THIRTEENTH EDITION

Income Tax 1983/84

INCLUDES FINANCE ACT 1983

Henry Toch

M&E HANDBOOKS

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Income Tax

1983/84

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Preface to the Thirteenth Edition

This HANDBOOK is intended primarily for students, but it is hoped that it will also prove of value to the lay reader. With these twin aims in mind, an attempt has been made to set out the basic principles of income-tax law and practice in a clear, concise and practical way and to assist law and accounting students at all stages of their preparation for examinations.

Since an understanding of the subject involves a knowledge of income-tax law, the authority for each principle explained will be stated; and since the application of the law involves a knowledge of accountancy, each principle explained is illustrated by practical examples.

This new edition incorporates the changes in the law made by the Finance Acts 1982 and 1983.

As in the past, I have also taken the opportunity to improve and clarify the text in the light of suggestions from colleagues and readers to keep in touch with the changing nature of examination questions.

Method of study. After completing study of the material in each chapter, the students should work through any problems provided, checking answers with those supplied in Appendix III. After this, the Progress Tests should be attempted, and answers checked with the text. Only after all the material has been mastered should the examination questions be attempted (Appendix II).

The examination questions are based on past examination papers, and I wish to express my gratitude to the various bodies who have given permission for their publication.

The book should be particularly useful to students preparing for examinations of the following bodies:

Institute of Chartered Accountants of Scotland;
Institute of Chartered Accountants in England and Wales;
Institute of Taxation;
Institute of Cost and Management Accountants;
Building Societies Institute;

Institute of Chartered Secretaries and Administrators;
Law Society;
Chartered Institute of Public Finance and Accountancy;
Association of Certified Accountants;
Stock Exchange;
Business Education Council Higher National Certificate;
Institute of Bankers;
Institute of Scottish Bankers.

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CHAPTER I

General Introduction

1. History. Income tax was first introduced in 1799 to pay for the wars with France. It was introduced as a temporary measure to last for one year. It was renewed annually until 1815 when, at the close of the Napoleonic wars, it was abolished. Income tax was not reintroduced until 1842, when it came to stay.

2. Nature of income tax.

(*a*) *An annual tax.* The important thing to remember is that it is an *annual* tax and must be reintroduced each year by the annual Budget. The year for which the tax is imposed is the year ending on 5th April. This is so inconvenient a date for all concerned that the date taken in practice is the 31st March, except in cases where the five days' difference substantially affect the income-tax liability. Students can generally assume that in examinations the 31st March may be taken as the date on which the income-tax year ends.

(*b*) *What is a "tax"?* What distinguishes a tax from other payments is that:

(*i*) a tax is a compulsory payment for which the Government need offer no service or explanation;

(*ii*) in order to collect the money, the law on the subject must be specific and definite enough to enable an exact sum to be calculated.

In other words, in your income-tax calculations there can only be *one* right answer. Any other figure must be wrong.

3. Basic questions. In examinations, the successful candidate is the one who can come to the right answer by applying the necessary principles; those who write a disquisition on the subject, without being able to apply the principles, will fail. Basically, the student has to answer the following questions.

(*a*) What is income for tax purposes?

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3. Basic questions. In examinations, the successful candidate is the one who can come to the right answer by applying the necessary principles; those who write a disquisition on the subject, without being able to apply the principles, will fail. Basically, the student has to answer the following questions.

(*a*) What is income for tax purposes?

(*b*) How much is it?
(*c*) How is it taxed?
(*d*) How is the tax paid?

4. What is income? Unless the sum received is "income" as legally defined, no problem arises. Thus, you are first of all concerned with the practical application of certain legal provisions. All law is arbitrary and on occasions illogical. It is sufficient to know what the law is and how to apply it; it is not necessary to find it fair and logical (*see* II, **1**).

