.

If a tax return is filed electronically, the tax liability is calculated by computer software. In all cases, the resulting assessment is referred to as a "self-assessment".

(h) Self assessment tax returns must normally be filed (i.e. submitted to HMRC) on or before the following dates:

- for paper returns, 31 October following the end of the tax year
- for returns filed electronically, 31 January following the end of the tax year.

However, if the return notice is issued after 31 July following the end of the tax year (but not after 31 October) the taxpayer has three months from the date of the notice to submit a paper return. The deadline for electronic filing in such a case remains at 31 January. If the notice is issued after 31 October, the taxpayer has three months from the date of the notice to submit the return either on paper or electronically.

(i) Penalties are imposed if a return is filed late. Furthermore, the submission of a late return may mean that the tax liability for the year is not determined until after the due date of payment (see below). A taxpayer who pays tax late will incur interest and may also incur a late-payment penalty (see Chapter 15).

(j) The 31 January which follows the end of a tax year is known as the "filing date" for that year. For example, the filing date for tax year 2016-17 is normally 31 January 2018. However, if a return notice is issued after 31 October, the filing date becomes the date which falls three months after the issue date of the notice.

(k) HMRC is empowered to correct a tax return (so as to rectify obvious errors or omissions or anything else that is believed to be incorrect) within nine months of the date on which the return is filed. Similarly, the taxpayer has the right to amend his or her tax return within 12 months of the filing date for that return.

(l) A taxpayer who has paid an amount of tax but now believes that this tax should not have been paid (a situation that could be caused by an error in a tax return) may make a claim for recovery of the overpaid tax. Such a claim must be made within four years of the end of the tax year to which it relates. Depending upon the circumstances of the case, HMRC may or may not accept the claim.

(m) The tax due in relation to a self-assessment is normally payable as follows:
   (i) A first payment on account (POA) is due on 31 January in the tax year to which the self-assessment relates.
   (ii) A second POA is due on the following 31 July.
   (iii) A final balancing payment is due on the following 31 January.

   For example, the tax due in relation to a 2016-17 self-assessment would normally be payable on 31 January 2017 (first POA), 31 July 2017 (second POA) and 31 January 2018 (balancing payment). Further information regarding the payment of tax is given in Chapter 15 of this book.

(n) An employed taxpayer whose balancing payment does not exceed £3,000 may ask that this should be collected via the PAYE system (see Chapter 7). In such a case, taxpayers who file their returns electronically are advised to do so by 30 December so as to give HMRC sufficient time to make the necessary arrangements.

### Determinations

If an individual fails to submit a tax return by the required filing date for that return, an Officer of Revenue and Customs may make a determination of the tax due, calculated according to "the best of his information and belief". There is no right of appeal against a determination and the tax due cannot be postponed. A determination can be displaced only if the individual files the required return.

### Notification of chargeability to tax

An individual who has not received a notice to submit a tax return, but has taxable income (or gains) of which HMRC is not aware, must notify HMRC of his or her chargeability to tax within six months of the end of the tax year in which the income arises. However, notification of chargeability is *not* required if *all* of the following conditions are satisfied:

(a) the individual has no capital gains
(b) the individual is not a higher-rate taxpayer (see Chapter 2)
(c) all of the individual's income has been subject to deduction of income tax at source (see Chapter 2) or has been dealt with via the PAYE system (see Chapter 7)
(d) the individual is not liable to a high income child benefit charge (see Chapter 7).

An individual who fails to notify chargeability within the permitted six-month period will incur a penalty (see Chapter 15).

### *Enquiries*

HMRC is empowered to "enquire" into any tax return. The usual reason for opening an enquiry is that HMRC suspects that something is wrong with the information provided in the return. However, some enquiry cases are selected entirely at random and HMRC is under no obligation to justify the opening of an enquiry or to state whether or not the case has been chosen randomly. Note that:

(a) If a tax return is filed by the due date, an enquiry cannot usually begin more than 12 months after the date on which the return is filed. This means that the "enquiry window" for a return which is filed early closes correspondingly early.

