Chapter 1

Introduction to the UK tax system

Introduction

The purpose of this first chapter is to provide an overview of the UK tax system. The principal UK taxes are introduced and classified and the main sources of tax law are explained. This chapter also outlines the structure and the functions of Her Majesty's Revenue and Customs (the organisation which is responsible for the administration of the UK tax system) and describes the procedure which is used to assess the tax liability of an individual in each tax year. The chapter concludes by distinguishing between tax evasion and tax avoidance.

UK taxes

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

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

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

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

Statute law

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

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<th>Tax</th>
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<td>Capital Allowances Act 2001</td>
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<td>Income Tax (Trading and Other Income) Act 2005</td>
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<td>Customs and Excise Management Act 1979</td>
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These statutes are amended each year by the annual Finance Act, which is based upon the Budget proposals put forward by the Chancellor of the Exchequer. Some of the tax statutes provide for the making of detailed regulations by statutory instrument. A statutory instrument (SI) is a document which is laid before Parliament and then automatically becomes law within a stated period unless any objections are raised to it.

Tax Law Rewrite project

The "Tax Law Rewrite" project was established in 1996 with the aim of rewriting UK tax legislation in such a way that it is clearer and easier to use. The output of this project includes CAA 2001, ITEPA 2003, ITTOIA 2005, ITA 2007, CTA 2009, CTA 2010 and TIOPA 2010. The project has now come to an end.
European Union law

Membership of the European Union (EU) involves adherence to EU law and if there is a conflict between EU law and the law of a member state then EU law takes priority. This applies as much to tax as to any other category of law and the EU’s influence on UK tax law may increase over time. At present, the main impact is on VAT, where the prevailing legislation takes the form of EU Directives. These Directives are binding on the UK and they dictate the results which the internal legislation of the UK must bring about.

Case law

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

Statements made by the tax authorities

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

(a) **Statements of Practice.** A Statement of Practice (SP) sets out the HMRC interpretation of tax legislation and clarifies the way in which the law will be applied in practice. For example, SP 2/02 (the second SP issued in 2002) deals with the taxation treatment of exchange rate fluctuations.

(b) **Extra-Statutory Concessions.** An Extra-Statutory Concession (ESC) consists of a relaxation which gives taxpayers a reduction in liability to which they are not entitled under the strict letter of the law. In general, concessions are made so as to resolve anomalies or relieve hardship. For example, ESC C5 is concerned with the income of industrial and provident societies.

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

(c) **Press releases.** These are issued throughout the year on a variety of tax-related subjects. Of especial interest are the press releases and notes which are issued on Budget day and which provide a detailed explanation of the Budget proposals.

(d) **Internal Guidance Manuals.** HMRC produces a comprehensive set of internal tax manuals for the guidance of its own staff. These manuals may be inspected at HMRC Enquiry Centres or accessed via the Internet.

(e) **Leaflets.** These are aimed at the general public and explain the tax system in non-technical language. For example, HMRC leaflet IR121 is a guide to tax and national insurance contributions for those approaching retirement.

Most of the information produced by the tax authorities is now available on the HMRC website, the address of which is [www.hmrc.gov.uk](http://www.hmrc.gov.uk).
The tax year

The changes to the tax system that are proposed in the annual Budget speech in March are generally intended to take effect as from the start of the next tax year. For individuals, a tax year, which is also known as a fiscal year or year of assessment, runs from 6 April to the following 5 April inclusive. For instance, tax year 2009-10 began on 6 April 2009 and ended on 5 April 2010. However, the tax year for companies is slightly different from the fiscal year. A corporation tax financial year runs from 1 April to the following 31 March and is identified by the year in which it begins. For instance, the financial year known as FY2009 began on 1 April 2009 and ended on 31 March 2010.

This book takes into account the provisions of Finance Act 2010 (based on the March 2010 Budget) and describes the UK taxation system for fiscal year 2010-11 and financial year FY2010. The book also covers the provisions of the June 2010 Emergency Budget insofar as these provisions affect 2010-11 and FY2010.

