Learn to slice correctly

Personal tax



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Tim Good considers top slicing relief, when it should be used and how it works when correctly applied

Key Points

What is the issue?

Certain investment products are marketed to investors on the basis that up to 5% of the initial investment may be paid each year to the investor without any immediate tax charge. Top slicing relief mitigates the effect of bringing into charge all in one year an amount of income that accrued over a number of years.

What does it mean for me?

Until recently, HMRC adopted a ‘short cut’ method to calculate the amount of relief, which is often used to teach this to professional exam candidates. However, tax calculations have become increasingly complicated and short cuts might not give the right answer.

What can I take away?

The difference between the short cut method and the statutory calculation will often be negligible. However, since the introduction in 2010 of the restriction of a taxpayer’s personal allowance by reference to total income, the difference can be very significant.

Anybody who has studied for the CTA qualification will be familiar with the basics of taxing chargeable event gains and calculating top slicing relief. To recap briefly: certain investment products (known variously as investment bonds or non-qualifying life policies) are marketed to investors on the basis that up to 5% of the initial investment may be paid each year to the investor without any immediate tax charge. These ‘tax-free’ withdrawals can be especially helpful for older higher rate taxpayers in managing their income tax liability. A tax charge may arise, however, if there is a partial withdrawal or complete encashment of the bond or policy and the proceeds exceed the unused 5% allowances.

We need not worry about how the taxable amount (called a chargeable event gain) is determined: the financial institution that issued the policy will provide the taxpayer (and HMRC) with a certificate that shows the amount of the chargeable event gain and the relevant number of years to be used in calculating any tax. Our job is to work out the tax.

Income, not gain

As so often with tax, the terminology is not helpful. Although the taxable amount is described as a chargeable event gain, it is taxed as savings income and is subject to income tax. If the policy is a UK policy (i.e. one issued by a UK resident company), the taxpayer can benefit from a notional basic rate tax credit (reflecting that the income and gains during the term of the policy will have been subject to UK tax payable by the issuing company). No notional tax credit attaches to a chargeable event gain arising on a foreign policy (i.e. one issued by a non-UK resident company).

One technical point of interest for the tax calculation is that a chargeable event gain on a UK policy is treated for the purposes of allocating the different tax rate bands as the highest part of the taxpayer's income (i.e. after dividend income), whereas a chargeable event gain on a foreign policy is treated for this purpose in the same way as other savings income (i.e. before dividends).

What is top slicing relief?

Top slicing relief is a relief given by reduction or repayment of income tax. It is provided for by Income Tax (Trading and Other Income) Act (ITTOIA) 2005 s 535; and is given effect at Step 6 of the income tax calculation that is set out in Income Tax Act (ITA) 2007 s 23.
The purpose of top slicing relief is simply to mitigate the effect of bringing into charge all in one year an amount of income (the chargeable event gain) that accrued over a number of years. As a simple example, suppose that the taxpayer had total income for 2020/21 of £48,000 (and remember that unless a Scottish taxpayer, the higher rate threshold was £50,000) and a UK chargeable event gain of, say, £40,000 for a term of 10 years. Without top slicing relief, £2,000 of the gain would be taxed at basic rate of 20% and £38,000 at higher rate of 40%. This would result in income tax of £15,600 on the chargeable event gain (before the notional basic rate credit).

Top slicing relief is intended to tax the total gain at the rates that would have applied if only one year's worth (the annual equivalent) of the gain were included as taxable income. In this simple example, the annual equivalent is £4,000, of which £2,000 would be taxed at basic rate and the other £2,000 at higher rate. Tax on one year's worth would be £1,200 and on 10 years' worth (i.e. the full gain) £12,000. Top slicing relief of £3,600 will achieve the intended mitigation. (For these purposes, we assume that at least £500 of the £48,000 income is other savings income so that the

personal savings allowance is already used!)

How is top slicing relief actually calculated?

This is where it gets tricky. The simple example set out above demonstrates the ‘short cut’ method used to teach this to professional exam candidates. It also demonstrates the short cut adopted until recently by HMRC. But as we all know, tax calculations have become increasingly complicated over the last decade and short cuts might not give the right answer. As we should also all know, in matters of tax there is no substitute for going back to the legislation and following the statutory provisions, rather than any intuitive or simplified approach.

As it happens, the statutory provisions that set out how to calculate top slicing relief (ITTOIA 2005 ss 535 and 536) can be expressed in relatively simple terms without doing injury to those provisions. The difficulty for HMRC (at least originally) is that converting the statutory provisions to formulae that could fit easily into the HMRC Self Assessment calculator (which, by the way, is a massive Excel spreadsheet that has to be updated every year for any changes to the tax calculation) was far from simple. Until the autumn of 2018, the HMRC calculator effectively used the short cut method described above.

