HM Revenue
& Customs

Business Assets and International
Customer Strategy and Tax Design
Royal House, Prince's Gate
2-6 Homer Road
Solihull
B91 3WG

Tim Good
Absolute Accounting Software
Commerce House
Telford Road
BICESTER
OX26 4LD

Phone 03000 530 261
9:00am - 5:30pm

Email robby.wells@hmrc.gsi.gov.uk

Web www.gov.uk

Date 6 February 2018

Dear Mr Good

Top Slicing Relief

With regard to your article for Taxation magazine, published on 27 September 2017, entitled Calculating top slicing relief (TSR), I'd like to draw your attention to what we believe are some inaccuracies in how you presented the calculation.

Apologies for our delay in responding to this matter. We have been carefully working through the issue to ensure we provide the right advice and are now in a positon to provide a full response. We are also providing this information to the agent community so that they are properly able to advise their clients.

In your article you make a number of points:

1. You advise that HMRC's SA Calculator does not operate correctly, as it does not take into account various allowances during the calculation process. You also advise that commercial software designed to replicate the calculation also operates incorrectly.

2. Your position is that the legislation does not specify that TSR should only apply to those taxpayers who straddle higher tax bands. The calculations in section 535 Income Tax (Trading and Other Income) Act 2005 (ITTOIA) should be applied to all taxpayers. You work through a number of examples to demonstrate your point in the article.

3. You state that HMRC's calculation takes shortcuts that bypass the legislation, leading to the amount of TSR being miscalculated. These shortcuts result in the calculation of the relieved liability on the annual equivalent not taking into account the savings rate band, personal savings allowance or personal allowance.

4. In your opinion, when the calculation of the relieved liability on the annual equivalent is performed, the calculation of income tax due under Income Tax Act 2007 (ITA) should be performed as if the gain is limited to the amount of the annual equivalent. In most of the provided examples, this means that the individual is entitled to a greater value of allowances on their step 2 calculation than their step 1 calculation,

which results in a lower tax value on the second calculation, and a larger amount of TSR.

We acknowledge that while the SA Calculator works for the vast majority of taxpayers, in some instances it is not calculating TSR correctly, and HMRC will be including this on the new Exclusion List for the SA Calculator, so that those affected can send in paper forms. We accept that the SA Calculator does not currently include the starting rate for savings or personal savings allowance for those entitled to it in the background calculation for TSR. This was an oversight and we are grateful to you for drawing this to our attention.

On your point about the when the calculation of the relived liability on the annual equivalent is performed, HMRC's view is that is that your analysis is incorrect. An individual's entitlement to allowances is determined for a particular tax year by the quantum of the individual's income for the year. To establish the TSR available the calculation requires the calculation of a notional gain. This is a fictional gain required to establish the amount of TSR available and does not change the actual amount of savings income or the total income for the individual for the tax year or the entitlement to allowances. It does not allow for reshaping the taxpayer's Income Tax position overall as if the fictional gain computed under the TSR rules were the actual gain.

Appendix 1 sets out a fuller explanation of HMRC's view: setting out the policy objective; the legislation; the calculation of Income Tax liability; HMRC's analysis and a number of examples based on HMRC's interpretation. Appendix 2 provides the detailed calculations for all examples.

We hope this letter clarifies HMRC's view and enables you to advise your clients on the correct calculation of TSR.

Yours sincerely

Robby Wells
Policy and Technical Adviser

Enc

Join the millions of taxpayers already using their Personal Tax Account to access a range of HMRC services. It takes just a few minutes to get started, go to www.gov.uk/personal-tax-account

To find out what you can expect from us and what we expect from you go to www.gov.uk/hmrc/your-charter and have a look at 'Your Charter'.

Policy objective

The chargeable event regime encompasses life insurance policies, life annuity contract and capital redemption policies. The approach of the regime is to charge Income Tax on a realisations basis, rather than an accruals basis. Individuals are not charged when property held in these policies is sold, or on the movement in the value of the policies. Instead, the individual is charged to tax when value is removed from the policy. This can be during the life of the policy, in which case it is a part surrender, or at the end of the ownership of the policy, when it is surrendered, assigned or the policy matures. There are some other instances dealt with in the legislation.

The realisations basis may benefit some individuals. For example, if the charge on the gains is deferred until after retirement, then the individual's income is likely to be lower, so the gains will potentially be subject to a lower tax rate than if they had been charged to tax on an accruals basis.

