# TAXREP 22/00

## TAX LAW REWRITE

# TRADING INCOME OF INDIVIDUALS: PART 3

***Memorandum submitted in June 2000 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales to the Inland Revenue in response to Exposure Draft no. 10 entitled: Trading income of individuals: Part 3 issued in May 2000.***

## CONTENTS


| | Section |
|---|---|
| **GENERAL COMMENTS** | **A** |
| **PROPOSED REWRITE CHANGES** | **B** |
| **SPECIFIC COMMENTS ON MATTERS OF PRINCIPLE** | **C** |
| **DETAILED COMMENTS ON DRAFTING** | **D** |

# Tax Faculty responses to Exposure Draft 10: Trading income of individuals: Part 3

## A General comments

### Overall

1. We welcome the opportunity to comment on Exposure Draft No 10 Trading Income of Individuals: Part 3 (Volumes 1 and 2) issued in May 2000.

2. We agree that the structure of Part 3 is a logical and helpful one, and that the layout shows more clearly the logic of the relationships between the various Cases I and II rules. A reader will still need access to an explanation of the logic of the structure, such as is set out in paragraphs 3.3 – 3.7 of ED10 Volume 1: Introduction and Commentary, in order to clearly appreciate it; but the improved practical value of the rewritten Part is self-evident and commendable, and the rewrite team's efforts are to be congratulated.

In particular, the changed classifications used for the clauses in Stage 2 are an improvement on the approach adopted in Exposure Draft No 4. We agree that centrally grouping rules according to whether they restrict or allow deductions in Chapters 3.3 and 3.4 is objective and more helpful to the reader, showing clearly the basic rules in Chapter 3.2 and the remaining general rules applying to all trades in the following Chapters 3.5 and 3.6 with the rules applying to certain trades only in Chapters 3.7 to 3.9.

The three step process in Chapters 3.2 – 3.4 is a sound basis on which to rewrite the legislation, and the crucial rule in 3.2.7 that the prohibitive rules operate unless overridden by a permissive rule provides a clear approach to it for the reader. We support the proposal to use the phrases 'no deduction is allowed' for the prohibitive rules that prevent deductions and 'a deduction is allowed' for the permissive rules that override all prohibitive rules; and where permissive rules do not override all prohibitive rules, the identification of each rule overridden and a statement that it does not apply.

We note that Persons Chargeable (section 59), Literary and Artistic Profits (sections 534 - 538) and Lloyd's Underwriters (sections 171 – 184 Finance Act 1993) remain to be tackled.

We note also that the Tax Law Rewrite Project Team is working towards a central definition, or series of definitions, by reference to which time limits can be expressed, and we welcome this with a view to avoiding the present laborious repetition.

3. We have the following more detailed general comments.

**Trade Profits: Basic Rules**

In Chapter 3.2 we would suggest moving 3.2.5 (Interest) and 3.2.6 (Animals kept for trade purposes) after 3.2.8 and renumbering the clauses accordingly. 3.2.7 (relationship between rules restricting and permitting deductions) and 3.2.8 (capital allowances and balancing charges), both dealing with aspects of wide application, perhaps follow more logically after 3.2.4 (Receipts and expenses). 3.2.5 and 3.2.6 are more specific in their effect, dealing respectively with the treatment of interest and trading stock.

**Recent legislation rewritten**

It is interesting to note the number of differences in the improved layout of rewritten 3.5.3 – 3.5.7 (Reverse premiums) with that in legislation as recent as FA 1999 Schedule 6. It is disappointing to note that the drafting of new legislation still needs improvement when subjected to the rewrite approach, although it is encouraging to note in contrast that Chapter 3.14 (change of accounting basis) needed little such improvement.

**Trade Profits: Herd basis rules**

We still have some difficulties with the herd basis rules in Chapter 3.7, as comments below.

**Trade Profits: Valuation of Stock and Work in Progress**

The layout throughout Chapter 3.10 deals with commendable clarity with the rules for valuation of trading stock and work in progress on cessation applicable to individuals. The introductory 3.10.3 (basis of valuation of trading stock) is a particularly helpful signpost. We agree that, whilst the approach adopted does result in a significant amount of repetition in the clauses, this is outweighed by the gain in clarity. In particular, there is a logical progression from 3.10.4 (persons not connected) to 3.10.5 (persons connected) and on to 3.10.6 (if connected, election possible) and it is not onerous to read though the same repeated subclauses 1(a) and (b) in each clause.

In view of the decision in IRC v Spencer-Nairn (1991) STC 60, we agree with the view in Commentary 5.478 that it is strictly correct to retain in the rewrite the distinction where it appears in the existing legislation between 'arm's length price' and 'open market value'. However, in the interests of simplicity and clarity it would be preferable to use one of these concepts only. This may merit further review; in particular whether the taxpayer could be disadvantaged if either of them was to be replaced generally by the other. If such disadvantages were identified, it might be possible to retain the existing term used in those cases; whilst standardising the remaining references in the tax legislation.

