

Income tax rules on interest: disguised interest

Who is likely to be affected?

Individuals and other persons subject to income tax rules on the taxation of savings and investment income.

General description of the measure

The measure will introduce legislation to ensure that a person who receives an amount that is economically equivalent to interest will be charged to income tax on that amount.

Policy objective

This measure will support fairness in the tax system by reinforcing the protection already afforded to the Exchequer against potential loss of tax as a result of avoidance arrangements intended to secure that interest-like returns escape income tax. It will support HM Revenue & Customs' (HMRC) anti-avoidance strategy to protect revenues and deter and counter tax avoidance by making anti-avoidance rules in this area more robust. The measure will also enable some existing anti-avoidance legislation in this area to be repealed, and in due course will allow for some other income tax rules on interest-like returns, such as those on deeply discounted securities and accrued income profits, to be rationalised and simplified.

Background to the measure

The measure was announced at Budget 2012 and a proposal to introduce legislation on disguised interest was included in a consultation document on possible changes to income tax rules on interest published by HMRC in March 2012.

Detailed proposal

Operative date

The legislation applies to all arrangements to which a person becomes party on or after 6 April 2013. In addition, where arrangements are in place on that date to which any of the repealed provisions applies, the legislation on disguised interest will apply to those arrangements.

Current law

Interest received by individuals and other non-corporate persons is subject to income tax in accordance with Chapter 2 of Part 4 of the Income Tax (Trading and Other Income) Act (ITTOIA) 2005. Chapter 12 of Part 4 of ITTOIA 2005 charges income tax on guaranteed returns from disposals of futures and options which give an interest-like return. Chapters 4 to 6 of Part 11 of the Income Tax Act (ITA) 2007 apply to amounts arising under stock lending and sale and repurchase arrangements (repos) which are treated as payments of interest.

Proposed revisions

Legislation will be introduced in Finance Bill 2013 to amend Part 4 of ITTOIA 2005 and insert a new Chapter 2A. The new chapter will provide for income tax to be charged on returns produced from arrangements that provide amounts that are economically equivalent to interest. A return will be 'economically equivalent to interest' if it arises by reference to the time value of money, at a rate comparable to a commercial rate of interest, and is practically

certain to be produced. The legislation will apply where no other income tax charge applies to the same income and there will be rules to prevent double taxation.

As a consequence of the introduction of this legislation, Chapter 12 of Part 4 of ITTOIA 2005 (guaranteed returns from the disposal of futures and options), and Chapters 4 to 6 of Part 11 of ITA 2007 (deemed manufactured payments and price differences under repos), will be repealed. Consequential changes will be made to related legislation in the Taxation of Chargeable Gains Act 1992.

Summary of impacts

Exchequer impact (£m)	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
	-	negligible	negligible	negligible	negligible	negligible
	This measure is expected to have a negligible impact on the Exchequer. Any impact will be set out at Budget 2013. This measure supports the Exchequer in its commitment to protect revenue.					
Economic impact	The measure is not expected to have any economic impacts.					
Impact on individuals and households	The proposed changes will impact only a small number of individuals and households who receive amounts that fall to be treated as disguised interest.					
Equalities impacts	The proposed changes are not expected to have a disproportionate impact on any protected equality groups.					
Impact on business including civil society organisations	This measure is expected to have a negligible impact on businesses and civil society organisations. The changes will affect primarily non-business income tax payers. Compliance costs and administrative burdens on the small number of non-corporate businesses that receive amounts treated as disguised interest are not expected to be significant.					
Operational impact (£m) (HMRC or other)	It is not anticipated that implementing this change will incur any significant additional costs or savings for HMRC or other public sector delivery organisations.					
Other impacts	<p><u>Small firms impact test:</u> Small firms may be affected, but as for other businesses the changes are expected to be negligible.</p> <p>Other impacts have been considered and none have been identified.</p>					

Monitoring and evaluation

HMRC will monitor income tax returns and avoidance disclosures to ensure that the legislation operates as intended.

Further advice

If you have any questions about the changes, please contact Tony Sadler on 020 7147 2608 (email: tony.sadler@hmrc.gsi.gov.uk).

