# Clarifying the Scope of the Welsh Rates of Income Tax

Technical Note
October 2018

## Contents                                                                 Page


| | | |
|---|---|---|
| Introduction | | **4** |
| Chapter 1 | Definition of a Welsh Taxpayer | **5** |
| Chapter 2 | General Issues | **6** |
| Chapter 3 | Charitable Giving | **7** |
| Chapter 4 | Pensions Tax Relief | **9** |
| Chapter 5 | Trustees and Personal Representatives | **11** |
| Chapter 6 | Other Income Tax Issues | **14** |
| Chapter 7 | Amendments to PAYE regulations | **20** |

The Wales Bill received Royal Assent on 17 December 2014 and became the Wales Act 2014. The 2014 Act introduces the Welsh rates of income tax. The Wales Act 2017 removed the requirement for a referendum before income tax powers for Wales could commence. The Welsh rates of income tax will come into force in April 2019.

This Technical Note sets out the UK Government's policy intentions in areas where the rate setting power interacts with other areas of the income tax system. The policy positions match those taken in relation to Scottish income tax, although due to the difference in devolved powers the resulting consequential legislative amendments may be different.

The legislative changes necessary to achieve these intentions will be introduced in two statutory instruments, drafts of which are published alongside this Technical Note.

The following commentary is based on current tax law. The UK Government's position in relation to any of the matters commented on may be reviewed in the event that changes are made to the wider tax system in future Finance Acts.

If you have any comments on the paper or draft statutory instruments, please send these by 5 November 2018 to technicalconsultation.writ@hmrc.gsi.gov.uk.

## Introduction

1. The Welsh rates of income tax, as introduced by the Wales Act 2014, will be charged on the non-savings, non-dividend income of those defined as Welsh taxpayers. The rate paid by Welsh taxpayers will be calculated by reducing the basic, higher and additional rates of income tax levied by the UK Government by 10 pence in the pound and adding new Welsh rates proposed by the Welsh Government and set by the National Assembly for Wales.

2. For instance, if the UK basic, higher and additional rates of income tax were 20 per cent, 40 per cent and 45 per cent respectively and the Welsh rates of income tax were 11 per cent, 12 per cent and 13 per cent, then the rates applied to those defined as Welsh taxpayers for basic, higher and additional rates of income tax would be 21 per cent, 42 per cent and 48 per cent respectively. If the Welsh rates of income tax were 9 per cent, 8 per cent and 7 per cent, then the rates applied to those defined as Welsh taxpayers would be 19 per cent, 38 per cent and 42 per cent. Welsh rates of 10 per cent for each band would mean no change from the UK rates.

3. The National Assembly for Wales will set three rates: the Welsh basic rate; the Welsh higher rate; and the Welsh additional rate. Together these three rates will be referred to as the Welsh rates.

4. As the Welsh rates of income tax are not a discrete tax they continue to be covered by existing UK double taxation agreements.

5. The non-savings, non-dividend income of a Welsh taxpayer (see Chapter 1) will generally be liable to the Welsh rates of income tax.

6. Savings income and dividend income (as defined in sections 18 and 19 respectively of the Income Tax Act 2007 (ITA) and to which sections 12 and 13 of ITA apply) arising to Welsh taxpayers will still be taxed at the appropriate UK rate.

7. However, in the interests of avoiding additional complexity for taxpayers, or a result whereby the costs of collection become disproportionate to the revenue raised, the Government proposes that there should be some exceptions to the general rule that the Welsh rates of income tax will always apply to the non-savings income of a Welsh taxpayer. These exceptions (and the rationale for them) are set out in detail at various places below.

## Chapter 1 – Definition of a Welsh taxpayer

8. The Wales Act 2014 inserts new sections 116E-116H into the Government of Wales Act 2006, which define who will be a Welsh taxpayer for the purposes of the Welsh rates. There are a number of steps to determine this.

9. Firstly, in order for an individual to be a Welsh taxpayer, they must be UK resident for tax purposes – an individual who is not UK tax resident cannot be a Welsh taxpayer.

10. The remaining parts of the definition are based on the location of an individual's sole or main place of residence. If they have one place of residence and this is in Wales, they are a Welsh taxpayer.