**Basis periods**

The structure of Chapter 3.12 (Basis periods) is substantially as in ED4, with one new clause relating to the treatment of business start-up payments received in an overlap period added; the ED4 clauses on when the late accounting date rules apply and treating a middle date as the accounting date have each been broken down into several clauses, and the two clauses concerning genuine commercial reasons for a change of accounting date have been merged. The result is much more intelligible than the original legislation.

However, ED10 does not make use of the technique of 'notes' to help readers understand the way the rules inter-relate, as ED4 did, and the reader is still going to need guidance of some kind to assist his understanding. In particular, the interaction of 3.12.15 – 3.12.17 is not easy to understand (treating middle date as accounting date) although these clauses correctly tax in total the actual profits of the periods of account involved whilst the 'middle date' treatment applies.

There is a long gap between the introductory 3.2.1(3) (The amount of profits charged) and Chapter 3.12; but this is unavoidable, given the structure of Part 3.

The clarifications in 3.12.2, 3.12.3, 3.12.4 and 3.12.5 that the relevant references are to the tax year are welcome.

**Cross-references**

There are various references to definitions in ICTA. These will require re-referencing as the various separate rewrite Acts emerge. The matter of cross-referencing generally will need to be kept under review as the rewrite proceeds.

4. In this document section references are to the Income and Corporation Taxes Act 1988 (ICTA) unless otherwise stated.

We refer to Exposure Draft No 4 March 1999 as 'ED4', and to Exposure Draft No 1 July 1997 as 'ED1'. 'Commentary' refers to the Commentary in ED1, ED4 or ED10 as appropriate. References are to the ED10 Commentary unless otherwise stated.

References to the masculine include references to the feminine.

'UK' means 'United Kingdom'.

'ESC' means Extra-Statutory Concession.

5. With comments on ED10 requested by 30 June 2000, adequate time has been given for commentary. However, the need to refer also to ED1 and ED4 and related submissions and responses for complete understanding of the relevant commentary, whilst very helpful has in practice made a review of ED10 a less straightforward exercise than a review of the exposure draft as a 'stand alone' document. As this may recur in future reviews, it will remain important to bear in mind the need on the reviewer's part for adequate time to carry out the review.

Working from a Table of Origins only in Volume 2 did not cause any difficulties in practice.

We would be happy to discuss our comments with you at a meeting if that would be helpful.

# B Proposed Rewrite Changes (PRCs)

We agree to the PRCs listed on pages 20-25 in Volume 1: Introduction and Commentary, subject to the comments and exceptions listed below.

**1. Changes in approach but not in the underlying law**.
We agree PRCs (1) – (11).

**2. Changes to the law and policy**

Page : Para

47 5.156 PRC(16). 3.4.6 (Contributions by employers)
We do not object to treating the contribution as deductible in the period of account in which it is paid.

62 5.280 PRC(22). 3.5.10 (Sums recovered under insurance policies, etc)
We agree PRC(22); but would it be preferable to reword 'is brought into account' as 'when brought into account is' (a receipt . . .) as more clearly relating the timing of the receipt to a period of account?

84 5.458 PRC(29). 3.9.15 (Allocation of ancillary capital expenditure)
We agree PRC(29) but note that 'ancillary capital expenditure' in 3.9.15(2)(d) includes the cost of purchase and preparation of land (in 3.9.13(5)(b)). This may have been partly allocated in an earlier period under 3.9.15 if not sold by the end of that period. 3.9.14(1)(a) nevertheless allows a full cost deduction in the period of sale, with a corresponding reduction in 3.9.15(2)(d) in the residual expenditure before a proportion of it is allocated to the relevant period in which the sale occurs. This is arithmetically incorrect and effectively accelerates the taxpayer's deduction for capital expenditure (in theory, but unlikely in practice, it could also throw the total of residual expenditure in 3.9.15(2) into minus); but it is a sensible practical expedient, to avoid the complexity of calculating written down values.

We wonder, however, why ancillary capital expenditure (which relates to land unsuitable for plots or interments) would be deducted as capital expenditure on purchase or preparation of land sold for interments or plots under 3.9.14(1)(a).

95 5.542 PRC(33). 3.12.12 (When the late accounting date rules apply)
We do not believe that it is appropriate to apply these rules automatically, with the taxpayer having to 'elect out'.

**3. Changes to the law but not to policy**

35 5.58 Clause 3.1.17 (Interest arising) should be dealt with as a PRC.

60 5.268 PRC(48). 3.5.8 (Assets of mutual concerns)

This PRC will exclude distributed capital gains from the 3.5.8 charge only if 'profits' in 3.5.8(1)(c) does not include capital gains. However, a mutual concern is likely to be an unincorporated association, and 'profits' is defined for corporation tax purposes as meaning income and chargeable gains (s 6(4)(a)). Moreover, how is it to be identified to what extent assets represent profits and to what extent they represent capital gains?

63 5.286 PRC(40). 3.6.2 (Meaning of 'trading stock')
We cannot see why materials should be excluded in 3.6.2(2)(a). We otherwise agree PRC(49).

90 5.496 PRC(50). 3.11 (Deductions from profits: unremittable amounts)
We support the proposal to include Extra-Statutory Concession B38 in the rewritten legislation.