Structure of HM Revenue and Customs

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

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

The routine work of HMRC is carried out by officials known as Officers of Revenue and Customs. With regard to direct taxation, the main function of these officials is to calculate or "assess" a taxpayer's tax liability and then to ensure that the correct amount of tax is paid. Under the Self Assessment system (see later in this chapter) a taxpayer may calculate his or her own tax liability, in which case HMRC officials will check that the taxpayer's self-assessment is correct.

At one time, tax assessment was the responsibility of Inspectors of Taxes whilst tax collection was handled separately by Collectors of Taxes. However, this separation of assessment and collection is now seen as outdated and the two functions have been combined. In consequence, the terms "Inspector" and "Collector" have been dropped in favour of the above-mentioned "Officer of Revenue and Customs".

The functions of HMRC with regard to indirect taxation (and VAT in particular) are explained later in this book (see Chapter 30).
HMRC has specialist offices which deal with such matters as pension schemes, charities, trusts and so forth but most of the day-to-day work relating to direct taxation takes place in local area offices. These local offices are responsible for routine assessment and collection and for ensuring that taxpayers comply with tax regulations. There is also a network of HMRC Enquiry Centres. These provide a first point of contact for taxpayers with general queries and carry stocks of tax forms and leaflets.

Administration of the tax system

The remainder of this chapter describes the system which is used each year to assess an individual's liability to income tax and capital gains tax. Later chapters explain the equivalent systems which are used for corporation tax, inheritance tax and VAT.

For tax years up to and including 1995-96, the assessment of an individual's tax liability was entirely the responsibility of the tax authorities and it was possible for taxpayers to delay the assessment (and payment) of tax by withholding information from the authorities for as long as possible. The introduction of the Self Assessment system in 1996-97 shifted the responsibility for assessment to the taxpayer and made it much more likely that tax is assessed and paid on time.

Self Assessment

If an individual's tax liability for a tax year cannot be collected entirely by deduction at source (see Chapter 2) or via the PAYE system (see Chapter 7), then the liability must be formally assessed. The amount of tax which is due for the year may be calculated by the taxpayer (or by the taxpayer's accountant) and then checked by HMRC. Alternatively, if the taxpayer prefers not to perform the calculation, the amount of tax due is calculated by HMRC. In either case, the first step is the completion of a tax return. The annual procedure is as follows:

(a) Tax returns are normally issued in April each year to those taxpayers who are likely to need them. Each tax return is accompanied by a formal notice requiring a return to be made and delivered to HMRC. The main tax return consists of a basic six-page form together with a four-page "additional information" form which covers some of the less common types of income and tax reliefs. The additional information form need not be submitted to HMRC if none of these types of income or tax reliefs apply to the taxpayer concerned.

There are also several sets of supplementary pages, each dealing with a different type of income or gains (e.g. income from self-employment). Taxpayers are sent only those supplementary pages which are thought to be relevant to their circumstances but can request further supplementary pages if necessary.

(b) A short tax return (STR) is available for taxpayers with simpler tax affairs.
(c) Rather than completing a paper tax return, taxpayers and their agents can file tax returns electronically by means of the Internet and are encouraged to do so. In fact, approximately 6.4 million returns were filed electronically for tax year 2008-09. This represents three-quarters of all returns submitted.

(d) The information requested in a tax return relates to the tax year just ended. For example, the tax returns which were issued in April 2010 required taxpayers to declare their income and gains for tax year 2009-10 and to claim allowances and reliefs (see Chapters 3 and 4) for the same year.

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

(f) If a main tax return is submitted on paper, the taxpayer has the option of calculating his or her own tax liability (using extra "tax calculation summary" pages) and then submitting this calculation to HMRC as part of the return. HMRC will calculate the tax liability for taxpayers who do not take up this option or for those who submit the short tax return (which does not include a self-calculation facility). If a tax return is filed electronically, the tax liability is calculated automatically by computer software. In all cases, the resulting assessment is referred to as a "self-assessment".

