Limit on Income Tax Reliefs

Draft Guidance

March 2013

Contents

1. **Overview**

1.1 This guidance covers the new income tax relief limit, which was introduced in the Finance (No 2) Bill 2013 and is intended to have effect for the tax year 2013-14 and subsequent tax years. However until the Bill receives Royal Assent the draft legislation may be subject to further amendment. This guidance therefore cannot be relied upon as if it were HM Revenue and Customs' (HMRC) guidance on the final legislation as enacted by Parliament.

1.2 The limit applies to certain reliefs, which were previously unlimited and that are available to reduce an individual's total income. The limit is the greater of £50,000 or 25 per cent of the individual's adjusted total income for a tax year.

1.3 This draft guidance explains, with supporting examples, how to work out income for the purpose of the limit, how the limit is calculated, which reliefs are subject to the limit, and how different circumstances are treated.

1.4 This draft guidance has been published in advance of Self Assessment Guidance to:

- help individuals who need to understand now how the limit on reliefs works

- seek feedback and views on the guidance to help ensure that final guidance is fit for purpose.

2. Comments

2.1 Views on this draft guidance are welcome. Final guidance will be included in Self Assessment Business Notes and HMRC manuals.

2.2 Please send comments to:

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3. **Limit on income tax reliefs**

3.1 There is a new limit on the amount of income tax relief that an individual may claim for deduction from their total income in a tax year. The limit does not affect the amount of relief that an individual may claim against capital gains. The limit applies from tax year 2013-14.

3.2 The limit applies to the aggregate of the relevant reliefs claimed for a tax year. The relevant reliefs are listed in section 4.

3.3 The limit in each tax year is the greater of £50,000 or 25 per cent of the individual's adjusted total income. For the purpose of calculating the limit "adjusted total income" is specifically defined and is explained in detail in section 5.

3.4 The limit is calculated separately for each tax year in which a relief is given effect. This is explained in more detail in section 7.

3.5 The following examples illustrate how the limit is computed.

Ben's total income in 2013-14 is £180,000. He claims relief for trade losses of £70,000 made in 2013-14 against his total income in 2013-14. Ben's relief limit in 2013-14 is £50,000 as this is the greater of £50,000 and 25 per cent of his income (which is £45,000).

Jas's total income in 2013-14 is £480,000. She claims relief for qualifying loan interest arising in 2013-14 of £125,000. Jas's relief limit is £120,000 as 25 per cent of her income is greater than £50,000.

4. Reliefs subject to the limit

4.1 The following list sets out the reliefs subject to the limit:

- Trade Loss Relief against general income– available for losses made by an individual carrying on a trade, profession or vocation (section 64 Income Tax Act 2007 (ITA));
- Early Trade Losses Relief – available to an individual in the first four years of the trade, profession or vocation (section 72 ITA);
- Post-cessation Trade Relief – available for qualifying payments or qualifying events within seven years of the permanent cessation of the trade (section 96 ITA);
- Property Loss Relief against general income – available for property business losses arising from capital allowances or agricultural expenses (section 120 ITA);
- Post-cessation Property Relief – available for qualifying payments or qualifying events within seven years of the permanent cessation of the UK property business (section 125 ITA);
- Employment Loss Relief – available in certain circumstances where losses or liabilities arise from employment (section 128 ITA);
- Former Employees Deduction for Liabilities – available for payments made by former employees for which they are entitled to claim a deduction from their total income in the year in which the payment is made (section 555 Income Tax (Earnings and Pensions) Act 2003);
- Share Loss Relief on non-Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) shares – available for capital losses on the disposal (or deemed disposal) of certain qualifying shares (Chapter 6 Part 4 ITA);
- Losses on Deeply Discounted Securities – available only for losses on gilt strips and on listed securities held since at least 26 March 2003 (section 446 – 448 and section

453 – 456 Income Tax (Trading and Other Income) Act 2005; and

- Qualifying Loan Interest – available for interest paid on certain loans. These include loans to buy an interest in certain types of company, or to buy an interest in a partnership (Chapter 1 Part 8 ITA).