**4. Removal of unnecessary material**

118 5.723 PRC(63).
We agree that s 63 FA 1999 applies to a football or other sports club, and not to an individual and accordingly need not be rewritten within Part 3. We would appreciate confirmation that it is intended that this section will be rewritten in the corporation tax rewrite.

The Commentary invites response to the following.

78 5.407 We are not in favour of adopting the alternative approach. We consider that the disadvantages are likely to outweigh the advantages, as set out in Commentary 3.9.5, in particular because the alternative approach could and probably would result in an increased Class 4 National Insurance contribution cost.

114 5.686 19.1.1 (Unremittable income: introductory)
Section 677 (Sums paid to settlor otherwise than as income) is an instance of a relevant charge to tax which is imposed by reference to income rather than on income. There may be other instances, as we have not been able to research this fully. As 19.1.1 gives a relief, we consider that the words "chargeable to tax by reference to", which is a wider expression, should be retained.

# C Specific comments on matters of principle

## 3 TRADING INCOME

## 3.1 Income taxed as trading income

General 3.1.1 to 3.1.3 as now rewritten form a neat introduction to Part 3.

***3.1.3 Trade profits: territoriality***

(1)(a) It is not readily clear that the entire profits of a trade are chargeable to tax under Part 3 in the case of a UK resident person who carries on a trade partly in the United Kingdom and partly abroad. In the case of a non-UK resident person carrying on a trade partly in the UK, 3.1.3(1)(b)(ii) limits the Part 3 tax charge to profits only from the part of the trade carried on in the UK. It might however be clearer to insert in 3.1.3(1)(b)(ii) after 'elsewhere,' the words 'when the charge to tax is upon the profits'.

***3.1.4 Profits of mines, quarries and other concerns***

We note the reasons in Commentary 5.9 for rewriting s 55. In this context, the four proposed rewrite changes are appropriate.

***3.1.5 Ventures in the nature of trade***

(1) The definition of 'trade' is of basic importance. Compared with s 832, the 3.1.5 definition is on the face of it less specific; but we agree that 'any venture in the nature of trade' does encompass the activities within s 832. A short definition of trade is impossible, other than by wide wording as in 3.1.5, and continued reliance on case law interpretation seems unavoidable.

We agree that 'any' equates with 'every' venture in this context.

***3.1.6 Commercial occupation of land***

For consistency of approach with now rewriting s 55, we support the rewriting of s 53(3) as 3.1.6. It is only a short section, but it does clarify for the avoidance of any doubt which activities concerning land can be trades.

***3.1.7 Farming and market gardening***

(2) Is it correct to exclude 'farming carried on as part of another trade'? Commentary 5.24 explains this (the reference to words in parentheses presumably being mistaken). S 53(1) does include in 'farming' farming carried on as part of a trade and s 53(2) then treats all 'farming', including where it forms part only of a trade, as being one trade.

***3.1.8 Divers and diving supervisors***

(1) We agree the change to ensure that all the profits are charged under Part 3 (Commentary 5.29)

(3) We approve the rewording to clarify that the duties can include a mixture of diving and supervising.

We also agree that 'diving supervisor' in s 314(1) is correctly interpreted as a supervisor who dives, as an integral part of the diving team, based on our assumption that s 314 would otherwise have referred to a 'supervisor' if its intended meaning was wider. It would clarify 3.1.8 if a definition of 'diving supervisor', making clear that he must dive as a member of the diving team, was included. It is not immediately obvious to the reader that the words 'diving supervisor' mean this rather than being descriptive and meaning simply a supervisor of the diving.

***3.1.9 Oil extraction and related activities***

(1) We agree that the rule treating these oil related activities as a single, separate, trade belongs here in Part 3, with the s 492(2) loss relief restriction to be included in Part 12 of the proposed Act relating to individuals.

(3) The siting of the definitions of 'oil extraction activities' and 'oil rights' in s 502(1) is not user-friendly; but we appreciate that the manner of dealing with definitions remains under review. For the purposes of Part 3 these definitions would be more accessible if set out also in 3.16.2 (Other definitions) or separately in Chapter 3.16 (Interpretation).

***3.1.10 Effect of becoming or ceasing to be a UK resident***

(1) In the case of a non-resident individual who carries on a trade wholly outside the UK and becomes UK resident, 3.1.3(2) will take him into charge under Part 9 (Foreign income). Does it need to be made clear in (1) that 3.1.10 applies to both Parts 3 and 9?

(3) Is it intended that this loss relief should apply to losses incurred in a trade carried on wholly or partly outside the UK whilst the individual was non-UK resident which are unrelieved at the time he becomes UK resident?

***3.1.11 Relationship between this Part and Part 5***

We note that this clause is to be reconsidered.

***3.1.13 Caravan sites where trade carried on***

General We commend the rewriting of ESC B29 into a statutory basis.