(g) Self assessment tax returns must normally be filed (i.e. submitted to HMRC) on or before the following dates:
   - for paper returns, 31 October following the end of the tax year
   - for returns filed electronically, 31 January following the end of the tax year.

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

(h) Penalties are imposed if a return is filed late. Furthermore, the submission of a late return may mean that the tax liability for the year is not determined until after the due date of payment (see below). This could result in the taxpayer becoming liable to surcharges and interest on overdue tax (see Chapter 14).

(i) The 31 January which follows the end of a tax year is known as the "filing date" for that year. For example, the filing date for tax year 2009-10 is normally 31 January 2011. However, if a return notice is issued after 31 October, the filing date becomes the date which falls three months after the issue date of the notice.
(j) HMRC is empowered to correct a tax return (so as to rectify obvious errors or omissions or anything else that is believed to be incorrect) within nine months of the date on which the return is filed. Similarly, the taxpayer has the right to amend his or her tax return within 12 months of the filing date for that return.

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

(k) The tax due in relation to a self-assessment is normally payable as follows:

(i) A first payment on account (POA) is due on 31 January in the tax year to which the self-assessment relates.

(ii) A second POA is due on the following 31 July.

(iii) A final balancing payment is due on the following 31 January.

For example, the tax due in relation to a 2010-11 self-assessment would normally be payable on 31 January 2011 (first POA), 31 July 2011 (second POA) and 31 January 2012 (balancing payment). Further information regarding the payment of tax is given in Chapter 14 of this book.

(l) A taxpayer who is entitled to a repayment of tax may make an entry on his or her tax return nominating a charity to receive all or part of that repayment. The taxpayer may also indicate on the tax return that Gift Aid (see Chapter 4) should apply to this charitable donation.

**Notification of chargeability to tax**

Individuals who have not received a tax return, but have taxable income or gains of which HMRC is not aware, must notify HMRC of their chargeability to tax within six months of the end of the tax year in which the income arises. However, notification of chargeability is not required if all of the following conditions are satisfied:

(a) the individual has no capital gains

(b) the individual is not a higher-rate taxpayer (see Chapter 2)

(c) all of the individual's income has been subject to deduction of income tax at source (see Chapter 2) or has been dealt with via the PAYE system (see Chapter 7).

An individual who fails to notify chargeability within the permitted six-month period will incur a penalty (see Chapter 14).
Enquiries

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

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

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

EXAMPLE

In April 2010, HMRC issues a notice requiring an individual to submit a tax return for the year 2009-10. The return is submitted electronically to HMRC on 8 December 2010.

(a) State the date by which any enquiry into the above return must begin.

(b) How would the situation differ if a paper return was submitted on 8 December 2010?

(c) How would the situation differ if an electronic return was submitted on 1 March 2011?

Solution

(a) The return is filed before the due date (31 January 2011). Any enquiry must begin within 12 months of the date that the return is filed (i.e. by 8 December 2011).

(b) The return is filed after the due date (31 October 2010). Any enquiry must begin by the quarter day which follows the first anniversary of the date that the return is filed (i.e. by 31 January 2012).

(c) The return is filed after the due date (31 January 2011). Any enquiry must begin by the quarter day which follows the first anniversary of the date that the return is filed (i.e. by 30 April 2012).

Discovery assessments

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

As from 1 April 2010, the time limit for making a discovery assessment is normally four years after the end of the tax year concerned. This increases to six years if the taxpayer has been negligent and 20 years if the taxpayer has been dishonest.
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**Determinations**

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

**Record keeping**

Taxpayers are required to keep proper records so that they can make a correct tax return and (if necessary) substantiate the figures entered on the return. A taxpayer who is in business or who lets property must normally preserve these records for five years after the 31 January which follows the end of the tax year concerned. Otherwise, records must be preserved for 12 months after the 31 January which follows the end of the tax year. For example, records for tax year 2010-11 must normally be retained until 31 January 2017 by a taxpayer who is in business or who lets property and until 31 January 2013 otherwise.