Income tax rules on interest: deduction of income tax

Who is likely to be affected?

Persons who are required to deduct income tax from certain payments of interest.

General description of the measure

The measure will amend tax rules on the deduction of income tax from yearly interest to provide that interest in respect of compensation payments will be subject to deduction of income tax at source. It will also clarify the meaning of the term 'arising in the UK' for the purposes of the duty to deduct income tax at source. It shall introduce a rule on the valuation of interest in kind and additionally require a person paying interest in kind or by funding bond to issue a certificate showing details of the payment.

Policy objective

This measure will protect tax revenues by ensuring that existing legislation on the deduction of income tax at source from interest operates as intended and will benefit persons paying and receiving interest under deduction of tax by removing uncertainty from the application of these rules.

Background to the measure

The measure was announced at Budget 2012 and proposals to amend this legislation were included in a consultation document on possible changes to income tax rules on interest published by HM Revenue & Customs (HMRC) in March 2012.

A summary of responses was published in October 2012.

Detailed proposal

Operative date

The amended legislation applies to payments of interest made on or after the date that Finance Bill 2013 receives Royal Assent.

Current law

Interest is taxable in accordance with legislation in Chapter 2 of Part 4 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005).

Certain payments, including payments of 'yearly interest arising in the United Kingdom', are required to be made under deduction of income tax, in accordance with legislation in Part 15 of the Income Tax Act 2007 (ITA 2007).

Proposed revisions

Legislation will be introduced in Finance Bill 2013 to amend section 874 of ITA 2007 to provide that income tax must be deducted from interest payable to an individual in respect of compensation payments. This will apply regardless of whether the interest paid is yearly interest. A secondary legislative power will allow this requirement to be disapplied where necessary. Sections 875 and 878 of ITA 2007 will be amended so that the exceptions from the duty to deduct income tax from payments of yearly interest made by building societies

and by banks in the ordinary course of their business will not apply to interest in respect of compensation payments.

Section 874 of ITA 2007 will also be amended, to put it beyond doubt that in determining whether interest arises in the UK for the purposes of the duty to deduct income tax from certain payments of yearly interest, no account is to be taken of the location of a deed under which interest is paid.

Chapter 2 of Part 4 of ITTOIA 2005 will be amended by inserting a new section 370A, to provide a rule for the valuation of interest in kind.

A new section 975A will be inserted into ITA 2007 requiring a person paying interest in kind to provide the recipient with a certificate showing the gross amount of interest paid and amount of tax deducted (if any). The same requirement will apply to a person paying interest in the form of a funding bond under section 380 of ITTOIA 2005 or section 413 of the Corporation Tax Act 2009.

Summary of impacts

Exchequer impact (£m)	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
	-	negligible	negligible	negligible	negligible	negligible
	This measure is expected to have a negligible impact on the Exchequer. Any impact will be set out at Budget 2013. This measure supports the Exchequer in its commitment to protect revenue.					
Economic impact	The measure is not expected to have any economic impacts.					
Impact on individuals and households	The proposed changes will only impact those individuals and households who receive interest which is covered by these proposals. The amount of additional administrative burden is thought to be negligible, and may represent a saving for certain taxpayers in that deduction of basic rate income tax at source may remove the need for them to complete a self assessment. Non-taxpayers will still be able to recover any tax deducted at source.					
Equalities impacts	The proposed changes are not expected to have a disproportionate impact on any protected equality groups.					
Impact on business including civil society organisations	<p>This measure is expected to have a negligible impact on businesses and civil society organisations. These measures will impact businesses that pay interest which is covered by these proposals. The main impacts will be on financial institutions and other businesses that make compensation payments to individuals on which interest is paid.</p> <p>A small number of businesses that pay interest in kind will be affected. One-off compliance costs and on-going administrative burdens (for example, arising from familiarisation with the amended legislation and from IT and other systems changes) are expected to be negligible.</p>					
Operational impact (£m) (HMRC or other)	It is not anticipated that implementing this change will incur any significant additional costs or savings for HMRC or other public sector delivery organisations.					
Other impacts	<p><u>Small firms impact test:</u> Small firms may be affected, but as for other businesses the changes are expected to be negligible.</p> <p>Other impacts have been considered and none have been identified.</p>					

Monitoring and evaluation

The measure will be kept under review through continuing discussion and engagement with interested parties, in particular financial sector firms and professional advisers.