(1)(a) In the absence of any definition of 'material activities', guidance will remain necessary concerning the sort of activities which could qualify (ED 1 Commentary, paragraph 2 on p 44). We welcome the clarifications in 5.44 of the ED 4 Commentary and the relaxation in 5.45 of that Commentary of the previous consistency requirement, enabling the taxpayer to invoke the clause in their self-assessment of trading profits on a tax year by tax year basis and without a formal election process. We note that definitions of 'caravan' and 'caravan site', or a cross-reference thereto, are expected to be added at a future date.

### *3.1.14 Surplus business accommodation*

General We commend the rewriting of IM523 onto a statutory basis.

(1)(d) We note the reasons in Commentary 5.49 for the decision not to define 'relatively small'.

(5),(6) The inclusion of a definition of 'temporarily surplus to requirements' is helpful and treating it where necessary as continuing to the end of the period of account in which the property concerned actually ceases to be temporarily surplus to requirements is sensible.

### *3.1.15 Payments for electric line wayleaves, etc*

(3) We wonder whether the inclusion of the words 'the same tax year' makes it sufficiently clear that subclause (2) is disapplied only for that year, and might nevertheless apply in appropriate circumstances in a later tax year. We suggest that 'in any tax year' be inserted after 'does not apply' in the first line, and that 'the same tax year' be replaced by 'that year'.

### *3.1.16 Relationship between this Part and Part 6*

We note that the development of this boundary provision clause is at an early stage.

Is the reference to its origin as in part s 95A(1A)(a) correct?

### *3.1.17 Interest arising*

We commend the rewriting of IM500 onto a statutory basis.

(4) A determination whether the day-to-day banking requirements of the trade have been exceeded is in practice likely to be a subjective matter, the onus of determining this falling initially on the taxpayer in his self-assessment. With an earned/unearned distinction at issue and the possible impact of trading loss relief for example, this will be relevant to the calculation of the taxpayer's income tax (and possibly through the calculation mechanism his capital gains tax liability). For the taxpayer this presents a somewhat nebulous situation in a self-assessment context, and there is no provision for its early agreement with the Inland Revenue. We would like you to give further thought as to how to assist the taxpayer.

## 3.3 Trade Profits: Rules restricting deductions

### *3.3.2 Expenses not wholly and exclusively for trade and unconnected losses*

(1) We appreciate the concern to distinguish expenses from losses; but the bracketed words in (1)(a) appear cumbersome. If omitted, a distinction between 'expenses' in (a) and 'losses' in (b) in the absence of any specific definitions of either would still be apparent.

***3.3.3 Bad and doubtful debts***

(1) We agree that the wording 'in respect of a debt' (Commentary 5.91) is preferable.

(1)(c) Should there be a signpost to the meaning of 'statutory insolvency arrangement' (definition in 3.16.2)?

***3.3.4 Expenses relating to provision of benefits***

General We do not agree that there is a gap in the current legislation. As drafted, 3.3.4(4) changes the law against the taxpayer. If the legislation gives a deduction but does not say when it is to be given, the timing must surely follow generally accepted accountancy principles. The requirements for payment and taxation as a benefit in s 76(4), (5) and (6) FA 1989 have to be satisfied to secure the deduction; but they do not determine its timing, as Commentary 5.94 concedes.

***3.3.6 Unpaid remuneration of employees***

(4) With reference to Commentary 5.100, in the context of the rewritten Part 3 we have no objection to the use of permissive wording rather than the mandatory wording in s 43(2)(b). We are concerned, however, that 3.3.6(2)(b) effectively means that if money is paid to an employee benefit trust and at a later date will be paid out as remuneration to someone who has not yet been identified then it cannot be deducted. We do not believe that the existing legislation says this.

***3.3.12 Interest paid to non-UK residents***

With reference to Commentary 5.128, the wording has been changed from that in clause 3.2.8 in ED1; but it is now clearer. The fact that a deduction is permitted for such interest up to the amount which would be payable at 'a reasonable commercial rate' still does not come through clearly, however.

## 3.4 Trade Profits: Rules permitting deductions

***3.4.5 Payments for restrictive undertakings***

(3) In our response to 3.2a.6 ED4, we objected to payments for restrictive undertakings being deductible only when paid and suggested that the accruals basis should instead apply. In paragraph 42 Responses to the Fourth Exposure Draft the Revenue disagree and restate their view that the current legislation in s 73(2) Finance Act 1988 does have a 'paid or treated as paid' timing rule. We do not agree. All that s 73(2) seems to do is to impose a condition that the sum must be paid if a deduction is to be given. It does not address timing. We can see no reason under s 73(2) why an expense should not be deductible in a period of account if properly accrued in that period but paid after its end.

***3.4.6 Contributions by employers***

(8) Section 112 Finance Act 1993 concerns deductions for contributions paid in chargeable periods, consistent with s 592(4) being an accounting period

of a company or a year of assessment (s 832). This will presumably need amending if the deduction in 3.4.6 is to be by reference to periods of account.

***3.4.12 Qualifying training courses***

(3)(a) In our responses to 3.2a.2(3) ED4 we commented that it would be helpful to have, in an appropriate part of the redrafted legislation, a consistent definition of 'full-time or substantially full-time'. We note that this point has not been taken in ED10.