By contrast, many individuals could suffer a disadvantage as a result of the realisations basis. They are charged to tax, in a single year, on gains that have accrued over a number of years. TSR is intended to assist with this, as its effect is to reduce the rate of tax charged on the gain by viewing it as spread over the life of the policy.

When holders of policies are charged to tax on their gains, they are treated as having paid Income Tax at the basic rate on the amount of the gain. Policyholders therefore only pay further tax if they are subject to tax at the higher or additional rate, and at the marginal rate between these rates and the basic rate.

TSR applies when a chargeable event gain straddles tax rate bands. The aim is to counteract the effect of the gain pushing an individual into a higher rate band when, although having accrued over the life of the policy, the total gain is charged in a single year.

If an individual has income (excluding the gain) subject to the higher rate, and all of the gain is within the higher rate band, then no TSR will be available. The aim of TSR is to assist taxpayers who have become higher rate taxpayers only by virtue of their chargeable event gains for the tax year concerned. In this case, the taxpayer was already a higher rate taxpayer. The chargeable event gain has not brought the taxpayer into the higher rate band and so TSR does not apply.

Legislation

TSR is a relief available to individuals liable to tax on a chargeable event gain arising under Chapter 9 of ITTOIA. The relief applies to individuals whose chargeable event gains straddle two income tax bands. The TSR legislation is contained in sections 535-537 ITTOIA.

S535 ITTOIA

This section sets out the criteria for determining whether an individual is entitled to TSR, and, if so entitled, provides the method for allocating the relief.

An individual is entitled to relief if their liability for the tax year, as defined in this section, exceeds their relieved liability for the tax year.

An individual's liability for the tax year is arrived at by deducting the Income Tax at basic rate treated as having been paid by section 530 ITTOIA from the total liability to Income Tax due on the chargeable event gains.

An individual's relieved liability is arrived at by following the steps set out in section 536 ITTOIA (for a single chargeable event) or section 537 ITTOIA (for multiple chargeable events).

In carrying out any of the calculations in respect of TSR, the highest part assumption applies. This means that the chargeable event gain is treated as the highest part of the individual's income for the year.

S536 ITTOIA

This section shows how to perform the calculation of an individual's relieved liability for a single chargeable event. The calculation has three steps.

Step 1

Find the annual equivalent of the gain. To do this, divide the amount of the gain by the number of complete years for which the policy/contract was held (N).

Step 2

Find the relieved liability on the annual equivalent. This is done by calculating the individual's liability to income tax on the annual equivalent on the basis that the gain is limited to the value of the annual equivalent, with highest part assumptions applying, and deducting the basic rate relief due on the annual equivalent, calculated under section 530.

Step 3

The relieved liability is multiplied by N.

Section 537 ITTOIA

Section 537 mirrors the calculation in section 536, but under Step 1 adds together the annual equivalent for each chargeable event.

The Calculation of Income Tax Liability

Chargeable event gains are treated as savings income for the purposes of ITA by virtue of section 18(4)(a) ITA. This is a component of the individual's total income for the year under section 23 ITA.

Personal Savings Allowance

An individual's entitlement to the Personal Savings Allowance is determined by the conditions in section 12B ITA.

This section states that if any of the individual's income for the year is additional rate income, the individual's allowance for the year. If they have income charged to higher rate, and no additional rate income, the allowance for the year is £500, and if they have neither higher nor additional rate income, the allowance is £1,000.

Starting Rate for Savings

The rules for calculating how much income is charged at the starting rate for savings nil rate are in sections 12 and 12B ITA.

In summary, if an individual's non-savings income is less than £5,000 more than the personal allowance (e.g. over £16,000 for 2016/17), then they are entitled to the nil rate on their savings income, up to that limit. If the individual's non-savings income is less than the personal allowance, the individual is entitled to the full £5,000 of savings income at the nil rate.

Personal Allowance

Section 35 ITA describes the rules for an individual's entitlement to claim a personal allowance, with sections 36 and 37 describing the rules for those born between 1938 and 1948, and those born before 1938 respectively.

It states that an individual's allowance is reduced when their adjusted net income exceeds £100,000. Adjusted net income is defined in section 58 ITA, and is based on their net income for the tax year, which is the sum of the amounts up to Step 2 of section 23 ITA.