Further advice

If you have any questions about the changes, please contact Tony Sadler on 020 7147 2608 (email: tony.sadler@hmrc.gsi.gov.uk).

1 Disguised interest

- (1) Schedule 1 contains provision about returns which are economically equivalent to interest.
- (2) References in this section to paragraphs are to paragraphs of that Schedule.
- (3) The amendments made by paragraph 1 (in so far as it relates to paragraphs 2(a) and 3) and paragraphs 2(a) and 3 have effect in relation to any arrangement which produces a return for a person which is economically equivalent to interest if the person becomes a party to the arrangement on or after 6 April 2013.
- (4) The amendments made by paragraph 1 (in so far as it relates to paragraph 2(b)), paragraph 2(b) and paragraphs 4 to 14 come into force on 6 April 2013.
- (5) Subsection (6) applies where any of the provisions repealed by paragraph 10(2) or 12(2) applies in relation to anything done by a person before 6 April 2013 which amounts to becoming party to an arrangement (within the meaning given by section 381A of ITTOIA 2005).
- (6) The person is to be treated for the purposes of Chapter 2A of Part 4 of ITTOIA 2005 as having become party to the arrangement on 6 April 2013 and tax is to be charged on the return accordingly (whether or not any part of the return was produced before 6 April 2013).

SCHEDULE 1

Section 1

DISGUISED INTEREST

Key amendments to Part 4 of ITTOIA 2005

- 1 Part 4 of ITTOIA 2005 (savings and investment income) is amended as set out in paragraphs 2 and 3.
- 2 In section 365(1) (overview of Part 4)–
 - (a) after paragraph (a) insert –
“(aa) Chapter 2A (disguised interest),”, and
 - (b) omit paragraph (k).
- 3 After Chapter 2 insert –

“CHAPTER 2A

DISGUISED INTEREST

381A Charge to tax on disguised interest

- (1) This Chapter applies where a person is party to an arrangement which produces for the person a return in relation to any amount which is economically equivalent to interest.
- (2) Income tax is charged on the return if the return is not charged to income tax under or as a result of any other provision of this Act or any other Act.
- (3) Subsection (2) does not apply to a return that would be charged to income tax under or as a result of another provision but for an exemption.
- (4) For the purposes of this Chapter a return produced for a person by an arrangement in relation to any amount is “economically equivalent to interest” if (and only if) –
 - (a) it is reasonable to assume that it is a return by reference to the time value of that amount of money,
 - (b) it is at a rate reasonably comparable to what is (in all the circumstances) a commercial rate of interest, and
 - (c) at the relevant time there is no practical likelihood that it will cease to be produced in accordance with the arrangement unless the person by whom it falls to be produced is prevented (by reason of insolvency or otherwise) from producing it.
- (5) In subsection (4)(c) “the relevant time” means the time when the person becomes party to the arrangement or, if later, when the arrangement begins to produce a return for the person.

- (6) In this Chapter “arrangement” includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable).

381B Income charged

Tax is charged under this Chapter on the full amount of the return, or any part of the return, arising in the tax year.

381C Person liable

The person liable for any tax charged under this Chapter is the person receiving or entitled to the return or the part of the return.

381D Avoidance of double taxation

- (1) This section applies if at any time a tax other than income tax (“the other tax”) is charged in relation to a return on which income tax is charged under this Chapter.
- (2) In order to avoid a double charge to tax in respect of the return, a person may make a claim for one or more consequential adjustments to be made in respect of the other tax.
- (3) On a claim under this section an officer of Revenue and Customs must make such of the consequential adjustments claimed (if any) as are just and reasonable.
- (4) Consequential adjustments may be made—
- (a) in respect of any period,
 - (b) by way of an assessment, the modification of an assessment, amending a claim, or otherwise, and
 - (c) despite any time limit imposed by or under any enactment.”