11. Individuals who have more than one place of residence in the UK will be a Welsh taxpayer if their main place of residence is in Wales for longer than in any other part of the UK. For example, if an individual with a single place of residence moves house into or out of Wales part way through a tax year, whether they will be a Welsh taxpayer in that year will depend upon which house is their main place of residence for the longer amount of time.

12. Individuals who cannot identify a main place of residence will need to count the days they spend in Wales and elsewhere in the UK – if they spend more days in Wales than in any other constituent part of the UK, they will be a Welsh taxpayer.

13. An individual who meets the definition of a Welsh taxpayer will be a Welsh taxpayer for a whole tax year.

14. There are separate rules which apply to Assembly members, MPs representing a constituency in Wales and MEPs representing Wales. Such individuals will automatically be treated as Welsh taxpayers, irrespective of where their sole or main residence is located or of where they spend the most days in the UK.

15. Guidance is available to assist taxpayers in identifying their main place of residence at www.gov.uk/hmrc-internal-manuals/welsh-taxpayer-technical-guidance.

## Chapter 2 – General Issues

16. Part 2 of the Wales Act 2014 inserts new provisions into ITA and the Government of Wales Act 2006. Any definitions contained in tax legislation which apply for the purposes of the ITA will therefore extend to the provisions inserted by Part 2, subject to any contrary interpretations or definitions contained in the Wales Act itself.

**Partnerships**

17. No special rules are proposed for partnerships.

18. Under Self Assessment, the individual partners are liable to tax on their own share of the partnership's income. Where the partner is a Welsh taxpayer, such income will potentially be subject to the Welsh rates of income tax in accordance with the general rules for individuals.

## Chapter 3 - Charitable Giving

19. When a taxpayer makes a voluntary donation to a charity through Gift Aid, the donation is made net of income tax at the basic rate, and the charity is able to claim repayment of that tax from HMRC (section 520(2) of ITA). For example, with a basic rate of 20 per cent, a gift of £100 is treated as a gift of £125 on which £25 tax has already been deducted. The charity is therefore able to reclaim the £25.

20. If the Welsh basic rate of income tax were higher than the UK basic rate, charities would benefit as they could claim back more tax in relation to donations made by Welsh taxpayers. Likewise, if the Welsh basic rate of income tax were lower than the UK basic rate, charities would lose out as they could claim back less in relation to donations made by Welsh taxpayers.

21. The UK Government has had an ongoing dialogue with charity representative bodies about the impact of having to identify donors liable at devolved rates of income tax in order to make accurate claims. The UK Government took account of those views when implementing the Scottish income tax powers, agreeing that the additional burden placed on charities would be disproportionate. It therefore decided that **Gift Aid for charities would continue to apply at the UK basic rate, regardless of the tax position of the donor**. **This will also be the case for donors liable at the Welsh rates** for the same reasons.

22. The UK Government will keep this issue under review though so that, if the Welsh or Scottish and UK rates diverge considerably or it becomes possible to provide Gift Aid relief at the correct rate without the currently anticipated administrative burden, the position can be reconsidered.

23. Donors who are higher and additional rate taxpayers are also able to claim tax relief on their donations. This relief is the difference between the higher/additional rate of tax and the basic rate of tax on the total 'gross' value of their donation to the charity. For example, if a higher rate taxpayer makes a £100 donation to a charity, the charity can claim Gift Aid at the basic rate, making the total value of the donation £125. The taxpayer can claim the difference between the higher rate of tax at 40 per cent and the basic rate of tax at 20 per cent on the total value of their donation, so they can claim 20 per cent of £125, a total of £25. Total tax paid, at 40 per cent on the £125 donation is £50, of which the charity can claim £25 and the donor can claim £25.

24. Once the Welsh rates are introduced, **Welsh taxpayers will be able to claim relief equal to the difference between the UK basic and the highest Welsh rate of tax that applies to them**.

25. So, whatever the Welsh rates might be, the total value of a donation of £100 by a Welsh taxpayer would be treated as £125. And a taxpayer who pays tax at above the UK basic rate would be able to claim the difference between their marginal rate of tax and the UK basic rate. So, for example, if the Welsh higher rate were 11 per cent, the Welsh taxpayer would then claim the difference between their higher rate (41 per cent)

and the UK basic rate (20 per cent) on the total valuation of the donation. This would be 21 per cent of £125, so a total of £26.25. Total tax paid, at 41 per cent on the £125 donation is £51.25, of which the charity can claim £25 and the donor can claim £26.25.