Exclusions

4.2 The limit does not apply to a relief in the following circumstances:

- to the extent that the relief is attributable to business premises renovation allowances;
- to deductions for trade or property loss relief or post-cessation trade or property relief made from profits of the same trade or property business;
- to the extent that trade loss relief is attributable to deductions of overlap relief; and
- to deductions for share loss relief where the shares are qualifying shares for EIS or SEIS relief.

Interaction with other provisions

4.3 The limit applies in addition to any other provisions that restrict relief, for example, relief for interest payments on a loan to invest in a film partnership is limited to 40 per cent of the interest that would otherwise be eligible for relief (section 399(4) ITA 2007). The 40 per cent qualifying element of the interest is then subject to the new limit.

5. Definition of income

5.1 This section sets out how an individual's adjusted total income is calculated for the purposes of the limit.

5.2 The principle is that individuals are treated equally by taking account of:

- the different ways that people make tax-relievable pension contributions, retirement annuity payments and charitable donations;
- the impact the above payments can have on the amount of their income for the purposes of income tax; and
- how they receive tax relief at their highest rate of tax on those payments.

5.3 The starting point for this calculation is the same for all individuals: their total income liable to income tax for the purposes of section 23 ITA. This figure is then adjusted based on the arrangements they make for pension deductions and/or charitable donations, to create a level playing field between those whose deductions are made before they pay income tax, and those whose deductions are made after tax. The result – "adjusted total income" – is the measure of income for the limit.

Pension contributions and charitable donations

5.4 People receive tax relief for pension contributions in a number of different ways, as illustrated in the example below.

5.5 Payments to an occupational pension scheme are commonly deducted from salary before tax through Pay As You Earn (a "net pay" arrangement). These payments are deducted when calculating an individual's total income under section 23 ITA. They therefore reduce the individual's income liable to tax, automatically providing tax relief at source at their highest rate of tax.

5.6 Other individuals make payments to their pension schemes out of their net income. The pension scheme then claims from HMRC the basic rate tax relief due which is added to the individual's pension pot (a "relief at source" arrangement). Higher and additional rate tax relief is provided to these individuals by adjusting their basic and higher rate bands. These payments are therefore not deducted when calculating the individual's total income.

5.7 People can also make tax relievable payments to retirement annuity schemes from their gross incomes that receive no tax relief at source. Instead individuals are able to claim from HMRC the full amount of the tax relief due ("relief on making a claim"). These payments are deducted from the individual's income when calculating their income tax liability (at step 2 of the calculation – see section 6).

5.8 An individual may have to claim relief from HMRC where it is not possible for the sponsoring employer or employers to deduct the whole amount of the contribution from the individual's employment income under a net pay arrangement because the contributions they pay in a tax year are more than the employment income they receive from the sponsoring employer(s) for the tax year. In these circumstances an individual may claim excess relief under section 193(4) Finance Act 2004 to obtain the balance of tax relief available on the contribution (see HMRC Registered Pension Scheme guidance, reference RPSM 05101360).

5.9 Finally the member of a non-UK pension scheme may be able to claim from HMRC migrant member relief or double taxation relief for the contributions they pay from their gross incomes to the scheme.

Example: Individuals with an income of £500,000 who pay £50,000 into a pension annually

Person (a) pays through net pay arrangements, person (b) has a personal pension with basic rate relief at source and person (c) makes a gross contribution to a retirement annuity

	(a) net pay	**(b) relief at source**	**(c) gross contribution**
"Total income" for the purpose of calculating tax	**£450,000**	**£500,000**	**£500,000**

5.10 There are similar differences between individuals who make charitable donations through a Payroll Giving scheme, and those who make donations through Gift Aid or make gifts of land and shares. Donations through Payroll Giving are deducted from salary before tax (similar to pension net pay arrangements), and automatically receive relief at the donor's highest rate. Conversely, donations using Gift Aid are made from taxed income. Basic rate tax relief for donations through Gift Aid are reclaimed by the charity, with any applicable higher and additional rate relief given by extending the donor's basic rate band. These differences are illustrated in the example below.