The simple expression of the statutory provisions is as follows:

- First, calculate tax on the full chargeable gain less the notional tax credit.
- Then calculate tax on the annual equivalent less the notional tax credit.
- Top slicing relief is the difference (if any) between tax on the full gain and tax on the annual equivalent multiplied by the number of years.

In performing these calculations, we are instructed by ss 535 and 536 to make a small number of adjustments to the normal basis of calculating a tax liability. The crucial instruction in s 536 is:

‘Find the relieved liability on the annual equivalent by calculating the individual’s liability (if any) to income tax on the annual equivalent, on the basis that the gain from the chargeable event is limited to the amount of the annual equivalent.’

What difference does it make?

The difference between the short cut method and the statutory calculation will often be nil or negligible. However, since the introduction in 2010 of the restriction of a

taxpayer's personal allowance by reference to total income, the difference can be very significant.
To take another simple example, suppose that the taxpayer had total income for 2019/20 of £50,000 and a UK chargeable event gain of, say, £100,000 for a term of 10 years. Without top slicing relief, all of the gain would be taxed at higher rate of 40% and this would result in income tax of £40,000 on the chargeable event gain (before the notional basic rate credit). The annual equivalent is £10,000 and, using the short cut method, all of this would be taxed at higher rate. Tax on one year's worth would be £4,000 and on 10 years' worth (i.e. the full gain) £40,000. On this basis, there would be no top slicing relief.

However, the short cut method disregards the clear instruction in s 536 to calculate tax on the annual equivalent 'on the basis that the gain from the chargeable event is limited to the amount of the annual equivalent'.

In Marina Silver v HMRC [2019] UKFTT 263, Judge Barbara Mosedale said:

'So applying the legislation, both literally and in accordance with Parliament's presumed intent, results in the steps set out in s 23 being applied in full to the hypothetical situation postulated by s 536(1). And that means that, at Step 3 Mrs Silver, hypothetically, was entitled to a personal allowance.'

Performing a full hypothetical calculation in this way for the simple example above would reinstate the personal allowance of £12,500 (but only for the s 536(1) hypothetical calculation) and £10,000 of this allowance would be allocated to the annual equivalent, resulting in nil tax on the annual equivalent and £20,000 of top slicing relief.

The Finance Act 2020 provisions

Two significant changes were made to the legislation with effect from 11 March 2020.

We are now told in s 536 that 'in determining the amount of the individual's personal allowance under s 35 of ITA 2007 (but not the amount of any other relief or allowance), it is assumed that the gain from the chargeable event is equal to the amount of the annual equivalent'.

And a new s 535(8) has been inserted which reads:

‘For the purposes of the calculations mentioned in subsection (1):

a. section 25(2) of ITA 2007 (deductions of reliefs and allowances in most beneficial way for taxpayer) does not apply; and
b. reliefs and allowances are available for deduction from an amount that, for the purposes of those calculations, is the highest part of the individual’s total income for the tax year only so far as they cannot be deducted from other amounts.’

Is the HMRC calculator now correct?

Unfortunately, we still cannot rely on the HMRC calculator (or any commercial tax return software that uses the same methodology) to give the right answer. Although the HMRC method now attempts to reflect the Finance Act 2020 provisions, it still fails to perform the hypothetical calculations required by s 536. This can result in differences in the amount of top slicing relief given of tens of thousands of pounds. Agent Update 83, published by HMRC in April 2021, rehearses HMRC’s position but should not be accepted uncritically. A detailed critique can be viewed at bit.ly/3xaYmzH.

Further challenges are heading to the tribunal

An appeal has been made (TC/2020/04234) involving a difference in the calculation of top slicing relief in the year of death (2017/18) of £44,000. This case involves three specific issues where it is argued that the HMRC policy is wrong:

- availability (before 11 March 2020) of the personal savings allowance in calculating tax on the annual equivalent (slice);
- retrospective application of the FA 2020 beneficial ordering rule; and
- HMRC’s practice of applying ITA 2007 s 25(2) to minimise the tax liability after, rather than before, deducting any notional tax credit on chargeable event gains.

There will almost certainly be further cases involving overpayment relief claims. Agents should make sure that overpayment relief claims for 2017/18 are submitted to HMRC by 5 April 2022.

Agents are at risk of compensation claims if they do not advise affected clients to submit claims or appeals. Sooner or later, an aggrieved client who has lost out on tens of thousands of pounds (perhaps because their accountant did not advise that an amendment, appeal or overpayment relief claim should have been made) will

make a negligence claim.