26. Tax relief for donations made to charity under the payroll giving scheme is given at source before an employee's PAYE tax is calculated, and is given at their marginal rate. **Where the employee's marginal rate is derived from the Welsh rates of income tax then the relief will apply at that marginal rate**.

27. Individuals who donate certain shares or land to a charity qualify for income tax relief (at the basic, higher and additional rates). All the tax relief has to be claimed through the Self Assessment return. **The approach here will follow that taken for other donations to charities where relief is claimed through Self Assessment – therefore if an individual is a Welsh taxpayer they would receive relief at the Welsh rates**.

## Chapter 4 - Pensions Tax Relief

28. **Pensions tax relief should be given at an individual's marginal rate.**

29. Tax relief is delivered in a number of different ways depending on the type of pension scheme, and the method chosen by the scheme trustees.

**Pension schemes operating the Net Pay Arrangement**

30. Under the Net Pay Arrangement (NPA) pension contributions are deductible from pay before the employee's individual PAYE tax calculation is applied. This means that tax relief is automatically given to the employee at their marginal rate of tax. **Where the employee's marginal rate of tax is derived from the Welsh rates of income tax then the relief should apply at that rate**. The operation of NPA will provide an employee who is a Welsh taxpayer with tax relief on their pension contributions at the Welsh rates of income tax automatically.

**Pension schemes operating Relief at Source**

31. Contributions made to pension schemes operating Relief at Source (RAS) are treated as paid after basic rate tax has been deducted. Under RAS, the contribution is paid out of income net of tax and the pension scheme claims the basic rate tax element of the contribution from HMRC and adds it to the individual's pension plan. Higher and additional rate taxpayers can claim any further tax relief from HMRC through Self Assessment.

32. **Once the Welsh rates of income tax are introduced pension schemes will claim relief at the Welsh basic rate for Welsh taxpayers who are members of their RAS scheme**. This means that, if the Welsh and UK rates diverge, Welsh RAS scheme members will receive a different amount of tax relief from UK taxpayers.

33. HMRC has been working on a solution with pension providers in the context of Scottish income tax that enables pension schemes to differentiate between Scottish and rest of the UK taxpayers in their records and make RAS claims at both Scottish and UK basic rates. HMRC will continue to work with pension providers to extend this solution to Welsh taxpayers and confirm the timetable for doing so.

34. Pension schemes will be told which members of their scheme are Welsh taxpayers. The information to make this decision comes from the information on the annual return of information sent to HMRC by pension scheme administrators. Schemes are informed of their members' status in the January before the start of the tax year and members will keep this status for the duration of that tax year, even if their position changes.

35. This will mean additional administrative burdens for pension providers, but continuing to provide relief at the UK basic rate for a Welsh taxpayer would mean that basic rate Welsh taxpayers would not receive the correct amount of relief if the rates diverged.

**Other arrangements for pension schemes**

36. This section applies to individuals who are able to claim tax relief direct from HMRC through the Self Assessment process, for example members of Retirement Annuity Contracts. **Individuals in these cases will receive relief at their marginal rate and so Welsh taxpayers will receive relief on their pension contributions at Welsh rates**.

**Tax charges for pension schemes**

37. Individuals whose pension savings are in excess of the annual allowance (AA) for tax relieved pension savings may be liable to an AA charge. The excess savings over the AA are added to the individual's taxable income and charged at their marginal rate of income tax. **The AA charge for Welsh taxpayers will be calculated at Welsh rates of income tax.**

38. In addition there are special tax charges for payments made out of pension savings that are based broadly on the current UK income tax rates. They are designed to incorporate a certain tolerance should rates alter by a small amount either up or down. If Welsh and other UK rates diverge to only a small extent, the outcome may be that the broadness of the brush applied to the calculation is sufficient to accommodate short term differences between UK and Welsh rates of income tax. Therefore, to avoid continual administrative and systems changes for pension schemes and HMRC, **no changes will be made to the rates of the special pension tax charges** initially. HMRC will monitor the position in case any divergence of rates is significant or continues over a period of time, in which case it may be necessary to consider introducing a parallel set of rates for scheme members who are Welsh taxpayers.