Consequential amendments

- 4 The following amendments are in consequence of the amendments made by paragraphs 2(a) and 3.

TCGA 1992

- 5 TCGA 1992 is amended as follows.
- 6 (1) Section 263A (agreements for sale and repurchase of securities) is amended as follows.
- (2) Before subsection (1) insert—
- “(A1) For the purposes of this section there is a repo in respect of securities if—
- (a) a person (“the original owner”) has agreed to sell the securities to another person (“the interim holder”), and
 - (b) the original owner or a person connected with the original owner—
 - (i) is required to buy back the securities by the agreement or a related agreement,

- (ii) is required to buy back the securities as a result of the exercise of an option acquired under the agreement or a related agreement, or
 - (iii) exercises an option to buy back the securities which was acquired under agreement or related agreement.”
- (3) In subsection (1) for the words from “falling” to “repos” substitute “where under a repo in respect of securities the original owner has transferred the securities to the interim holder”.
- (4) Omit subsection (5).

7 After section 263A insert –

“263AA Section 263A: interpretation

- (1) Subsections (2) to (7) apply for the purposes of section 263A.
- (2) References to buying back securities include references to –
 - (a) buying similar securities, and
 - (b) in the case of a person connected with the person who is the original owner under the repo, buying the securities sold by the original owner or similar securities.
- (3) Subsection (2) applies even if the person buying the securities has not held them before.
- (4) References to repurchase or a repurchaser are to be read accordingly.
- (5) For the purposes of subsection (2) securities are similar if they give their holders –
 - (a) the same rights against the same persons as to capital and distributions, interest and dividends, and
 - (b) the same remedies to enforce those rights.
- (6) Subsection (5) applies even if there is a difference in –
 - (a) the total nominal amounts of the securities,
 - (b) the form in which they are held, or
 - (c) the manner in which they can be transferred.
- (7) Agreements are related if they are entered into in pursuance of the same arrangement (regardless of the date on which either agreement is entered into).
- (8) In section 263A and this section “securities” means –
 - (a) shares in a company wherever resident,
 - (b) loan stock or other securities of –
 - (i) the government of the United Kingdom,
 - (ii) a local authority in the United Kingdom,
 - (iii) another public authority in the United Kingdom,
 - (iv) a company resident in the United Kingdom or other body resident in the United Kingdom, or
 - (c) shares, loan stock, stock or other securities issued by –

- (i) a government, local authority or other public authority of a territory outside the United Kingdom, or
 - (ii) another body of persons not resident in the United Kingdom.”
- 8 (1) Section 263F (power to modify repo provisions: non-standard repo cases) is amended as follows.
- (2) In subsection (2) for the words from “cases” to the end substitute “any case mentioned in section 263A(1).”
- (3) For subsection (9) substitute –
 - “(9) “Post-agreement fluctuations” are fluctuations in the value of –
 - (a) securities transferred in pursuance of the original sale, or
 - (b) representative securities,which occur in the period after the making of the agreement for the original sale.
 - (10) “Representative securities” are securities which, for the purposes of the repurchase, are to represent securities transferred in pursuance of the original sale.”
- 9 In section 263G (power to modify repo provisions: redemption arrangements) –
 - (a) in subsection (2) for the words from “cases” to the end substitute “any case mentioned in section 263A(1).”, and
 - (b) omit subsection (4).

ITTOIA 2005

- 10 (1) ITTOIA 2005 is amended as follows.
- (2) Omit Chapter 12 of Part 4 (disposals of futures and options involving guaranteed returns).
- (3) In section 687(2) (application of charge to tax) at the end insert “or to income falling within Chapter 2A of Part 4”.
- (4) In Schedule 2 (transitionals and savings), omit paragraph 95.
- (5) In Schedule 4 (abbreviations and defined expressions) omit the entry for “future (in Chapter 12 of Part 4)”.

FA 2007

- 11 In FA 2007 in Schedule 14 (sale and repurchase of securities: minor and consequential amendments) omit paragraphs 22 and 23.