(b) If a return is filed late or is amended after the date on which the return was due to be filed, the enquiry window is extended until the quarter day which follows the first anniversary of the date on which the return or amendment was filed. For this purpose, the quarter days are 31 January, 30 April, 31 July and 31 October.

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**EXAMPLE**

In April 2016, HMRC issues a notice requiring an individual to submit a tax return for the year 2015-16. The return is submitted electronically to HMRC on 8 December 2016.

(a) State the date by which any enquiry into the above return must begin.
(b) How would the situation differ if the return was submitted on 1 March 2017?

***Solution***

(a) The return is filed before the due date (31 January 2017). Any enquiry must begin within 12 months of the date that the return is filed (i.e. by 8 December 2017).
(b) The return is filed after the due date (31 January 2017). Any enquiry must begin by the quarter day which follows the first anniversary of the date that the return is filed (i.e. by 30 April 2018).

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### *Discovery assessments*

HMRC may raise a "discovery assessment" if it is discovered that full disclosure has not been made in a tax return and that tax has been lost as a result.

The time limit for making a discovery assessment is normally four years after the end of the tax year concerned. This increases to six years if the taxpayer has been negligent and 20 years if the taxpayer has been dishonest.

### Record keeping

Taxpayers are required to keep proper records so that they can make a correct tax return and (if necessary) substantiate the figures entered on the return. A taxpayer who is in business or who lets property must normally preserve these records for five years after the 31 January which follows the end of the tax year concerned. Otherwise, records must be preserved for 12 months after the 31 January which follows the end of the tax year. For example, records for tax year 2016-17 must normally be retained until 31 January 2023 by a taxpayer who is in business or who lets property and until 31 January 2019 otherwise.

## Appeals

Taxpayers have the right of appeal in relation to a number of HMRC decisions. For example, a taxpayer may appeal against a discovery assessment or against an HMRC amendment to a self-assessment. The main features of the appeals system are as follows:

(a) An appeal must be sent to HMRC in writing within 30 days† of the disputed decision.

(b) The taxpayer may also apply to postpone payment of all or part of any tax which is payable as a result of the decision, though interest will continue to accrue on the postponed amount until the appeal is settled. However, postponement is generally not available if the appeal relates to the use of a tax avoidance scheme covered by the DOTAS rules (see below) or in connection with arrangements which have been counteracted by HMRC under the GAAR (see below).

(c) On receiving an appeal, HMRC considers the taxpayer's reasons for disputing the decision. Most appeals are settled by discussion and agreement at this stage.

(d) If the taxpayer and HMRC are unable to agree, the taxpayer will be offered an internal review of the decision. A taxpayer who wishes to accept this offer must normally do so within 30 days. An internal review is carried out by an HMRC officer who has not previously been involved with the disputed decision and is usually completed within 45 days. The review officer then writes to the taxpayer to inform him or her of the review's conclusions.

(e) A taxpayer who rejects the offer of an internal review may appeal to a tribunal within 30 days of the date of the offer letter. Otherwise, an appeal to a tribunal may be made within 30 days of the date of the review conclusion letter.

(f) Most appeals are dealt with by the Tax Chamber of the First-tier Tribunal. However, more complex appeals may be heard by the Tax and Chancery Chamber of the Upper Tribunal. The Upper Tribunal also hears appeals against First-tier Tribunal decisions.

(g) If either HMRC or the person concerned is dissatisfied with a decision made by the Upper Tribunal, a dispute on a point of law may be referred to the Court of Appeal.

† *The time limit for an appeal against a "simple assessment" is 60 days.*

(h) The costs of bringing an appeal before the First-tier Tribunal are usually fairly modest. Parties bear their own costs and so a taxpayer who loses an appeal is not normally required to pay HMRC's costs (unless the taxpayer has acted wholly unreasonably). The costs of taking an appeal to higher authority can be very high and an unsuccessful taxpayer may be required to pay HMRC's costs in defending the appeal as well as his or her own costs.