***3.4.14 Recovery of tax***

(2) In our response to 3.2a.3(2) ED4 we suggested that the self-assessment time limit of 31 January should be substituted for 5 April. We note that this point has not been taken.

***3.4.17 Payments in respect of employment wholly in employer's trade***

(2) It is not readily apparent to the reader that, if the proviso to 3.4.17(2) applies, an accruals basis of deduction applies; whereas if that proviso does not apply, then 3.4.17(6) applies a payments basis (see Commentary 5.194 and 5.195)

***3.4.18 Payments in respect of employment in more than one capacity***

We would support the inclusion of guidance on apportionment .

***3.4.19 Additional payments***

Section 90(3) provides that references in s 90 to permanent discontinuance include references to any occasion on which the trade is permanently discontinued by s 113(1). Why has this not been rewritten in 3.4.19?

***3.4.21 Personal security expenses***

(1)(a) Section 112 (2) Finance Act 1989 makes it clear that any of the individuals in a partnership come within the scope of s 112. The rewrite focuses on 'the trader', and it appears necessary to interpret the 3.4.21(1)(a) reference to 'the trader' as meaning each of the individuals in a partnership to achieve the same result. We disagree with Commentary 5.206 that the rewrite makes it clear that the provision applies whether the threat is to one or more than one of the partners.

(2) In our response to 3.2a.7(2) ED4 we pointed out that there is no override of the non-deduction of capital expenditure, enquiring how expenditure on improving the security of (say) a wall could be deducted. In Responses to the Fourth Exposure Draft (paragraph 49) it is confirmed that the section does not apply to capital expenditure. If capital expenditure is to be wholly dealt with under 2.5.7 Capital Allowances Bill rewrite (Personal security), it would be helpful to have a cross-reference from 3.4.21 making this clear. The distinction is presumably that capital expenditure on acquiring, bringing the asset into existence or improving it (as the improvement expenditure to the wall in our above example) will be within the capital allowances legislation, whilst any revenue expenditure in

connection with the provision of the asset (including an improved asset) for or its use by the trader come within 3.4.21.

(3) In our response to 3.2a.7(3)(a) and (4) ED4 we drew attention to the apparent inconsistency of requiring that the person's sole object in incurring the expense should be to meet a threat ((3)(a)) whereas he need only use the asset partly to improve his personal physical security ((4)) and hence could use it for other purposes unrelated to the threat. This is perpetuated in 3.4.21(3). We assume that this is to provide some flexibility when the purpose is to meet a threat but other use of the asset can arise in practice.

## 3.5 Trade Profits: Receipts

No matters of principle.

## 3.6 Trade Profits: Transfers of trading stock

No matters of principle.

## 3.7 Trade Profits: Herd Basis Rules

General Chapter 3.7 deals with the herd basis rules in 3.7.4 – 3.7.10. The structure is logical, dealing first with the initial herd (3.7.4), then dealing with individual new additions (3.7.5), the replacement of individual animals (3.7.6), the sale of individual animals (3.7.7) and then the sale of a substantial part or the whole of the herd (3.7.8), followed by the consequences if a new herd in whole or part is acquired within 5 years of a 3.7.8 sale (in 3.7.9 and 3.7.10).

In the absence of any overview, however, the reader still has to study these sections very carefully in order to understand their application. For example, the essence of 3.7.6 is that a receipt arises under 3.7.6(2) in respect of the old animal and a deduction under 3.7.6(4) or (5) for the new one, with both the amount of the receipt and the deduction being subject to possible restriction; but this is not readily discernible to the reader in the lengthy text. It would perhaps help to move subclauses (6) and (7) up to immediately after (2), and renumber the subclauses accordingly, to more clearly identify the treatment of the receipt and deduction.

In 3.7.7 it would help in 3.7.7(1) to insert 'when section 3.7.6 applies' after 'animal' in (a) and to insert 'when section 3.7.8 applies' after 'year' in (b).

In 3.7.8 it would be helpful to insert 'whole' before 'herd' in the first line of 3.7.8(1). Similarly in 3.7.9(1)(a) it would be helpful to insert 'whole' before 'herd', to emphasise the distinction from 3.7.10 which deals with replacement of part sales of the herd.

The interaction of 3.7.9(2), which applies 3.7.6, with 3.7.9(7) and (8) also tests the reader. Where 3.7.9(7) applies, possibly some years after the sale of the old herd, 3.7.6 is disapplied and 3.7.7 is applied to treat the non-substantial decrease in the number of animals in the new herd as compared with the old as simply a number of individual animals sold from the old herd (with the profit or loss on sale then becoming taxable/deductible). Where the difference in numbers is substantial, and 3.7.9(8) applies instead, then either 3.7.8 or 3.7.10 is applied so that no receipt or deduction arises in respect of the animals constituting the reduction; but because 3.7.9(2) is not disapplied it appears that the animals in the new (reduced) herd are treated as replacements in the old herd with 3.7.6 applying (the sale proceeds of the old animal then being a receipt and the cost of the new animal a deduction). It is not easy for the reader to comprehend this, and it might help if 3.7.9(8) expressly applied 3.7.6 to the animals replaced by the new herd (as 3.7.10(2) does for the purposes of that clause, which is generally clearer with its references to animals sold and replaced and sold and not replaced). Similarly, where 3.7.9(9) applies, it is apparently the intention that 3.7.6 should still apply to the lesser number of animals in the old herd. Can this be made clearer?