HMRC's Analysis

As I set out at the start of this letter we do not agree in full with the treatment you suggest in your article. Our disagreement lies with your interpretation of Step 2 in section 536(1) ITTOIA.

You have suggested that when calculating the relieved liability on the annual equivalent, a full calculation of income tax should be performed under ITA, with all the allowances due that would be due if the gain from the chargeable event is limited to the amount of the annual equivalent. In your examples, this leads to larger allowances as this notional gain reduces the individual's total income.

However, it is our view that an individual's entitlement to the personal savings allowance is determined by whether any of their income for the year is additional rate or higher rate income. This is determined in the main calculation for Income Tax under ITA, and is not affected by the notional calculation of the annual equivalent. This means that if an individual's chargeable event gain in a particular tax year moves their income for that year into the additional rate band, then no personal savings allowance is available. This will be the case when calculating the liability on the annual equivalent, even if their notional total income would be below the additional rate threshold.

The amount of savings income that can be treated as falling within the starting rate for savings and the savings nil rate is determined by section 12A ITA, and this too is not affected by the notional calculation of the liability on the annual equivalent, as for the personal savings allowance.

As I have previously made clear an individual's entitlement to these allowances is determined for a particular tax year by the individual's income for that year. The calculation of the relieved gain using the notional gain does not change the amount of income for the individual for the tax year, so does not affect their entitlement to these allowances.

Example 1

In 2016/17 an individual has employment income of £100,000 and a chargeable event gain of £100,000 on the surrender of a life insurance policy held for 2 years.

In this example you calculate that TSR of £2,900 is due whilst the Tax Calculator shows £2,500 (see Appendix for my detailed calculations for all examples).

In this example, however, TSR of £2,500 is correct. The difference between the two calculations arises because when calculating the individual's relieved liability you allow the benefit of the personal savings allowance whilst the Tax Calculator does not. In this example the Tax Calculator gives the correct result.

Section 12B (2) ITA states that,
"If any of the individual's income for the year is additional-rate income, the individual's savings allowance for the year is nil"

The personal savings allowance is not therefore available where any part of an individual's total income for the year is charged to additional rates.

I note your proposition that when calculating relieved liability "the only way to perform this calculation must be to carry out the ITA 2007 income tax calculation 'on the basis that the gain from the chargeable event is limited to the amount of the annual equivalent'". I do not agree. Section 12B (2) ITA is only concerned with an individual's income for the year. Section 536 ITTOIA requires a calculation of liability to income tax on an annual equivalent but specifically only using highest part assumptions and with an amended basic rate tax credit. There is nothing within section 536 that requires recalculation of allowances based on the annual equivalent. Therefore, the relieved liability calculation must use allowances based on total income rather than the annual equivalent.

Example 2

In 2016/17 an individual has no income other than a chargeable event gain of £250,000 on the encashment of a UK non-qualifying life insurance policy held for two years.

In this example you calculate that TSR of £12,600 is due. You consider that the Tax Calculator gives the wrong result as in calculating both the individual's liability and relieved liability on the chargeable event gain the effect of the starting rate for savings and the personal savings allowance is overlooked.

I agree that the starting rate for savings should feature in the calculations under sections 535 (3) and 536 ITA. The individual has no non-savings income and so the starting rate for savings should be allowed in full. For the reasons outlined in Example 1, no personal savings allowance can be given in either calculation. See the appendix for my detailed calculations.

As the Tax Calculator does not allow the starting rate for savings in this scenario, it will be amended as soon as practicable. In the interim I agree that individuals that have been overcharged should submit revised tax returns.

Example 3

In 2016 an individual employment income of £95,000 and a chargeable event gain of £100,000 on a life insurance policy held for ten years.

In this example you calculate that TSR of £21,250 is due whilst the Tax Calculator only gives relief of £2,250.

The difference between the two calculations arises because your calculation of relieved liability allows personal allowances of £8,500 and the personal savings allowance of £500. The issue of the personal savings allowance and personal allowance has been addressed above.

Section 35 ITA withdraws allowances once adjusted net income (as defined in section 58 ITA) exceeds £100,000. Personal allowances are therefore given in relation to adjusted net income. As set out above there is no provision to recalculate personal allowances when making a calculation of relieved liability under section 536. In this scenario the Tax Calculator gives the right result.