ITA 2007

- 12 (1) ITA 2007 is amended as follows.
- (2) Omit the following provisions (which deal with deemed manufactured payments and repos) –
 - (a) section 596(5),

-
- (b) sections 597 to 605,
 - (c) section 606(1) to (7) and (9) and (10), and
 - (d) sections 607 to 614.
- (3) In Schedule 1 (minor and consequential amendments), omit paragraphs 543 and 544.
- (4) In Schedule 2 (transitionals and savings) omit paragraphs 112 to 124.
- (5) In Schedule 4 (index of defined expressions) –
- (a) omit the entries for –
 - “company UK REIT (in Chapter 4 of Part 11)”,
 - “distribution (in Chapter 4 of Part 11)”,
 - “gross amount (in Chapter 4 of Part 11)”,
 - “group (in Chapter 4 of Part 11)”,
 - “group UK REIT (in Chapter 4 of Part 11)”,
 - “manufactured dividend (in Chapter 4 of Part 11)”,
 - “principal company (in Chapter 4 of Part 11)”,
 - “property rental business (in Chapter 4 of Part 11)”, and
 - “the repurchase price of the securities (in Chapter 4 of Part 11)”,
 - and
 - (b) in the entry for distribution (except in Chapter 4 of Part 11), omit “(except in Chapter 4 of Part 11)”.

CTA 2010

- 13 In CTA 2010 in Schedule 1 (minor and consequential amendments) omit paragraphs 540 to 543 and 544(a), (c) and (d).

FA 2010

- 14 In FA 2010 in Schedule 6 (charities etc) omit paragraph 21(4).

EXPLANATORY NOTE

DISGUISED INTEREST

SUMMARY

1. This clause and Schedule make provision for amounts from arrangements that produce returns that are economically equivalent to interest (disguised interest) to be taxed as income.

DETAILS OF THE CLAUSE

2. Subsection (3) of the clause provides that the changes made by the Schedule apply to returns from arrangements to which a person becomes party on or after 6 April 2013. This is subject to transitional rules that provide that where a person is party to arrangements before 6 April 2013 and those arrangements would have been within any of the provisions repealed as a consequence of the introduction of the new rules on disguised interest, returns arising from those arrangements on or after that date are taxable as disguised interest.

DETAILS OF THE SCHEDULE

3. Paragraph 1 of the Schedule provides for the amendment of Part 4 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA), which contains the income tax rules on savings and investment income.
4. Paragraph 2 amends section 365 of ITTOIA by adding disguised interest to the list of savings and investment income that is charged to income tax under the rules in Part 4 of ITTOIA.
5. Paragraph 3 inserts new Chapter 2A, which contains the charge to income tax on disguised interest, into Part 4 of ITTOIA.
6. New section 381A defines the charge to tax on disguised interest. New subsection (1) establishes the scope of the income tax charge on disguised interest. It applies to an ‘arrangement’ that produces for the person who is party to it a return in relation to which an amount is ‘economically equivalent to interest’. The legislation applies to any return that is economically equivalent to interest, which is produced by the arrangement in any way. This includes anything done in relation to the arrangement from which a return will be produced, such as disposing of an instrument before maturity, or a person otherwise ceasing to be party to the arrangement.