***3.7.1 Election for application of herd basis rules***

General The application of the election to partnerships remains to be considered (as explained in paragraph 9 of the Commentary on clause 3.2b.1 in ED4), and our comments on paragraph 9 of 3.2b.1 in ED4 remain relevant.

***3.7.3 Other interpretive provisions***

(2) The 3.7.2(5) definition of 'production herd' already incorporates a reference to 'a herd of animals of the same species (irrespective of breed)' and we do not see the point in repeating this requirement again in 3.7.3(2)(a

***3.7.9 Acquisition of new herd began within five years of sale***

(1) We welcome the removal of the provision that the 5 year period begins with the date on which the last animal of the old herd was sold (similarly in 3.7.10(1)); but it is still difficult to understand how this section will be applied. If the whole herd is sold in separate parts during the one year period in 3.7.9(1)(a), does the sale date of each part now trigger its own start of a five year period under 3.7.9(1)(b)? If so, how are animals disposed of to be identified with replacements? In 3.7.9(1)(b) what does 'begins to acquire' mean? Does this mean that if one replacement animal is acquired before the expiry of the five year period, then the acquisition of another production herd has begun and that all animals acquired at any time after the expiry of the 5 year period up to the number in the original herd are to be treated as replacements? If so, when can the number of

animals in the new herd be finally established for the purposes of 3.7.9(7) and (8)?
Similar difficulties arise with 3.7.10, when part of a herd sold is replaced.

## 3.8 Trade Profits: Films and sound recordings

***3.8.6 Films and sound recordings: production or acquisition expenditure***

(1) In the case of certified master versions a distinction is drawn between preliminary expenditure (3.8.8) and production or acquisition expenditure (3.8.9), whereas for other film and sound recordings 3.8.6 refers only to production or acquisition expenditure (although 3.8.8(4) clearly envisages preliminary expenditure as within the scope of 3.8.6). Why is this? Should 3.8.6 be expressly worded to include preliminary expenditure?

It would further clarify the distinct treatment of certified master versions if a subsection (e) was added to exclude cases where sections 3.8.8 – 3.8.10 apply. The wording might simply be 'sections 3.8.8, 3.8.9 and 3.8.10 do not apply'.

(3) It remains unclear whether the choice of the 'cost recovery' method rather than the 'income matching' method of allocation can be made on a film-by-film basis. As paragraph 83 Responses to the Fourth Exposure Draft states that this is the intention, inserting words such as 'In respect of each film' at the beginning of subclause (3) would make this clear. It would also help to make 3.8.8, 3.8.9 and 3.8.10 similarly clear, as regards the choice between the basic allocation method and the special rules for certified films, perhaps by including 'on that particular film' in 3.8.8(3) after 'expenditure' in the second line, in 3.8.9(2) after 'expenditure' in the third line, and in 3.8.10(3) after 'expenditure' in the second line.

(3) The wording 'or this section' in the second line, taken with the closing words after the comma in the third line is confusing. Presumably the intention is to permit an allocation only once, as in the cases of allocation under 3.8.8, 3.8.9 and 3.8.10. Would it be better to delete the words 'or this section' in the second line, or make clear that expenditure can be allocated only once under 3.8.6? A similar point arises in connection with 3.8.8(4) and 3.8.10(4). 3.8.9(2)(c) copes with this point by an 'has not already been allocated under . . . this section' approach.

## 3.9 Trade Profits: Other specific trades

***3.9.2 Exchanges of gilts for gilt strips and consolidation of gilt strips***

(6) For ease of reference, it would be preferable to import fully the definition of 'strip' from section 47(18) Finance Act 1942.

***3.9.6 Alternative basis of assessment in early years of practice***

(1)(2) Subject to the phrase being appropriate for Scottish advocates, we agree the use of the phrase 'independent practice'.

(3) There is no definition of 'cash basis' (but there was none in s 43 Finance Act 1998 either).

(5) From a reading of 3.9.6 it is not readily clear that it is in fact an exemption from 3.2.2 although this is made clear in 3.2.2(3). It might be preferable to rewrite (5) as 'If for any period of account an accounting basis is adopted that complies with section 3.2.2 (true and fair view), the exemption from that section given by this section ceases. In that case, that section applies to all subsequent periods of account.'

***3.9.8 Mineral exploration and access***

This clause achieves its purpose (to disallow what is regarded as capital expenditure), as explained in the Commentary on clause 3.2e.1 in ED4, and will remain intelligible to those needing to apply it in the oil and gas industry as a specialist provision; but for the lay reader it is not easily comprehended, particularly in view of all the negatives in 3.9.8(2).