## Chapter 5 - Trustees and Personal Representatives

39. Trustees and personal representatives of estates of deceased persons have a residence status for tax purposes. There are different rules for each.

40. This is already a complex area and the UK Government wishes to avoid additional complexity. The introduction of “Welsh resident” trusts and estates would add another layer of complications for trustees and personal representatives. **Trusts will therefore retain their current (UK or non-UK) residence status and be taxed at UK rates where appropriate**. This replicates the position with regards to Scottish income tax.

41. Trusts and deceased estates are not generally affected by the Welsh rates of income tax. Income arising to trusts will not be chargeable to the Welsh rates, which apply only to individuals. A body of trustees (on whom liability for tax due on trust income falls), is treated as a single ‘person’ for tax purposes, and is not an individual. Neither is the personal representative of the deceased acting in an individual capacity.

42. However, **trust or estate income arising to or received by an individual Welsh taxpayer would be chargeable to the Welsh rates**. There are a number of different types of trust though and there are implications in relation to the Welsh rates when income is paid out to beneficiaries. These would be treated in the following ways.

**Bare trusts**

43. Under a **bare trust** arrangement, income is treated for tax purposes as arising direct to the beneficiary. As a result, those beneficiaries who are Welsh taxpayers would include this income as part of their total income in the normal way, and **this would be liable to the Welsh rates of income tax**.

**Discretionary and accumulation trusts**

44. Income from **discretionary and accumulation trusts** is distributed to beneficiaries at the discretion of the trustees. The trustees of UK resident trusts are currently charged on their income at the trusts tax rate (45%) or dividend trust rate (38.1%). The beneficiaries’ income is treated as being received net of tax at the trust rate, so they currently receive a tax credit of 45 per cent.

45. Income flowing through these trusts loses its character – in other words, irrespective of whether the income arising to the trust was savings or non-savings income all the income would be treated as non-savings income in the hands of the beneficiaries. **Income payments from discretionary trusts will therefore be liable at the Welsh rates when paid to beneficiaries who are Welsh taxpayers**.

46. In broad terms the trustees of non-resident discretionary trusts are only liable to income tax at the trust rate on the UK source income that they receive. They are not liable to UK income tax on foreign source income although they may be liable to tax on this income in the overseas jurisdiction. Discretionary income distributions from non-UK

resident trusts are treated as untaxed income of the beneficiary irrespective of whether the trustees have suffered tax on the trust income. The beneficiary may if certain conditions are met claim credit for some of the tax paid by the trustees. **Such income should be included by Welsh taxpayers as part of their total income in the normal way, and this would be liable at the Welsh rates of income tax**. This would be consistent with the current tax treatment, the position in relation to Scottish taxpayers and simple to administer.

**Deceased Estates and Interest in Possession Trusts**

47. A **UK-resident Interest in Possession (IIP) trust** is one where the beneficiary has a legal right to the trust income as it arises. In England and Wales, prior to making a payment to the beneficiary, the trustee is required to pay tax at the UK basic rate of tax.

48. Personal representatives dealing with **estates of deceased persons** will not be liable at the Welsh rates of income tax on income arising during or at the end of the administration of the estate. When paying income from the residue of a deceased estate to the beneficiary they will similarly have paid UK basic rate tax on that income.

49. In either case, the beneficiary could be receiving non-savings, non-dividend income which has borne tax at the UK basic rate. Currently, beneficiaries liable at the UK basic rate of tax may have no need to do anything further – they would not need to submit a tax return merely to report the IIP or residuary estate income because there would be no additional tax to pay (although some basic rate IIP beneficiaries may feel it worthwhile to reclaim tax in cases where the trustees have borne expenses out of the income to which the beneficiary is entitled). Beneficiaries liable to tax at the higher or additional rates will have further tax to pay and will be required to complete tax returns.