The tax-paying public has been divided by one expert into two groups: (*a*) those who pay their tax because they are told to pay it, and (*b*) those who pay it because they know it is written down somewhere that they must pay it. The second group is, of course, the group of experts, since they know the law well enough to be able to check it by looking it up. Whenever a certain course is taken in your calculations, you must be able to give the authority for your decision, i.e. to show that it is in accordance with a section of the statute or a judgment. Personal opinions as to what the law *ought* to be are irrelevant.

5. How much? Having discovered that the money in question is income, the amount of it must be determined, since it is possible that (for example) a person may receive director's fees of £6,000 and yet pay allowable bank interest of £7,000 in any one year. In these circumstances no tax liability can arise, since although the person has income he has in fact "none" for tax purposes.

6. How income is taxed. Once having established that the person has a *positive* amount of income, the question arises: "How is it to be taxed?"

It is likely that some part of a person's income will be tax-free and the rest will be taxed at different rates, since the British system is graduated, increasing the rate of tax as the income level increases.

7. How the tax is paid. When the liability is established, the question arises: "How is the tax to be paid?" Some tax is deducted at source when the income arises, some is paid on 1st January and some on 1st July. In the case of Corporation Tax the tax is not payable until the January of the following year.

PROGRESS TEST 1

1. Describe, in general terms, the nature of income tax. **(2)**
2. How is income taxed and how is tax paid? **(6, 7)**

CHAPTER II

Principles of Income Tax

1. What is income? A famous judge commented:

"Income tax, if I may be pardoned for saying so, is a tax on income. It is not meant to be on anything else. It is one tax, not a collection of taxes essentially distinct. There is no difference in kind between duties of income tax assessed under Schedule D . . . or any other Schedule of the charge." Lord Macnaghton in *Attorney General* v. *L.C.C.* (1908).

The first problem, then, is to *define* income. This is quite difficult, since what may be income in the hands of one person may be a capital receipt in the hands of another. If, for example, a commercial traveller sells a house to a builder, making a small profit, this profit, unless it can be held to be an adventure in the nature of trade, is not taxable as income. On the other hand, if the builder sells this same house and makes a profit on the transaction, this profit would have to be included in his taxable trading profit.

In other words, what determines whether a certain sum is taxable or not is the *source* from which the sum is derived. If the profit can be said to come from a trade, it is taxable; if not, it escapes tax as income, but may be taxable as a capital gain.

2. The Schedules. The income-tax statutes nowhere define income. Instead they enumerate the sources of income as comprehensively as possible. The main statute is the Income and Corporation Taxes Act 1970, which consolidated the law still operative since 1842. In addition, there are the Finance Acts (at least one each year), which contain any changes in the law since 1970.

3. Schedules A and B. Sections 67–92 of the Income and Corporation Taxes Act 1970 cover tax in respect of ownership and occupation of land and buildings, charged under Schedules A and B.

4. Schedule C. Sections 117–121 relate to tax in respect of profits arising from public revenue dividends payable in the United Kingdom and Eire. Since all these sums are subject to *taxation at source*, the collection of this tax is a matter for Government departments and does not concern the professional man (questions on Schedule C are not usually set in examinations).

> NOTE: When, as here, the sections are shown without reference to the statute, they relate to the Income and Corporation Taxes Act 1970.

5. Schedule D. Sections 108–167, as amended by subsequent Finance Acts, provide for taxation under Schedule D. Most of the assessments with which the accountant, lawyer or tax department of a bank have to deal fall under this Schedule, which deserves detailed study.

Schedule D is now divided into six Cases: s. 109, I.C.T.A. 1970.

Case I. Tax in respect of any trade carried on in the United Kingdom or elsewhere. The comprehensive definition of trade is: "Trade includes every trade, manufacture, adventure or concern in the nature of trade" (s. 526, I.C.T.A. 1970).

Case II. Tax in respect of any profession or vocation. The word "vocation" has been interpreted by the judges as "methods of earning a livelihood" such as keeping a boardinghouse or letting rooms furnished. A vocation in its income tax sense has a much wider meaning than in its normal sense of "calling".