Example 1

In 2016/17 a customer has employment income of £100,000 and a chargeable event gain of £100,000 on the surrender of a life insurance policy held for 2 years.

Before the effect of TSR (section 535 ITTOIA) the income tax payable is:

Employment Income	100,000
Chargeable Event Gain	100,000
Total income	200,000
Personal allowance	Nil

Employment Income	Income	Rate	Tax
Basic Rate	32,000	20%	6,400
Higher Rate	68,000	40%	27,200
Chargeable Event Gain			
Higher Rate	50,000	40%	20,000
Additional Rate	50,000	45%	22,500
Total Tax			76,100

Top Slicing Relief

1. Total Liability

In this example, the individual's liability to income tax on the gain is £42,500 (i.e. £50,000 at 40% and £50,000 at 45%). Less the £20,000 BR liability this gives a liability on the gain of £22,500.

Higher Rate	50,000	40%	20,000
Additional Rate	50,000	45%	22,500
			42,500
Less			
Basic Rate Liability	100,000	20%	(20,000)
			22,500

2. Relieved Liability

The Annual Equivalent is the gain spread over the number of years the policy was held. For this calculation of relieved liability N = 2. The calculation is therefore based on a gain of £50,000. This is all chargeable at 40% giving rise to a liability of £20,000. Less the £10,000 BR liability this gives a figure of £10,000. Multiplied by N gives a relieved liability of £20,000.

Gain	100,000		
Years held (N)	2		
Annual Equivalent	50,000		
Higher Rate	50,000	40%	20,000
			20,000
Less			
Basic Rate Liability	50,000	20%	(10,000)
			10,000
Liability x N			20,000

TSR is therefore:

Total liability	22,500
Less relieved liability	(20,000)
Top slicing relief	2,500

This is the amount of TSR that the SA Tax Calculator gives in this situation.

Therefore, the individual's final tax position is:

Total Tax Liability	76,100
Top Slicing Relief	(2,500)
Basic Rate Relief	(20,000)
Tax Due	53,600

Article Calculation

Total liability (as above) is £22,500.

Relieved liability

Nil Rate	500	0%	0
Higher Rate	49,500	40%	19,800
			19,800
Less			
Basic Rate Liability	50,000	20%	(10,000)
			9,800
Liability x N			19,600

Total liability	22,500
Less relieved liability	(19,600)
Top slicing relief	2,900
Total Tax Liability	76,100
Top Slicing Relief	(2,900)
Basic Rate Relief	(20,000)
Tax Due	53,200

Example 2

In 2016/17, an individual had no income other than a chargeable event gain of £250,000 arising from a policy they had held for two years.

The initial tax calculation, before TSR is:

Employment Income	0		
Chargeable Event Gain	250,000		
Total income	250,000		
Personal allowance	Nil		
Chargeable Event Gain	Income	Rate	Gain
Starting Rate	5,000	0%	0
Basic Rate	27,000	20%	5,400
Higher Rate	118,000	40%	47,200
Additional Rate	100,000	45%	45,000
Total Tax Liability			97,600

Top Slicing Relief

1. Total Liability

To calculate the TSR, we currently take the tax due on the gain, without applying the Starting Rate for Savings, which means that £32,000 is in the basic rate band, and the liability to income tax is £130,100. Please note that we consider that the tax calculator is incorrect in doing so and the £5,000 starting rate should be applied. This is reflected in the calculation below.

Starting Rate	5,000	0%	0
Basic Rate	27,000	20%	5,400
Higher Rate	118,000	40%	47,200
Additional Rate	100,000	45%	45,000
			97,600
Less			
Basic Rate Liability	250,000	20%	(50,000)
			47,600

2. Relieved Liability

We calculate the tax due on the Annual Equivalent. In this case that is £125,000.