50. **Income from interest in possession trusts and deceased estates will be taxed at the Welsh rates when arising to beneficiaries who are Welsh taxpayers**. This decision has been taken on the basis that, although it is recognised that this could cause some administrative issues if the Welsh and UK rates diverge in future, such an eventuality is preferable to making an already complex area of legislation even more challenging for taxpayers. This also replicates the position with regards to Scottish income tax.

51. With **non-UK resident interest in possession trusts** the issues are different as the trustees will only be liable to UK income tax on UK source income and that income will not be subject to the trust rate. The trustees will not be liable to UK income tax on any foreign income that they receive. It should also be noted that the beneficiary's right to income under foreign law in respect of interest in possession trusts can differ from that described above for UK trusts and consequently the treatment of the income in the hands of the beneficiary can differ. In some foreign law jurisdictions the beneficiaries are entitled to their appropriate share of each item of trust income when it arises to the trustees. These are known as Baker type trusts. In such circumstances the beneficiaries are chargeable on their share of trust income. If the trust income has borne UK tax it is treated as taxed income of the beneficiaries and each beneficiary's share is income that has been taxed at whatever rate of tax it has borne. **This income**

**will be taxed at the beneficiary's appropriate tax rate – if they are a Welsh taxpayer, they will therefore pay tax at the Welsh rates on non-savings income from the trust**.

52. Under some other foreign law jurisdictions beneficiaries of interest in possession trusts are entitled only to their appropriate share of the net trust income that remains after the trustees have paid trust expenses; these are referred to as Garland type trusts. The beneficiaries are chargeable on the arising basis by reference to the income receivable by them from the trust. This applies whether or not it was paid out by the trustees. The income is treated as a new source of income and will be returned by the beneficiary as untaxed foreign income. **If the beneficiary is a Welsh taxpayer, they will therefore pay tax at the appropriate Welsh main rate on this income**.

53. If trustees have already paid UK or foreign tax on the trust income, the beneficiary can claim relief for this tax, subject to certain conditions being met. This must be outside of their Self Assessment return though.

54. Once the Welsh rates are introduced, **such claims would be able to be set against tax charged at the Welsh main rates, in the same way as is currently allowed**.

<u>**Settlor interested trusts**</u>

55. **Settlor interested trusts** are trusts where the settlor (the person who put funds into the trust), or certain family members, can benefit from the trust. The trustees are required to pay tax at the appropriate rate. The settlor will be liable at their marginal rate, although they will receive a tax credit for the tax paid by the trustees.

56. Income in the hands of the settlor will continue to be charged at their marginal rate – **therefore, if the settlor is a Welsh taxpayer, this income will be chargeable at the Welsh main rates**. This will also be the case if there is an offshore structure and the transferor or beneficiary are assessable to tax under the Transfer of Assets legislation at sections 720 and 731 of ITA.

## Chapter 6 - Other Income Tax Issues

57. **Payments to foreign entertainers and sportspersons** are currently subject to a withholding tax at the UK basic rate. Since such persons are by definition not resident in the UK for income tax purposes, **the UK basic rate will continue to apply wherever the entertainer or sportsperson performs**.

58. Long-term UK residents who are not domiciled here can pay an **annual charge to be taxed under the remittance basis**. **This will not be affected by the introduction of the Welsh rates of income tax**. Payments of the charge due from Welsh taxpayers will continue to be paid direct to the UK Exchequer.

59. Accrued income is income which is due to an individual at the date of death, but had not been paid over prior to death. This income is treated as part of the estate for Inheritance Tax purposes. It is also taken into account when calculating the residuary income of the individual's estate. In this circumstance, a beneficiary can claim relief for a **reduction in residuary income** equal to the Inheritance Tax applicable to the accrued income. The reduction is calculated in reference to the Income Tax rates **therefore, if the individual is a Welsh taxpayer, the relief will be calculated in reference to the Welsh rates of income tax**.

60. The **Non-resident Landlord Scheme** (NRLS): Unless certain conditions are met, rents paid to landlords not resident in the UK are made after a deduction of tax. The Scheme is a withholding tax mechanism which collects tax on rental income received by non-resident landlords whose usual place of abode is outside the UK. Although there is no statutory definition of 'usual place of abode' the NRL Scheme applies to all landlords leaving the UK for a period that is expected to, or will, exceed six months. The obligation to withhold and pay this basic rate income tax rests on the non-resident landlord's representative, either with the person who collects the rents (e.g. UK letting agent) or with the tenant, and it is their liability (although the representative is entitled to be indemnified by the non-resident landlord for all such payments). The Government sees no reason for this to change once the Welsh rates of income tax is introduced, so **the UK rate will continue to apply to rents paid to landlords not resident in the UK**.