Example: Individuals with an income of £500,000 who make £50,000 of charitable donations

Person (a) donates through Payroll Giving, person (b) makes a gift aid donation and person (c)'s donation is in the form of land or shares

	(a) Payroll Giving	(b) Gift Aid	(c) Gift of land and/or shares
"Total income" for the purpose of calculating tax	£450,000	£500,000	£500,000

5.11 The first step in calculating an individual's total adjusted income for the purposes of the limit is to bring together all the amounts of income that is chargeable to income tax This is their "total income" (step 1, section 23 ITA).

5.12 The following amounts will then be deducted to determine adjusted total income;

- pension contributions made under relief at source arrangements
- payments into a retirement annuity
- amounts claimed in respect of pension contributions for:
    - excess relief
    - migrant member relief

- double tax relief

5.13 This will seek to ensure that people are treated equally regardless of the arrangements they have for making pension contributions. The deduction of tax for pension contributions recognises that they are effectively deferring income to be paid back at a later stage, as pensions. This treatment ensures that sums paid into pensions are not “double-counted”. Adjusted total income will therefore be a figure net of any pension contributions.

5.14 Individuals will have the opportunity on their Self Assessment tax return to declare donations made through Payroll Giving. For individuals who choose to do so, payments made under Payroll Giving arrangements will then be added back to their total income figure. This will ensure that people are treated equally regardless of the arrangements they have for making charitable donations.

5.15 The result will be the individual’s “adjusted total income”. The adjusted total income for the purpose of calculating the cap in each of these situations will be as set out in the examples below.

Example: Individuals with an income of £500,000 who pay £50,000 into a pension annually

Person (a) pays through net pay arrangements, person (b) has a personal pension with basic rate relief at source and person (c) makes a gross contribution to a retirement annuity

	(a) net pay	(b) relief at source	(c) gross contribution
Total income for the purpose of calculating tax	£450,000	£500,000	£500,000
Adjustment to total income	0	-£50,000	-£50,000
Adjusted total income for calculation of the limit	£450,000	£450,000	£450,000

Example: Individuals with an income of £500,000 who make £50,000 of charitable donations

Person (a) donates through Payroll Giving, person (b) makes a gift aid donation and person (c)'s donation is in the form of land or shares

	(a) Payroll Giving	(b) Gift Aid	(c) Gift of land and/or shares
Total income for the purpose of calculating tax	£450,000	£500,000	£500,000
Adjustment to total income	+£50,000	0	0
Adjusted total income for calculation of the limit	£500,000	£500,000	£500,000

6. Order of relief

6.1 Some tax reliefs reduce the amount of the individual's income before the calculation of their income tax liability starts. Examples are pension net pay arrangements and Payroll Giving where relief is given by reducing the amount of the individual's gross pay brought into their tax calculation. Other tax reliefs are given effect as a deduction calculating the individual's total income. Below is the statutory structure for calculating the amount of an individual's income which is liable to income tax (section 23 ITA).

1. Step 1 determines the individual's "total income" by bringing together all the amounts of income (components) on which the individual is liable to income tax.

2. Step 2 deducts those reliefs (other than personal allowances) that are given effect against the individual's total income. These may be reliefs that reduce total income or a component of total income. The general rule is that the order in which such reliefs are given is that which results in the greatest reduction in the individual's income tax liability is given first (section 27 ITA 2007). The result after step 2 is the individual's net income for the year.