***3.9.15 Allocation of ancillary capital expenditure***

(1)(3) The use of the same 'PS' and 'PA' lettering for the purposes of two different formulae might confuse; but should not cause a careful reader any difficulty. It might, however, be prudent to use different letters in each to distinguish the formulae. The formula in (3) is subsidiary to (2)(b), which in turn is subsidiary to the formula in (1).

## 3.10 Trade Profits: Valuation of stock and work in progress

***3.10.6 Sale basis of valuation: election by connected persons***

(5) As Commentary 5.480 indicates, section 100(1D) ICTA is not an easy section to understand, and this still applies to 3.10.6(5). Its purpose is not clear to a reader. It might help to insert the words '(being lower than its actual cost)' or similar after 'amount' in the first line.

## 3.11 Deductions from Profits: Unremittable amounts

***3.11.4 Withdrawal of relief***

(2)(c) The words 'applied outside the United Kingdom in another way' are clearly less precise than the circumstances listed in paragraph 8 of ESC B38. It is possible to extract these circumstances from paragraph 8 and we would prefer to see them rewritten within 3.11.4, perhaps as a related subclause. We alternatively suggest that they should be put on record in some other way – perhaps as a Revenue Interpretation in Tax Bulletin?

## 3.12 Basis periods

***3.12.6 Final tax year***

We agree that it is more logical to put the more usual case first (3.3a.6(3) in ED4) and that the rewritten 3.12.6 is an improvement.

***3.12.9 Deduction for overlap profit in final tax year***

It would be helpful to say what happens if there is a loss in the final year.

***3.12.10 Restriction on bringing losses into account twice***

In (a) and (b) the reference should be to 'calculating the profits *or losses* of the . . . basis period'.

***3.12.14 Rules if there is no accounting date***

3.12.14(5) refers to the actual profits of the period (at most) 1 – 5 April in the first year and not the deemed nil figure imposed by 3.12.14(4). We suggest inserting 'actual' before profits in 3.12.14(5).

***3.12.18 When a change of accounting date occurs***

(4) In the first line it might be clearer to replace 'corresponds to' with 'is the same date in the year as'.

***3.12.19 Change of accounting date in third tax year***

General In our response to 3.3a.14(1) ED4, we suggested that it would be helpful to also include a reference to the situation if the accounting date in the third year falls less than twelve months after the end of the basis period for the second tax year. In this situation the general rule in 3.12.2 applies, and we remain of the view that it would be helpful to spell this out.

***3.12.20 Change of accounting date in later tax years***

General In view of the references to 'new accounting date' in 3.12.21(3)(a) & (b) it may be appropriate to insert 'new' before the references to 'accounting date' in 3.12.20(3) and (4).

(2) It would clarify which tax year is being referred to if after 'period' was inserted 'for the tax year in which the change of accounting date occurs'.

***3.12.21 Conditions for basis period to end with accounting date***

General Should 'new' be inserted in the 3.12.21 heading before 'accounting date'? Similarly in the index on page viii of ED10 Volume 2.

***3.12.23 The year after an ineffective change of accounting date***

(1) As drafted this section applies only to the year immediately after the tax year in which the ineffective change of accounting date occurs. How are later years to be dealt with, where the new accounting date is retained? The clause needs to be amended to cope with this (basis periods continuing to run to the old accounting date).

(3) The subclause will read better if 'that change of accounting date' is changed to 'the change of accounting date'.

## 3.13 Averaging profits of farming and market gardening

No matters of principle

## 3.14 Change of Accounting Basis

General We note that paragraph 7, Schedule 6, FA1998 (liability of personal representatives in case of death of person chargeable) has not been rewritten in Chapter 3.14. We assume that this will be rewritten elsewhere in the proposed Act.

***3.14.2 Positive amount charged as income***

General We note that the absence of any Class 4 National Insurance contributions charge on the adjustment income is to be preserved (Commentary 5.603).

***3.14.5 Calculation of the adjustment***

Paragraph 3(1) Schedule 6 Finance Act 1998 says that the 'Third step' of the method statement applies in the case of a profession or vocation 'adopting a new accounting basis to comply with section 42 (true and fair view)'. It does not say adopting 'for the first time'. It might therefore cover a change from one basis that gives a true and fair view to another (as indicated in Commentary 5.597). If so, the statement in Commentary 5.610 that only barristers (and also advocates) in the first seven years of practice can now make a change of basis after 5 April 2000 is not correct. However, as the other requisite for the 'Third step' to apply, that there was a preceding change before 6 April 1999, puts a further limit on its likely application in future, we have no objection to preserving the effect of this unusual case in a general saving provision.

***3.14.10 Application to partnerships***

We note that this clause may finally be grouped together in a special chapter with others dealing exclusively with partnership matters (Commentary 5.625).

## 3.15 Post-cessation receipts

***3.15.6 Post-cessation receipts charged under this Part***

General We note that the absence of any Class 4 National Insurance contributions charge on post-cessation receipts will be preserved (Commentary 5.649).

## 3.16 Interpretation

No matters of principle.

## 5.1 Reverse premiums

No matters of principle.

## 19.1 Unremittable income

No matters of principle.

## 19.2 Interest, surcharges and penalties

No matters of principle.