61. **Landlords Finance Cost Restriction**: Income tax payers may make a deduction for finance costs in computing the profits or losses of a property business. This is restricted from 2017–18 onwards for residential properties. From 6 April 2017 onwards tax relief for income taxpayers who are residential landlords and higher rate taxpayers, is restricted: this is being gradually phased in over a four-year period so that the full restriction does not apply until 2020–21. Relief will be given only at 20% (the current prevailing UK basic rate of income tax). **Welsh taxpayer's liability to the Welsh rates will need to be included in these calculations.**

62. Under the **Construction Industry Scheme** (CIS), where payments are made to certain subcontractors in the construction industry, deductions must be made on account of income tax, corporation tax or Class 4 National Insurance Contributions (NICs). There

are two rates of deduction – one for subcontractors registered with the scheme (20 per cent) and one for subcontractors who are not registered (30 per cent). At present, the rate of the deduction for registered subcontractors is the same as the UK basic rate. The Government believes that it would make sense for the rate of deduction to be a uniform rate throughout the UK, so **no change will be made to the rate of deduction for payments to subcontractors in Wales** – this will also make it easier for contractors to administer the CIS, especially if they operate in both Wales and elsewhere in the UK. This will not affect the ultimate liability to tax of Welsh taxpayer subcontractors who will pay tax at the Welsh rate of income tax through their Self Assessment return in the normal way.

63. **PAYE settlement agreements** (PSAs) are an arrangement between HMRC and employers to account for tax and Class 1B NICs on benefits in kind or expenses that are minor, irregular or impracticable to collect using normal PAYE or benefits reporting mechanisms. The amount of tax and NICs collected under the PSA may not be exactly the same as the amounts due from the employees if separately calculated, but any variances are tolerated because of the reduction in administrative burdens for both the employer and HMRC.

64. The agreements take the form of a broad-brush calculation based on assumptions about the tax liabilities of the employees – e.g. whether they are basic, higher or additional rate taxpayers. Taking account of whether employees are Welsh taxpayers will make this calculation more complicated, but not to do so would increase the variance between the true liability and that calculated by the PSA. So, **a Welsh taxpayer's liability to the Welsh rates will need to be included in these calculations**.

65. Incentive awards are a way of rewarding employees and others with cash, goods or holidays rather than increases in pay. Schemes can vary from national promotions to a prize raffle held by a small firm. Rewards of goods or holidays will usually involve the use of a voucher. Employers frequently meet the tax payable on a non-cash incentive award given to an employee by entering into a PSA. Employers and third parties providing incentive awards can also enter into special accounting arrangements for non-cash awards. These arrangements are called **taxed incentive award schemes** (TIAS). Under the arrangements, persons who make awards either to their own or other people's employees, or both, can enter into a contract with HMRC to account directly for tax on the awards. The providers have the option of accounting for tax at either the basic rate, higher or additional rate on the grossed up value of the awards they make.

66. Unlike awards covered by PSAs, non-cash awards and the tax paid on them under TIAS arrangements remain assessable on the employee. So the employee has to enter the grossed-up value of the award and the tax paid on it on any tax return. But normally no further tax is due from an employee unless the provider has only entered into a basic rate TIAS and the recipient of the award is liable at the higher or additional rate. For reasons of consistency, **the treatment for taxed incentive award schemes follows that of PSAs so Welsh taxpayers' liability reflects Welsh rates**.

67. The special 'policyholder' rate of **corporation tax that is applied to life assurance companies and friendly societies on returns ultimately attributable to savers and**

**investors** is set at the same level as the UK basic rate of tax. Since these companies do not fall within the definition of a "Welsh taxpayer", **this rate of corporation tax will not be affected by the Welsh rates**.

68. **Real estate investment trusts** (REITs) are property investment companies that have elected to join the REIT regime. REITs are exempt from tax on their property rental profits. Payments from REITs out of these profits are made as property income distributions (PIDs) and in the hands of the investor these are taxed as income from property. A sum representing income tax at the basic rate must be deducted from the PID when paid to individuals.