**Appeals**

Under the Self Assessment system, taxpayers have the right of appeal in relation to a number of HMRC decisions. For example, a taxpayer may appeal against a discovery assessment or against an HMRC amendment to a self-assessment.

An appeal may involve an internal review of the decision by an HMRC official and/or a hearing before a tribunal. The main features of the appeals system are as follows:

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

(b) The taxpayer may also apply to postpone payment of all or part of any tax which is payable as a result of the decision, though interest will continue to accrue on the postponed amount until the appeal is settled. Any non-postponed tax is payable on the due date in the usual way. If the appeal is subsequently settled in the taxpayer's favour, any overpaid tax is refunded.

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

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

(f) Most appeals to a tribunal are dealt with by the Tax Chamber of the First-tier Tribunal. However, very complex appeals may be heard by the Finance and Tax Chamber of the Upper Tribunal. The Upper Tribunal also hears appeals against decisions made by the First-tier Tribunal.

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

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

The HMRC Charter

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

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

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

The Adjudicator

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

Taxpayers are required to provide information which is correct and complete. Dishonest behaviour (such as concealing a source of income) is known as tax evasion and is against the law. The law relating to tax evasion was strengthened by the Finance Act 2000, which introduced a statutory offence of fraudulently evading income tax. On summary conviction in a magistrate's court, offenders may be sentenced to up to six months in prison and may be fined up to £5,000 (the "statutory maximum"). On indictment in a higher court, the penalties are increased to a maximum of seven years in prison and/or an unlimited fine.

Tax avoidance

Taxpayers are entitled to organise their financial affairs in any way they please and may do so in such a way that their tax burden is minimised. This perfectly legal activity is known as tax avoidance. For example, a taxpayer might legally avoid income tax by moving funds from a bank account which pays taxable interest to an ISA which pays tax-free interest (see Chapter 6). Tax avoidance (which is legal) should be contrasted sharply with tax evasion (which is not).

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

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

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

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

- Direct taxes are charged on income, profits and other gains. The main direct taxes are income tax, capital gains tax, inheritance tax and corporation tax. National Insurance contributions are also a form of direct taxation. Indirect taxes are taxes on spending and are paid as part of the price of a bought item. Indirect taxes include VAT, stamp duty, customs duties and excise duties.
- Taxation law is a combination of statute law and case law. Statements made by the tax authorities have no legal force but provide information on the authorities' interpretation of the law.
- The fiscal year runs from 6 April to the following 5 April. The corporation tax financial year runs from 1 April to the following 31 March.
- HM Revenue and Customs (HMRC) calculates a taxpayer's tax liability or checks the taxpayer's own calculation of the liability. The calculation is based upon the information provided in an annual tax return.
- Paper tax returns must normally be filed by 31 October following the end of the tax year to which they relate. Returns submitted electronically must be filed by the following 31 January.
- A taxpayer who has not received a tax return, but has taxable income or gains of which HMRC is not aware, must notify HMRC of his or her chargeability to tax within six months of the end of the tax year in which the income arises.
- If a tax return is submitted on or before the required filing date for that return, HMRC cannot initiate an enquiry into the return more than 12 months after the date on which the return is submitted. Discovery assessments may be made after the enquiry window has closed if it is discovered that the taxpayer has not made full disclosure of all relevant facts.
- Taxpayers have the right of appeal against certain HMRC decisions. Appeals which cannot be settled by agreement between the taxpayer and HMRC are dealt with by a two-tier tribunals system.
- Tax evasion should be distinguished from tax avoidance. The former involves dishonest conduct by the taxpayer and is illegal. The latter involves the sensible arrangement of the taxpayer's affairs so as to minimise the liability to tax and is perfectly legal.