> NOTE: The student must be warned that the *technical* meaning of ordinary words is sometimes different from what one would expect and it is therefore essential that the student should be clear about the legal definitions of the terms used.

For practical purposes there is now no difference in the rules for assessment, etc., between Cases I and II.

Case III. Tax in respect of any interest on money whether yearly or otherwise, or any annuity, or other annual payment or discounts. From 1970–71 onwards, annual interest is paid gross but other annual payments are still subject to tax deduction at source.

Case IV. Tax in respect of income arising from securities *out of the U.K.*, except such as are charged under Schedule C. A security for this purpose is a debenture but not a share.

Case V. Tax in respect of income arising from possessions *out of the U.K.* Possessions include rents from properties situated abroad, foreign dividends and commissions.

The distinction between Cases IV and V is of historical interest only, since for many years now income falling under the two cases has been treated exactly alike.

Case VI. Tax in respect of annual profits or gains not falling under any other Case or Schedule.

This covers miscellaneous income, and is all-embracing. It covers simply any sum which the judges record as being in the nature of income.

6. Schedule E. Sections 181–207, I.C.T.A. 1970, divide the charge as follows.

Case I. Resident person holding an office in the U.K., the duties of which are not performed abroad.

Case II. Non-resident person who carries on an office or employment in the U.K.

Case III. Resident person employed by foreign employer is taxable in respect of remittances.

Pensions are also taxable under this Schedule.

7. Schedule F. Dividends and other annual payments paid by companies.

8. Who is liable? Income tax, in general, has to be paid annually, by all U.K. residents, not only on income arising in the U.K. but also on income arising anywhere (foreign tax suffered may qualify for double-taxation relief). Moreover, income receivable in the U.K. suffers tax whether the recipient is a U.K. resident or not. Thus a person living in the United States pays British income tax on rents received from a house owned and let in the U.K.; in the same way, a British resident pays British income tax on rents received from a house let in the U.S., subject to double-taxation relief which may be due.

9. Income of the wife. "A woman's income chargeable to income tax shall, so far as it is income for a year of assessment during which she is a married woman living with her husband, be deemed for income-tax purposes to be his income and not her income": s. 37, I.C.T.A. 1970.

This means that, for income-tax purposes, a married woman living with her husband is treated like an infant or l~~unatic~~ as an *incapacitated person*.

This section results in the curious position that a married man is responsible for the tax on the income of his wife but, under the married women's property law, the husband has no right to this income.

In practice, most of the wife's income suffers tax at source before payment is made to her and therefore no complications normally arise. Moreover, if either the husband or the wife do not wish to be assessed together they can make a claim for separate assessment under s. 38, I.C.T.A. 1970. The claim must be made within six months before the 6th July in any year of assessment for which the claim is made.

Practical illustrations of the tax position in the case of marriage and separation and the treatment of husband and wife generally will be provided in IV.

Section 23, F.A. 1971, provides for election to have a wife's earnings treated separately. Both husband and wife must sign the election. For 1980–81 the election must be made or revoked by 5th April 1982 twelve months after the end of the relevant year of assessment.

10. Concept of "total" income. As explained earlier, certain deductions can be made from the *gross* income to arrive at the *net* or statutory (total) income for income-tax purposes.

Certain annual payments made under a *legal obligation* can be deducted from the gross income. Examples of the type of payment usually coming under this heading are:

(*a*) certain bank interest;
(*b*) mortgage or building society interest;
(*c*) annuities;
(*d*) court order payments;
(*e*) payments made under a separation agreement;
(*f*) payments under covenants of which there are two kinds:

(*i*) covenants in favour of registered charities, which have to be for at least *four* years and under which payments must not exceed £5,000 in any one year (£3,000 for 1981–82 and 1982–83), and

(*ii*) covenants in favour of individuals which must be for at