3 Step 3 deducts the personal allowance and blind person's allowance (where applicable) from net income.

4 Step 4 applies the rates of tax to the amounts of components remaining after step 3. It is at this step that any extension to an individual's basic rate limit or higher rate limit is given effect to provide higher rate relief or additional rate relief on Gift Aid donations or personal pension contributions that have had basic rate relief at source.

5 Step 5 adds together the amounts of tax calculated on each component.

6. Step 6 deducts 'tax reducers'. These include, for example, relief in respect of subscriptions for shares qualifying under the Enterprise Investment Scheme where, since 6 April 2011, tax relief is available at 30 per cent of the cost of the shares (Part 5 ITA).

7. Finally, Step 7 adds any other amounts of income tax to which the individual is liable. This could be, for example, to recover

excess relief for Gift Aid, pension scheme provisions or the Child Benefit Charge. The result is the individual's tax liability for the tax year.

6.2 The reliefs that are limited all take effect at **step 2** of the income tax calculation. Where an individual has more than one step 2 relief, they can decide which reliefs they wish to use in a tax year, and therefore the extent to which those separate reliefs contribute to their relief limit for the year.

6.3 The example below shows how a combination of reliefs might be applied.

Example - Patrick

Patrick has total income in 2013-14 of £400,000 and his relief limit is £100,000 (25 per cent of £400,000). He has a combination of payments and losses he wants to claim relief for as follows:

- Qualifying loan interest £70,000
- Property losses £50,000
- Trade losses £30,000

As Patrick's claim for relief will exceed his relief limit, he considers how to apply his reliefs and decides his 2013-14 relief limit of £100,000 will comprise:

- Qualifying loan interest relief £70,000 plus
- Property loss relief £30,000

He chooses to prioritise his loan interest relief as he cannot use this relief in another year. He makes the balance up with his property losses and he uses the remainder of that relief against 2014-15 total income. He carries forward his trade losses to use against income in future years from the same trade.

7. Claims involving more than one year

7.1 Some claims allow loss relief to be given by reference to the income of a tax year or tax years earlier than the year of loss. These include claims to Trade Loss Relief, Early Trade Losses Relief, Employment Loss Relief and Share Loss Relief.

7.2 Claims for loss relief involving more than one year relate to the later year, in which the loss arises. Where the later year is 2013-14, a relief limit must be calculated for each earlier year involved in the claim, as illustrated in the following example:

Example – Julie

Julie runs an established trade that makes up annual accounts to 30 April. Her accounts to 30 April 2013 adjusted for tax purposes produce an allowable loss of £110,000 for tax year 2013-14. Julie wants to use as much as she can against her total income for 2013-14 and the previous year 2012-13. Julie's total income is £200,000 in both 2012-13 and 2013-14 giving her a relief limit of £50,000 in each year.
2013-14 Trade loss relief £50,000
2012-13 Trade loss relief £50,000

leaving £10,000 unrelieved 2013-14 losses to carry forward against future profits from the same trade.

<u>How the limit applies to transitional years</u>

7.3 Relief for losses arising in years prior to 2013-14 is not subject to the limit. But if a relief arising for 2013-14 or a later tax year is given by reference to a year before 2013-14, the limit does apply and is calculated by reference to the adjusted total income of that earlier year.

7.4 Property loss relief against total income can be given in the loss-making year or the subsequent year. If a 2012-13 property loss is claimed against total income of the 2013-14 tax year, the limit will not apply as the loss is a 2012-13 loss.

7.5 The limit applies even if the relevant financial arrangements were entered into before this legislation. If those arrangements result in a loss in 2013-14 or a later year, any relief will be subject to the limit. For example shares purchased prior to 2013-14 that are disposed of (or deemed to be disposed of) at a loss in 2013-14 or later, that qualify for Share Loss Relief (but not EIS/SEIS relief) will be subject to the limit. Similarly, qualifying loan interest paid in 2013-14 and subsequent years on loans taken out prior to 2013-14, will be subject to the relief limit.