7. New subsection (2) provides that the charge under new section 381A applies only where the return is not taxed under any other income tax provision. Hence, where a return is taxable both as disguised interest and (for example) as a profit from a deeply discounted security, the latter rules take priority. Subsection (3) ensures that this also applies where the return chargeable under that other provision is exempt from income tax.
8. New subsection (4) provides that for the purposes of the legislation, a return is 'economically equivalent to interest' where it is reasonable to assume that it refers to the 'time value of that amount of money', is reasonably comparable to a commercial rate of interest, and where at the 'relevant time' there is 'no practical likelihood' that the return will be cease to be produced. 'The time value of that amount of money' takes its meaning from case law on the meaning of interest. In *Bennett v. Ogston* (15TC374) Rowlatt J described interest as 'payment by time for the use of money'. 'Practical likelihood' takes its meaning from cases involving the *Ramsay* principle, and is to be interpreted in the light of the judgment of the House of Lords in *Scottish Provident Institution* (76TC538) as precluding attempts to manufacture a 'falsifying' arrangement.
9. New subsection (5) defines 'relevant time' to mean the later of when the person becomes party to the arrangement or when the return begins to be produced. The combined effect of these provisions is that it must be clear at the outset that the return will be produced.
10. New subsection (6) defines the term 'arrangement' to include any agreement, understanding, scheme, transaction or series of transactions whether or not legally enforceable. It will include combinations of contracts or transactions that produce amounts that are economically equivalent to interest, such as box option schemes that are currently subject to rules under Chapter 12 of Part 4 of ITTOIA on guaranteed returns from disposals of futures and options. It will also include the manufactured payments and price differences that arise on stock lending and sale and repurchase arrangements (repos).
11. New section 381B charges the full amount of the return, or any part of the return, arising in the tax year. The charge on disguised interest is thus the same as that on interest taxable under Chapter 2 of Part 4 ITTOIA. 'Full amount' means the gross amount without deductions, and the term 'arising' takes its meaning from case law. In *Dunmore v McGowan* (52TC307) it was held that interest was taxable when it 'enured to the benefit' of the taxpayer. The charge on the amount arising in the tax year includes any part of the return that arises in that tax year. For example, where the arrangement is not undertaken or completed as originally envisaged, and only part of the return from the arrangement materialises, the amount taxable as having arisen is

the disguised interest at that point – that is, that part of the return actually produced.

12. New section 381C establishes that the person liable for income tax on disguised interest is the person receiving or entitled to the return, or any part of the return. As with section 381B, this replicates the position that applies to a person who receives or is entitled to interest under Chapter 2 of Part 4 of ITTOIA.
13. New section 381D prevents double taxation where the same income is taxable as disguised interest and under other tax provisions. It provides for HMRC to make ‘just and reasonable’ amendments to any other tax liabilities, where a person makes a claim.
14. Paragraphs 5 to 10 make consequential amendments, including the repeal of Chapter 12 of Part 4 of ITTOIA (guaranteed returns from disposals of futures and options) and Chapters 4 to 6 of Part 11 of the Income Tax Act 2007 (ITA 2007), (amounts arising under stock lending and sale and repurchase arrangements (repos)). Other consequential amendments are made to related legislation under the Taxation of Chargeable Gains Act 1992, the Corporation Tax Act 2010 and the Finance Act 2010.

BACKGROUND

15. Current income tax rules contain a number of provisions under which interest-like returns are charged to income tax in the same way as interest.
16. The new legislation provides a comprehensive income tax charge on disguised interest. It enables the repeal of existing anti-avoidance legislation on guaranteed returns from futures and options (which are a form of disguised interest arrangement), and allows for the simplification of income tax rules that treat certain amounts arising on stock lending and repos as payments of interest.
17. The legislation follows consultation in 2012 on a number of possible changes to income tax rules on interest. It is based on the disguised interest rule for corporates in Chapter 2A of Part 6 of the Corporation Tax Act 2009 and follows a similar principle-based approach to the drafting of legislation on financial products.
18. In due course it is anticipated that the legislation will facilitate the simplification of other income tax rules that tax returns from interest-like arrangements, such as legislation on deeply discounted securities and accrued income.

FINANCE BILL

19. If you have any questions about this change, or comments on the legislation, please contact Tony Sadler on 020 7147 2608 (email: tony.sadler@hmrc.gsi.gov.uk).

1 Payments of interest

- (1) Schedule 1 contains provision in connection with the payment of interest for the purposes of income tax.
- (2) The amendments made by that Schedule have effect in relation to any payment of interest which is made on or after the day on which this Act is passed.

SCHEDULE 1

Section 1

DEDUCTION OF INCOME TAX AT SOURCE ETC

Deduction from interest payable on compensation

- 1 Chapter 3 of Part 15 of ITA 2007 (deduction from certain payments of yearly interest) is amended as follows.
- 2 In section 874 (duty to deduct from certain payments of yearly interest) after subsection (5) insert –
 - “(5A) For the purposes of subsection (1) a payment of interest which is payable to an individual in respect of compensation is to be treated as a payment of yearly interest (irrespective of the period in respect of which the interest is paid).
 - (5B) But the Commissioners for Her Majesty’s Revenue and Customs may make regulations which provide that subsection (5A) does not apply in the circumstances prescribed in the regulations.”
- 3 In section 875 (interest paid by building societies) at the end insert “unless it is treated as a payment of yearly interest by virtue of section 874(5A).”
- 4 In section 878 (interest paid by banks) after subsection (1) insert –
 - “(1A) But that duty does apply to such a payment if it is treated as a payment of yearly interest by virtue of section 874(5A).”