69. It would put a considerable administrative burden on REITs to require them to identify if an individual in receipt of a PID is a Welsh taxpayer – therefore, **REITs will continue to deduct at the UK basic rate from PIDs**.

70. **Authorised investment funds** (AIFs) are open-ended investment companies, pooling capital from a variety of investors – the AIF's investments will typically be in stocks, shares and bonds. The AIF itself is chargeable to corporation tax and any payments it makes to investors are in the form of dividends, or in the case of bond funds, in the form of interest payments. As dividend income and interest payments are excluded from the definition of the Welsh rates of income tax, **there are no Wales Act consequential issues relating to AIFs**.

71. **Property authorised investment funds** (PAIFs) are a type of AIF which invests in property – as such, much of its income is derived from rents on these properties. As a result, when the PAIF makes a payment to any individual investors, this is treated as rental income in the hands of the recipient and the PAIF makes a deduction from the payment equivalent to the UK basic rate of tax.

72. The PAIF fund managers may not be able to identify their investors. Even if they can, they will have no way of knowing whether or not their investors are Welsh taxpayers and, therefore, whether they should deduct the UK or Welsh rates of income tax. Therefore, as with REITs, **PAIFs will continue to deduct at the UK basic rate from payments to individual investors**.

73. For both REITs and PAIFs, **Welsh taxpayers will pay tax at the Welsh rates on non-savings income from PAIFs and REITs**. This is in line with the position for Scottish income tax.

<u>**Payments subject to a basic rate withholding tax**</u>

74. Part 15 of ITA legislates for a number of situations where a business making a payment of income to an individual is required to deduct tax at the UK basic rate prior to making the payment. While, in many cases, these would be payments of savings income (as statutorily defined in section 18 of ITA and, therefore, outside the scope of the Welsh rates of income tax), some payments, which are neither savings nor dividend income would, by default, be charged to income tax as non-savings income. These include, for

example, certain types of annual payment, including payments from certain non-pension annuities.

75. **If the Welsh and UK rates diverge, basic rate Welsh taxpayers in receipt of such payments will face either over- or underpayments of tax.** However, putting in place a system to prevent this would cause a considerable administrative burden to fall on companies making such payments.

76. **Payments which are subject to a basic rate withholding tax under Part 15 of ITA should not be within the scope of the Welsh rates of income tax**. This replicates the position with regards to Scottish income tax.

**Order of set-off**

77. The above will introduce the concept of non-savings income of a Welsh taxpayer which is chargeable at the UK rates. This therefore introduces a small degree of flexibility in the order in which an individual might want to set off reliefs and deductions from their total amount of income. Current rules in section 25 of ITA enable an individual to set off their reliefs and deductions in a way that results in the greatest reduction in their income tax liability. That flexibility remains but, by recategorising particular sources as described above, it may result in a reduction in the overall tax payable.

78. Once reliefs and deductions have been applied, there are then specific rules in place within the tax system regarding the order in which the remaining chargeable income should be set against the various rate bands. Broadly speaking, the statutory order prescribes non-savings income is taxed first, followed by savings income then dividend income. Chargeable event gains and payments from trustees of settlor-interested settlements are exceptions and taxed last of all.

79. However, these rules do not make any distinction in relation to different types of non-savings income. For example, a distribution of income from a PAIF would be amalgamated with other parts of an individual's non-savings income (e.g. their salary or income from a property) and set against their allowances as a single block.

80. For the Welsh taxpayer, this creates a situation where, if the Welsh and UK main rates diverge, income within that non-savings 'block' could be charged at two different rates of tax. However, **Welsh taxpayers in receipt of non-savings income charged at the UK rates will still be able to benefit from the current statutory approach and arrange their income set-off in such a way as to result in the greatest reduction to their tax liability**.

**Deficiency relief**

81. A similar situation arises where taxpayers are able to take advantage of deficiency relief from a life insurance policy. Deficiency relief may be available to individuals when their life insurance policy, life annuity contract or capital redemption policy comes to an end. Individuals may be entitled to the relief if the tax calculation needed

when a policy or contract comes to an end gives a negative result rather than a gain, but taxable gains have arisen earlier in the life of the same policy or contract.