8. **Specific Circumstances**

8.1 This section provides guidance for unusual or specific circumstances where consultation feedback has suggested that the calculation of the relief limit may be more complex. The circumstances covered here are:

- calculation of adjusted total income for long term UK resident non-domiciles paying the Remittance Basis Charge; and
- the application of the limit where an individual carries on multiple activities.

<u>Remittance Basis Charge Payers</u>

8.2 The Remittance Basis Charge (RBC) is a £30,000 tax liability for long term UK resident non-domiciles who claim the remittance basis. From April 2012, a second tier of the charge of £50,000 came into effect for longer term UK residents. The RBC charges tax on foreign income and capital gains nominated by the individual resulting in an increased tax liability of £30,000 or £50,000. A very small number of individuals paying the RBC will also claim reliefs in excess of £50,000 and be subject to the limit of 25 per cent of income. For these individuals the amount of income in fact required to generate the RBC is taken into account in calculating income for the purpose of the limit. If insufficient foreign income or gains are actually nominated to generate the necessary tax increase a further amount of foreign income is deemed to have been nominated in addition to the actually nominated income and gains.

8.3 The actual or deemed nominated income figure is added to the individual's total income (at step 1 of the income tax calculation) to calculate the limit on reliefs as illustrated in the example below:

Example – Emilia

Emilia has £2,000,000 UK source income, claiming reliefs subject to the limit of £600,000, and is claiming the remittance basis with liability to the £30,000 remittance basis charge.

Based on the UK income without the nominated income the reliefs would be limited to £500,000 leaving £1,500,000 in charge to tax. The UK income fully occupies the basic and higher rate bands so it is necessary, to produce a tax increase of £30,000, to nominate £66,667 of income as this will be taxed at the additional rate of 45 per cent to produce a tax increase of £30,000. The £66,667 is added to the UK source income for the purpose of calculating the relief limit giving Emilia a relief limit of £516,667 (25 per cent of £2,066,667).

8.4 In rare circumstances the increase in the relief will impact on the marginal tax rates applicable to the calculation of the RBC. This is because the increase in the relief limit affects the calculation of nominated income. In these cases a calculation loop can emerge as illustrated in the next example:

Example – Oliver

Oliver has £200,000 UK source income, claiming reliefs subject to the limit of £70,000, and is claiming the remittance basis with liability to the £30,000 remittance basis charge.

Based on the UK income without the nominated income the reliefs would be limited to £50,000 leaving £150,000 in charge to tax. The UK income fully occupies the basic and higher rate bands, so in order to produce a tax increase of £30,000, it is necessary to nominate £66,667 of income which will be taxed at the additional rate of 45 per cent to produce a tax increase of £30,000. The £66,667 will also be added to the UK source income for the purpose of calculating the relief limit.

When the £66,667 nominated income is added to the £200,000 UK income the relief limit is increased to £66,667 (25 per cent of £266,667). The increased limit results in £16,667 of the nominated income, which was taxed at 45 per cent, to fall into the higher rate band (40 per cent). The £66,667 nominated income now only yields an additional £29,167 in tax. This means that the nominated income for the RBC has to increase to £68,750 to produce the £30,000 charge.

That in turn increases the relief limit to (25 per cent of £268,750) £67,188; which in turn reduces the tax yield on the nominated income to £29,375.20 and so on.

8.5 This calculation can continue in a permanent loop. But in most cases after three calculations the result varies by less than £1. The nominated figure of income for the relief limit should be taken at the third calculation, and rounded-up to the next whole pound.

8.6 The calculation will be performed in the Self Assessment process in which the appropriate nominated income figure will be used. This situation will affect only a very small number of individuals and HMRC is not producing a separate calculator. Additional assistance with the calculation will be given as required on request.

Multiple activities

8.7 Trade loss relief against general income and early trade losses relief are included in the reliefs that are subject to the relief limit, except for certain exclusions for losses attributable to business premises renovation allowances or a deduction for overlap relief.