Gain	250,000		
Years held (N)	2		
Annual Equivalent	125,000		
Starting Rate	5,000	0%	0
Basic Rate	27,000	20%	5,400
Higher Rate	93,000	40%	37,200
			42,600
Less			
Basic Rate Liability	125,000	20%	(25,000)
			17,600
Liability x N			35,200

This is the Relieved Liability, and so TSR is:

Total liability	47,600
Less relieved liability	(35,200)
Top slicing relief	12,400

Therefore, the individual's final tax position is:

Total Tax Liability	97,600
Top Slicing Relief	(12,400)
Basic Rate Relief	(50,000)
Tax Due	35,200

Article Calculation

Total Liability

Starting Rate	5,000	0%	0
Basic Rate	27,000	20%	5,400
Higher Rate	118,000	40%	47,200
Additional Rate	100,000	45%	45,000
			97,600
Less			
Basic Rate Liability	250,000	20%	(50,000)
			47,600

Relieved Liability

Gain	250,000		
Years held (N)	2		
Annual Equivalent	125,000		
Starting Rate	5,000	0%	0
Savings Allowance	500	0%	0
Basic Rate	26,500	20%	5,300
Higher Rate	93,000	40%	37,200
			42,500
Less			
Basic Rate Liability	125,000	20%	(25,000)
			17,500
Liability x N			35,000

Total liability	47,600
Less relieved liability	(35,000)
Top slicing relief	12,600

Therefore, the individual's final tax position is:

Total Tax Liability	97,600
Top Slicing Relief	(12,600)
Basic Rate Relief	(50,000)
Tax Due	35,000

Example 3

In 2016/17 the customer has employment income of £95,000 and a chargeable event gain of £100,000 on the surrender of a UK policy held for 10 years.

Before the effect of TSR, the income tax payable is:

Employment Income	95,000
Chargeable Event Gain	100,000
Total income	195,000
Personal allowance	0

Employment Income	Income	Rate	Tax
Basic Rate	32,000	20%	6,400
Higher Rate	63,000	40%	25,200
Chargeable Event Gain			
Higher Rate	55,000	40%	22,000
Additional Rate	45,000	45%	20,250
Total Tax			73,850

1. Total Liability

Higher Rate	55,000	40%	22,000
Additional Rate	45,000	45%	20,250
			42,250
Less			
Basic Rate Liability	100,000	20%	(20,000)
			22,250

2. Relieved Liability

Gain	100,000		
Years held (N)	10		
Annual Equivalent	10,000		
Basic Rate	0	20%	0
Higher Rate	10,000	40%	4,000
Additional Rate	0	45%	0
			4,000
Less			
Basic Rate Liability	10,000	20%	(2,000)
			2,000
Liability x N			20,000

This is the Relieved Liability, and so TSR is:

Total liability	22,250
Less relieved liability	(20,000)
Top slicing relief	2,250

Therefore, the individual's final tax position is:

Total Tax Liability	73,850
Top Slicing Relief	(2,250)
Basic Rate Relief	(20,000)
Tax Due	51,600

Article Calculation

1. Total Liability

Total liability (as above) is £22,250.

2. Relieved liability

The Annual Equivalent is £10,000. This means that total income would be £105,000, resulting in a personal allowance of £8,500 and Nil Rate PSA of £500.

His calculation for income is then as follows:

Gain	100,000
Years held (N)	10
Annual Equivalent	10,000

Personal Allowance	8,500	0%	0
Savings Allowance	500	0%	0
Higher Rate	1,000	40%	400
			400
Less			
Basic Rate Liability	1,500	20%	(300)
			100
Liability x N			1,000

This results in TSR of:

Total liability	22,250
Less relieved liability	(1,000)
Top slicing relief	21,250

The tax then due is:

Total Tax Liability	73,850
Top Slicing Relief	(21,250)
Basic Rate Relief	(20,000)
Tax Due	32,600

This is a difference of £19,000.

Note on Article Calculation

The personal allowance in the example in the article has been utilised against the chargeable event gain, when the highest part assumptions would mean that the personal allowance should have been put against the employment income in any such example.

Notwithstanding our view that the individual is not entitled to a personal allowance in this case, we think that the calculation for relieved liability in the article should have been:

Employment Income	Income	Rate	Tax
Basic Rate	32,000	20%	6,400
Higher Rate	54,500	40%	21,800
Annual Equivalent			
Savings Allowance	500	0%	0
Higher Rate	9,500	40%	3,800
			3,800
Less			
Basic Rate Liability	10,000	20%	(2,000)
			1,800
Liability x N			18,000

Total liability	22,250
Less relieved liability	(18,000)
Top slicing relief	4,250

Total Tax Liability	73,850
Top Slicing Relief	(4,250)
Basic Rate Relief	(20,000)
Tax Due	49,600

This is a difference of £2,000, which would be entirely due to the PSA with the effect multiplied over 10 years.