Deduction from yearly interest: specialities

- 5 In section 874 of ITA 2007 (duty to deduct from certain payments of yearly interest) after subsection (6) insert –
 - “(6A) In determining for the purposes of subsection (1) whether a payment of interest arises in the United Kingdom no account is to be taken of the location of any deed which records the obligation to pay the interest.”

Payment of interest in kind

- 6 After section 370 of ITTOIA 2005 insert –
 - “(370A) **Valuation of interest not paid in cash**
 - (1) This section applies to the payment of an amount of interest in the form of –
 - (a) goods or services, or
 - (b) a voucher.
 - (2) Where this section applies by virtue of subsection (1)(a), the amount of the payment is to be taken to be equal to the market value, at the time the payment is made, of the goods or services.

- (3) Where this section applies by virtue of subsection (1)(b), the amount of the payment is to be taken to be equal to whichever is the higher of –
 - (a) the face value of the voucher,
 - (b) the amount of money for which the voucher is capable of being exchanged, or
 - (c) the market value, at the time the payment is made, of any goods or services for which the voucher is capable of being exchanged.
 - (4) In this section references to a voucher are to a voucher, stamp or similar document or token which is capable of being exchanged for money, goods or services.”
- 7 In section 380 of that Act (funding bonds) in subsection (3) at the end insert “(but does not include any instrument providing for payment in the form of goods or services or a voucher)”.
- 8 In section 939 of ITA 2007 (duty to retain bonds where issue treated as payment of interest) in subsection (6) at the end insert “(but does not include any instrument providing for payment in the form of goods or services or a voucher)”.
- 9 After section 975 of that Act insert –

“975A Statements about certain payments of interest

- (1) This section applies if a person makes –
 - (a) a payment of interest of which the whole or part is in the form of goods or services or a voucher, or
 - (b) a payment which is treated as a payment of interest by virtue of section 413 of CTA 2009 or section 380 of ITTOIA 2005 (funding bonds).
- (2) The person making the payment must provide the recipient with a statement showing –
 - (a) the gross amount of the payment,
 - (b) the amount of the sum deducted under any provision of Chapters 2 to 7 or under section 919 or 928 (if any),
 - (c) the actual amount paid, and
 - (d) the date on which the payment was made
- (3) Where this section applies by virtue of subsection (1)(a), the amounts mentioned in paragraphs (a) to (c) of subsection (2) are to be calculated in accordance with section 370A of ITTOIA 2005.
- (4) Where this section applies by virtue of subsection (1)(b), the amounts mentioned in paragraphs (a) to (c) of subsection (2) are to be calculated in accordance with section 413 of CTA 2009 or section 380 of ITTOIA 2005, as the case may require.
- (5) A statement under this section must be –
 - (a) provided to the recipient on the date that the payment is made, and
 - (b) in writing.
- (6) The duty to comply with this section is enforceable by the recipient.

- (7) In this section references to a voucher are to a voucher, stamp or similar document or token which is capable of being exchanged for money, goods or services.”
- 10 In section 413 of CTA 2009 (issue of funding bonds) in subsection (3) at the end insert “(but does not include any instrument providing for payment in the form of goods or services or a voucher)”.

EXPLANATORY NOTE

DEDUCTIONS OF INCOME TAX AT SOURCE ETC

SUMMARY

1. This clause and Schedule make changes to tax rules on deduction of income tax from interest relating to compensation payments, interest in kind and specialty debt.

DETAILS OF THE CLAUSE

2. Subsection (2) of the clause provides that the changes made by the Schedule apply to interest paid on or after Royal Assent.