8.8 In addition the limit does not apply to trade loss relief against total income or early trade losses relief to the extent that a trade loss is set against profits from the same trade of an earlier year.

8.9 Where an individual carries on more than one type of activity it is important to identify the scope of the trade to which the losses relate. Different trading activities carried on by an individual may be part of the same trade or comprise separate trades. This is an important distinction as in the case of a single trade the profits and losses from different trading activities would be amalgamated in arriving at the profit or loss of the trade and only the overall trade loss would be subject to the limit. However, in the case of separate trades and a claim to set-off a loss from one trade against the profit of another, the profit of latter would be general income and so relief would be subject to the limit.

8.10 In most cases the scope of the trade will be obvious as the trader will be carrying on one type of trading activity. The position may, however, be less clear where a trader is carrying on a number of different types of trading activity.

8.11 The scope of a trade is a question of fact. The starting point is simply to look at what the trader does, informed by what they say that they are trying to do, and then consider:

- Which activities are trading activities?
- How far the activities are run as one business?
- How far do the activities depend upon each other? Could one activity continue to exist independently of the other?
- Whether the activities look like the same business, for example do they have the same trading name?

8.12 There is nothing in law to prevent the owner of a business carrying on more than one trade at the same time but it is unusual for trading activities carried on by the same person, or persons, to amount to more than one trade unless:

- the activities are so fundamentally different that they cannot constitute one trade; or
- the activities are not interconnected, interlaced nor interdependent.

8.13 It is important not to take too narrow a view; a single trade can be a broad umbrella covering various connected trading activities. It is also important to remember that businesses will change over time, so whilst for tax purposes the trade is the same trade, the scope of the trade today may be different to that of five or ten years ago.

Example: John

John owns and runs a hotel. It has the typical features of a hotel of its type, with restaurant, gymnasium and other facilities. John also owns and runs separate conference facilities, a 9 hole golf course and driving range, and provides wedding packages. He also lets holiday cottages.

- The conference facilities are built on the side of the hotel and are run as an integral part of the hotel, using the bank account, the same reception, cleaning and catering staff;

- The 9-hole golf course and driving range adjoins the hotel, John runs it as an attraction for hotel guests but it is also open to non-residents. It is advertised under the hotel name and the same staff maintain the golf course and hotel grounds;

- John has obtained a wedding licence for a historic barn. Although the barn is on the other side of the golf course from the hotel, the weddings are run as part of the hotel, with the catering provided from the hotel kitchens;

- The holiday cottages qualify as furnished holiday lettings, the cottages are cleaned between guests by the hotel cleaners.

John is operating the different trading activities as a single business, with common management and common staff. The only activity that is not part of the hotel trade is the letting of holiday cottages, because these are part of a property business and not a trading activity.

The position could be different if the facts were changed. If the golf course was run completely separately, with its own management and staff, so that the only point in common was that John owned them both, then John would have two trades, an hotel and a golf course.

Annex A: **Examples of reliefs not subject to the limit**

The list below provides examples of some reliefs that are not covered by the limit because they are either computational in nature, for example prevent double taxation, they cannot be used against total income, are subject to existing limits, do not apply to individuals or have been excluded for policy reasons. This section is for reference purposes and will not form part of final guidance.

- Relief for charitable donations: Gift Aid, payroll giving, gifts of land and shares and Community Investment Trust Relief
- Business Investment Exemption (Part 2 Schedule 12 of the 2012 Finance Act)
- Annual Payments
- Foreign tax credit
- Dividend tax credit
- Terminal trade loss relief
- Losses arising from furnished holiday lettings
- Losses arising from miscellaneous transactions listed at section 1016 ITA 2007
- Enterprise Investment Scheme
- Seed Enterprise Investment Scheme
- Venture Capital Trust
- Relief for Pension savings
- Qualifying loan interest paid by a personal representative on a loan to pay inheritance tax

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