82. The amount of the deficiency relief tax reduction is determined using the amount of any deficiency to reduce the amount of income liable at the higher rate. **The relevant legislation will therefore be amended to include income liable at the Welsh higher rate, factoring in the possibility that the Welsh higher rate could be higher or lower than the UK higher rate**.

**Social security lump sum**

83. Section 7 of the Finance (No.2) Act 2005 (FA (No.2) 2005) governs the treatment of social security pension lump sum payments. This section enables social security pension lump sum payments to be treated as income for the purposes of the charge to income tax, but not to be taken into account in determining the total income of an individual.

84. It further allows the social security pension lump sum to be taxed at the highest rate of tax that would be applied to that individuals step 3 income (as set out in the ITA). Where the individuals step 3 income for the applicable year of assessment is nil, the lump sum will be taxed at 0%.

85. There is currently no reference to the Welsh rate of income tax in Section 7 of the FA (No.2) 2005. Therefore amendments are required to this legislation to ensure that **Welsh taxpayers receive the same treatment as the rest of the UK in respect of social security pension lump sums and will be taxed at the appropriate Welsh rates.**

**Transfer of assets**

86. Chapter 2 of Part 13 of ITA provides for the Transfer of Assets (ToA) legislation. Broadly, this regime is designed to prevent UK resident individuals avoiding tax by transferring an asset so that income that would have arisen to that individual arises to a person abroad instead (although a UK individual is still entitled to benefit from the income). Where this happens there is a ToA charge on a UK resident individual calculated by reference to the income arising to the person abroad – the UK resident that is charged is usually the person who has transferred the asset but may not be (it can be someone else who has received a benefit as a consequence of the transfer).

87. Where a ToA charge arises, this will form part of an individual’s income for income tax purposes and the resulting tax rate will then be determined under Chapter 2 of Part 2 of ITA, depending on the nature of the income. **For Welsh taxpayers, non-savings, non-dividend income will be taxed at Welsh rates**, where applicable.

**Transferable tax allowance for married couples and civil partners**

88. Chapter 3A of Part 3 of the Income Tax Act (ITA) 2007 governs the transferable tax allowance for married couples and civil partners. The legislation allows a spouse or

civil partner to transfer ten percent of their personal allowance to their spouse/civil partner, where the qualifying conditions are met.

89. The current position is that both the person making the election to transfer their personal allowance and the person receiving the tax reduction must not be liable to tax at a rate other than the basic rate, the default basic rate, the savings basic rate, the dividend nil rate, the Scottish basic rate, a Scottish rate below the Scottish basic rate, Scottish intermediate rate, the dividend ordinary rate, the savings nil rate or the starting rate for savers.

90. The transferred allowance is given effect as a reduction to the recipient's tax liability (rather than their taxable income).

91. Welsh taxpayers should be entitled to take advantage of the transferable allowance, provided they meet the necessary criteria. Therefore the legislation will be amended to ensure those liable to the Welsh basic rate continue to be eligible to the transferable tax allowance, and the allowance will be by reference to the Welsh basic rate.

## Chapter 7 – PAYE Amendments (excluding PSAs)

92. The PAYE Regulations govern the operation of the PAYE system under which income tax is deducted at source from an employee's pay. A number of amendments are required to the Income Tax (Pay As You Earn) Regulations 2003 to include reference to the Welsh rates of income tax and to make new reporting obligations in respect of it. These are set out in draft of the Income Tax (Pay As You Earn) (Amendment No.2) Regulations 2018 that accompanies this Note. Policy relating to PAYE Settlement Agreements is dealt with in the preceding chapter.

93. In addition to detailed consequential changes, the regulations will provide for a new "C" prefix[1] to the standard tax code as an indicator that the Welsh rates of income tax apply.

94. The Government intends to follow the same system of making Welsh taxpayers aware of the amount of Welsh rates of income tax they have paid as for Scottish taxpayers and Scottish income tax. This means the Welsh rates will be shown separately in HMRC's Tax Calculator and annual Tax Summary. The regulations accompanying this Note give effect to that requirement for employers and pension providers.

[1] For Cymru