# D Detailed comments on drafting

## 3.3 Trade Profits: Rules restricting deductions

***3.3.9 Business gifts: exceptions***

(6)(b) We note that the briefer description 'English Heritage' in 3.2.13(5)(b) of Exposure Draft No 1 has now been replaced by the full title 'the Historic Buildings and Monuments Commission for England'.

***3.3.10 Car hire***

This clause might arguably be moved into Chapter 4, as its wording perhaps emphasises more the deduction or reduction aspects rather than the disallowance as a deduction of part of the hiring expenses.

## 3.4 Trade Profits: Rules permitting deductions

***3.4.3 Taxable premiums, etc.***

We note that this section remains to be rewritten.

***3.4.8 Employees seconded to charities and educational establishments***

Section 86(3)(d) ICTA (any other educational body . . .) has been omitted from the rewrite definition of 'educational establishment'. Why is this?

***3.4.20 Payments made by the Government***

(3) In the definition of 'statutory payment' Butterworths 1999-2000 (Part 1) gives the references as 'section 166' in (a) and 'Article 201' in (b). Confirmation is sought that the references to 'section 167' and 'Article 202' in 3.4.20 are correct.

## 3.8 Trade Profits: Films and sound recordings

***3.8.5 Expenditure treated as revenue in character***

(1) It would emphasise more clearly the overriding relevance of a s 2.6.1 Capital Allowances Act election if subclause (1) began with 'Unless an election under section 2.6.1 Capital Allowances Act has effect, if –' and the words after the comma in the penultimate line were deleted.

***3.8.6 Films and sound recordings: production and acquisition expenditure***

General It would help the reader to understand the structure of Chapter 3.8 and emphasise the distinction between the universal alternative methods in 3.8.6(2) and (3) and the special methods for certified master versions in 3.8.8 –3.8.10 if the heading '*Films and sound recordings: allocation of expenditure*' read as '*Films and sound recordings: normal methods of*

*allocating expenditure*', the italicised heading for 3.8.7 – 3.8.10 read 'Certified master versions: special methods of allocating expenditure' and if the 3.8.10 heading incorporated 'Certified master versions:' at its beginning to link it in with sections 3.8.7 and 3.8.9.

It remains to be considered how to deal with non-traders (paragraph 2 of Commentary on clause 3.2c.5 in ED4).

***3.8.11 When expenditure is incurred***

(5) In the context of 3.8.10, are the references to 'asset' in (a) and (d) appropriate? Is this an overhang from the original capital allowances legislation? Would it be better to refer to 'the original master version'?

## 3.9 Trade Profits: Other specific trades

***3.9.16 Exclusion of expenditure met by subsidies***

(5)(b) We note that the reference is to 'calculating' the profits; whereas 'computing' is used in 11.1.5(1)(b)(ii) of the ED9 Capital Allowances Bill. 'Calculating' is the word generally used in Part 3.

## 3.14 Change of accounting basis

***3.14.8 Election to accelerate charge***

(4) In the absence of any definition of 'the original amount of adjustment income' it would be helpful to insert after these words in the second line 'as calculated in 3.14.5'.

***3.14.9 Transitional cases***

(2) Should the words in the first line be 'had not been charged' rather than 'had not been not charged'?

## 3.15 Post-cessation receipts

***3.15.12 Relief for individuals born before 6 April 1917***

3.9.6 cannot apply where the practice has been carried on for more than seven years. Accordingly, for it to still apply the barrister must have started his practice in 1994 or later. However, to come within 3.15.12 the barrister must have been carrying on his practice on 18 March 1968. Accordingly the two are mutually exclusive. If a barrister was in practice in 1968, ceased to practice and started again in, say, 1996, both provisions still could not apply as when he ceases his second trade it would not be "the trade" carried on in 1968 and 3.9.6(2) would exclude the operation of

3.9.6 entirely as the barrister will have previously held himself out as available for fee-earning work i.e. prior to March 1968.
Accordingly, if 3.15.12 can apply only to barristers or advocates then there is no point in keeping it.

## 3.16 Interpretation

General Whilst correctly rewritten, certain of the 'definitions' are slight and others descriptive rather than definitive because of similar defects in the original legislation. For example, the definition of 'farming' in 3.16.1 depends upon the meaning of 'husbandry' which is not defined in 3.16.1(2), specialised examples only being given of what it includes. The definitions of 'forestry' and 'woodlands' in 3.16.2 are not informative. We appreciate that case law will often have a bearing; but it could be argued that the rewrite presents an opportunity to improve the definitions where possible.

## 19.2 Interest, Surcharges and Penalties

General We agree that it is helpful to bring together all the rules prohibiting a deduction for interest, surcharges and penalties imposed by statute, and we agree that provisionally placing this clause in Part 19 of the proposed Act is appropriate. The introduction by separate tax of specific statutory references in a consistent order is also helpful. We note that further work will be done regarding the rewriting of the VAT repayment supplement exemption from tax and the provision that interest on unpaid tax is to be paid without deduction of income tax (Commentary 5.701 & 5.702).

14-13-36
TJH
30.6.00