DETAILS OF THE SCHEDULE

Interest payable on compensation

3. Paragraph 1 of the schedule provides for Chapter 3 of Part 15 of the Income Tax Act 2007 (ITA 2007) to be amended. Chapter 3 sets out the tax rules on deducting income tax from payments of ‘yearly interest’. The meaning of ‘yearly interest’ is derived from case law and refers, broadly, to interest on a debt where the debtor and creditor intend that the debt should exist for more than a year, or where it is mutually accepted that the interest may be paid from year to year.
4. Paragraph 2 amends section 874 of ITA 2007 by inserting new subsections (5A) and (5B). The new subsections provide that interest that is payable to an individual in respect of compensation is to be treated as a payment of yearly interest. As a consequence, the person paying the interest will be required to deduct income tax at source from it. This is subject to a regulation-making power to allow for this requirement not to apply in circumstances prescribed by the Commissioners for HM Revenue and Customs.
5. Paragraph 3 amends section 875 of ITA 2007, to disapply the exception from the duty to deduct income tax from yearly interest that currently applies to a building society, where interest is treated as yearly interest because it is payable in respect of compensation.
6. Paragraph 4 similarly amends the equivalent exception in section 878 of ITA 2007 that applies to yearly interest paid by a bank in the ordinary course of its business, by inserting new subsection 878(1A) of ITA. Building societies and banks will therefore have to deduct income

tax from interest payable in respect of compensation, where otherwise they would have been able to rely on the relevant exception.

Specialty debt

7. Paragraph 5 amends section 874 of ITA 2007 by inserting a new subsection (6A) to provide that in determining whether yearly interest arises in the UK for the purposes of the duty to deduct income tax at source, no account is to be taken of the location of a deed under the terms of which interest is payable. The amendment clarifies the position on the obligation to deduct income tax from yearly interest arising on 'specialty debt' (that is, debt paid under a deed).

Interest in kind

8. Paragraph 6 inserts a new section 370A into the Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005). The new section provides a rule to determine how interest paid in kind in the form of goods, services or vouchers is to be valued. This value is to be the market value of the goods or services at the time the interest is paid, or in the case of vouchers, the greater of the face value of the voucher, the amount of money for which it can be exchanged or the market value, at the time of the payment, of the goods or services for which it can be exchanged.
9. Paragraphs 7, 8 and 10 amend section 380 of ITTOIA 2005, section 939 ITA 2007 and section 413 of the Corporation Tax Act 2009 (CTA 2009) respectively to exclude interest in kind from the definition of a funding bond for income tax and corporation tax. The amendments make it clear that the legislative provisions applying to funding bonds and interest in kind are mutually exclusive.
10. Paragraph 9 provides for a new section 975A to be inserted into ITA 2007. The new section requires a person who pays interest in kind, or in the form of a funding bond within section 380 of ITTOIA or section 413 of CTA 2009, to provide the recipient with a statement in writing. The statement must show the amount of the interest paid in kind or as a funding bond, the amount of tax deducted (if any), the net amount paid, and the date of payment. Unlike the similar requirement in section 975 ITA where interest is paid in cash, a certificate under new section 975A will be required in any case when any interest is paid in kind or as a funding bond, not just if the recipient requests it.

BACKGROUND

11. This legislation follows consultation in 2012 on a number of possible changes to income tax rules on interest and on deduction of income tax from interest.

12. The application of the current rules on deducting income tax from interest can be unclear and inconsistent in certain situations. For example, tax is required to be deducted from interest on compensation payments if it is 'yearly interest', but not if it is 'short interest'; and, even if it is yearly interest, no tax is required to be deducted if the institution paying it is a building society or a bank paying it in the ordinary course of its business. A common example of interest paid on such compensation is that paid by financial institutions in cases of financial mis-selling.
13. Similarly, the amount of tax to be deducted when any interest is paid in kind can be difficult to ascertain in the absence of a clear rule providing how the interest is to be valued.
14. The changes clarify the application of the legislation and ensure that the rules on deduction of income tax operate in a consistent manner.
15. If you have any questions about this change, or comments on the legislation, please contact Tony Sadler on 020 7147 2608 (email: tony.sadler@hmrc.gsi.gov.uk).