## Tax evasion

Taxpayers are required to provide information which is correct and complete. Dishonest behaviour (e.g. concealing a source of income) is known as *tax evasion* and is against the law. On summary conviction in a magistrates' court, an offender may be imprisoned for up to six months. If the conviction is obtained on indictment in a higher court, the maximum prison term is seven years. In either case, a fine of any amount may also be imposed.

## Tax avoidance

Taxpayers are entitled to organise their financial affairs in such a way that their tax burden is minimised. This perfectly legal activity is known as *tax avoidance*. For example, a taxpayer might legally avoid income tax and/or capital gains tax by moving funds into a tax-efficient investment (see Chapter 6). Tax avoidance (which is legal) should be sharply contrasted with tax evasion (which is not).

Tax avoidance is acceptable within limits but, over the years, tax advisors have shown great ingenuity in devising very complex and highly artificial tax avoidance schemes to exploit "loopholes" in the tax system. These schemes often result in a significant loss of tax revenue until eventually blocked by specific anti-avoidance legislation. So as to limit the effectiveness of tax avoidance schemes, a regime known as DOTAS (Disclosure of Tax Avoidance Schemes) has been introduced which requires certain disclosures by those who devise such schemes or use them. A summary of the requirements is as follows:

(a) Those who promote and market schemes which bear certain "hallmarks" of tax avoidance are required to provide HMRC with details of each scheme. Promoters must provide a description of the scheme, including details of its tax consequences and the statutory provisions on which it relies. The scheme is then registered by HMRC and is allocated a registration number.

(b) Taxpayers using such a scheme are required to quote the registration number of the scheme in their tax returns. Taxpayers who develop their own "in-house" tax avoidance schemes must provide details of each scheme directly to HMRC.

These rules are intended to provide HMRC with advance warning of tax avoidance schemes, so enabling swifter and more effective investigation and counteraction.

### *General anti-abuse rule (GAAR)*

Finance Act 2013 introduced a "general anti-abuse rule" (GAAR) into UK tax law. This rule applies to income tax, capital gains tax, inheritance tax, corporation tax and certain indirect taxes. The aim of the GAAR is to counteract tax advantages arising from abusive tax arrangements. Tax arrangements are defined as "abusive" if they cannot be regarded as reasonable in relation to the relevant tax law, having regard to whether the arrangements:

(a) are consistent with the principles on which the relevant tax law is based
(b) involve any contrived or abnormal steps
(c) are intended to exploit any shortcomings in the tax law.

The GAAR empowers HMRC to make "just and reasonable" adjustments to counteract the tax advantages that would otherwise arise from tax arrangements that are deemed to be abusive. These adjustments may involve increasing a taxpayer's tax liability or imposing a tax liability where otherwise there would be none. However, before making any such adjustments, HMRC must comply with the following procedure:

(a) If an officer of HMRC considers that a tax advantage has arisen as a result of abusive tax arrangements, the taxpayer concerned must be provided with a written notice to that effect. The notice must explain why HMRC considers the arrangements to be abusive and must set out the proposed counteraction. The taxpayer then has 45 days in which to make written representations in response to this notice.

(b) If, after considering any representations received from the taxpayer, HMRC still believes that counteraction should be taken, the matter must then be referred to the GAAR Advisory Panel (an independent panel established for this purpose). The taxpayer must be notified that the matter is being referred in this way and then has 21 days in which to make written representations to the Advisory Panel.

(c) The GAAR Advisory Panel considers the tax arrangements concerned and produces an opinion notice, stating whether or not (in the opinion of the Panel members) the arrangements are abusive. HMRC must then issue a notice to the taxpayer, setting out whether the tax arrangements are to be counteracted.

Taxpayers may appeal against an HMRC decision to counteract tax arrangements. When considering such an appeal, the tribunal or court must take into account the opinion expressed by the GAAR Advisory Panel.

## The HMRC Charter

The HMRC Charter sets out the rights and obligations of taxpayers. The Charter explains what the taxpayer can expect from HMRC and what HMRC expects from the taxpayer. In summary, the taxpayer can expect:

- to be treated even-handedly and with respect and to be treated as honest
- to receive help and support from HMRC

- to be tackled if he or she breaks or bends the rules of the tax system
- that HMRC will be professional and act with integrity
- that HMRC will protect taxpayer information and respect taxpayer privacy
- that the costs of dealing with HMRC will be kept as low as possible.

In return, HMRC expects taxpayers to be honest, to take care to get things right and to treat HMRC staff with respect.

### *The Adjudicator*

An independent and impartial Adjudicator considers complaints made by taxpayers who are not satisfied with the quality of the service they have received from HMRC. The Adjudicator writes an annual report and makes recommendations for improvements to HMRC procedures and practices. The Adjudicator is not empowered to hear tax appeals.

## Summary

- The main direct taxes are income tax, CGT, inheritance tax and corporation tax. Indirect taxes include VAT, stamp duty and excise duties.
- Taxation law is a combination of statute law and case law. Statements made by the tax authorities provide information on the authorities' interpretation of the law.
- The fiscal year runs from 6 April to the following 5 April. The corporation tax financial year runs from 1 April to the following 31 March.
- Individuals who fall within the scope of the Self Assessment system are normally required to submit an annual tax return. Paper returns must be filed by 31 October following the end of the tax year. Returns submitted electronically must be filed by the following 31 January.
- A taxpayer who has not received a tax return notice, but has taxable income or gains of which HMRC is not aware, must notify HMRC of his or her chargeability to tax within six months of the end of the tax year in which the income arises.
- If a tax return is submitted by the required filing date, HMRC cannot initiate an enquiry into the return more than 12 months after the date on which the return is submitted. Discovery assessments may be made after the enquiry window has closed if it is discovered that the taxpayer has not made full disclosure of all relevant facts.
- Tax appeals which cannot be settled by agreement between the taxpayer and HMRC are dealt with by a two-tier tribunals system.
- Tax evasion involves dishonest conduct by the taxpayer and is illegal. Tax avoidance involves the sensible arrangement of the taxpayer's affairs so as to minimise the liability to tax and is perfectly legal.

Chapter 2

# Introduction to income tax

## Introduction

Income tax assessments are computed for a tax year (or "year of assessment") and are based on the taxpayer's total income for the year from all sources, ignoring any income which is exempt from income tax. This chapter explains the main features of an income tax computation, in preparation for the much more detailed information which is provided in subsequent chapters.

Most of the primary legislation relating to income tax used to be located in the Income and Corporation Taxes Act 1988, but this legislation has mostly been rewritten and moved to more recent statutes. Income tax legislation can now be found mainly in the Income Tax (Earnings and Pensions) Act 2003, the Income Tax (Trading and Other Income) Act 2005 and the Income Tax Act 2007, as amended by subsequent Finance Acts.

## Taxable persons

Individuals who are resident in the UK for a tax year are generally charged to income tax on all of their income for that year, including both income arising in the UK and income arising overseas. However, there are two main exceptions to this general rule:

(a) Some forms of income are exempt from income tax altogether (see below).

(b) UK residents who are not UK-domiciled (i.e. whose permanent home is not the UK) may claim that their overseas income should be subject to UK income tax only to the extent that the income is remitted to the UK. However, this may lead to an additional tax charge of £30,000 or more in some cases (see Chapter 32).

Individuals who are not UK residents are liable to pay income tax on their UK income only (see Chapter 32). Income tax is payable by:

(a) adults, on their own income and on their share of the income of a partnership

(b) children, if they have sufficient income to pay tax (see below)

(c) trustees, on the income of a trust or settlement

(d) personal representatives, on income arising from the estate of a deceased person.