



# Possible changes to income tax rules on interest

**Summary of Responses**  
October 2012

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# 1. Introduction

1.1 HMRC published a [consultation document](#) on possible changes to the income tax rules on interest on 27 March 2012. The consultation closed on 22 June 2012. This document summarises the responses received and explains HMRC's further proposals on this subject.

1.2 The aim of the consultation was to seek views on possible changes to the charge to income tax on interest under Part 4 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA), and the requirement to deduct income tax from interest and other payments in accordance with Part 15 of the Income Tax Act 2007 (ITA). The consultation document made proposals for changes to the following aspects of the taxation of interest:

- Interest included in compensation payments would be subject to deduction of income tax at source.
- References to 'yearly' interest in Part 15 of ITA would be removed, and changes made to the meaning of the term 'arising in the UK'.
- The exemption from the requirement to deduct income tax from quoted Eurobonds would be restricted where such bonds were held between companies in the same group.
- 'Interest-in-kind' would be subject to deduction of income tax at source in cash, and the rules on funding bonds aligned with such treatment.
- Legislation would be introduced on 'disguised interest'.

1.3 A total of 72 responses were received from a range of businesses, representative bodies and trade associations, professional bodies and firms, and individuals. The number of responses commenting on each of the topics raised in the consultation document was as follows:

<b>Subject</b>	<b>No. of responses</b>
Compensation	17
Yearly interest	52
Arising in the UK	14
Quoted Eurobonds	47
Interest in kind	9
Funding bonds	24
Disguised interest	21

1.4 In addition to receiving written responses, HMRC held a number of meetings to discuss the proposals with businesses, representative bodies and professional firms.

1.5 The responses to the consultation are described in more detail in the following chapters in this document, but in summary the views expressed by those who replied on each of the topics included in the consultation were broadly as follows:

- Changes to the rules on deduction of tax from interest included in compensation payments to provide greater clarity for taxpayers were generally welcomed, but concern was expressed that changes would increase administrative burdens on business.
- Most respondents wanted to see references to 'yearly' interest retained in Part 15 of ITA 2007.
- Opinions were mixed on the merits of changes to the term 'arising in the UK'.
- Most respondents were against changes to the quoted Eurobond exemption.
- Proposals for specific rules on the deduction of income tax from interest-in-kind were generally welcomed but concern expressed at the complexity of the proposed approach.
- Most respondents were against the proposal that income tax due on funding bonds should be paid in cash.
- Most respondents were in favour of, or had no objection to, the introduction of legislation on disguised interest, but wanted to see this done in the context of the simplification of other tax rules.

1.6 Many responses made the comment in relation to all the proposals in the consultation, that any changes would need to be accompanied by improvements to HMRC's guidance, and that due provision for commencement, transitional rules and 'grandfathering' provisions would be needed to minimise the impact on existing arrangements.

1.7 Chapters 2 to 6 of this document set out the proposals the Government intends to take forward from the consultation. In summary, legislation will be introduced in Finance Bill 2013 on:

- deduction of tax from interest included in compensation payments;
- specialty debt;
- interest in kind;
- the valuation of funding bonds;
- disguised interest.

1.8 The proposals in the consultation document on 'yearly' interest, the quoted Eurobond exemption and cash payment of tax on funding bonds will not be taken forward.

1.9 Chapter 7 of this document sets out the next steps relating to these proposals.

## 2. Interest included in compensation payments

2.1 The consultation document sought views on the following proposals:

- Section 380A ITTOIA would be amended or extended so that, through secondary legislation, it could be applied generally to ‘payments representing interest’ included in compensation payments.
- Chapter 2 of Part 15 of ITA would be amended so that compensation payments made by deposit-takers and building societies could be included in the Tax Deduction Scheme for Interest (TDSI) rules.
- Chapter 3 of Part 15 of ITA would be amended so that interest included in compensation payments made by bodies outside the TDSI rules would be subject to deduction of tax at source.

2.2 Responses to the consultation focused mostly on two aspects of the proposals:

- The type of payments that should be subject to deduction of tax.
- The administrative burden arising from any such changes.

2.3 In general respondents did not favour amendments to the legislation in section 380A ITTOIA which applies to ‘payments representing interest’ under the Financial Services Compensation Scheme (FSCS). Some argued that any extension to the requirement to deduct tax at source should be applied only on a case by case basis.

2.4 There was support for the principle of providing consistency for the treatment of compensation payments, on the basis that the majority of recipients are basic rate taxpayers who would no longer have to submit self assessment tax returns of the gross income received.

2.5 However, some firms and representative bodies raised concerns about the administrative burden on firms making such payments. Deposit takers did not favour the idea of including the interest element of non-saving products, such as compensation payments, within the TDSI, as this would require the modification of existing systems and processes, in particular forms R85, R105 and the production of certificates under section 975 of ITA 2007.

2.6 Firms that are not deposit takers and currently make payments outside TDSI said they may incur additional administrative costs in applying deduction at source to payments that are currently paid gross, for example where the interest in question is regarded as ‘short’ rather than ‘yearly’.

2.7 Some respondents favoured a *de minimis* limit for the requirement to deduct tax, or a *de minimis* limit to the reporting requirement, to ensure that small payments were not subject to deduction at source.

## Proposals

2.8 The Government proposes legislation in Finance Bill 2013 to make it clear that the requirement in Chapter 3 of Part 15 of ITA to deduct income tax from interest applies to compensation payments made to individuals, including payments made by banks in the ordinary course of their business.

2.10 This would be subject to a secondary legislative power to disapply this rule in cases where its application might be difficult.

2.11 The legislation would not re-characterise as interest amounts that are not interest on first principles.

2.12 No changes are proposed to section 380A of ITTOIA.

2.13 No changes are proposed to the application of the TDSI rules in Chapter 2 of Part 15 of ITA.

## 3. Yearly interest arising in the UK

3.1 The consultation document sought views on the following proposals:

- Chapter 3 of Part 15 of ITA would be amended so that it applies to all payments of interest not otherwise covered by the rules in Part 15, not just to 'yearly interest'.
- Section 874 of ITA would be amended so that the question of whether or not interest is interest 'arising in the UK' would be determined without reference to the location of any agreement or deed evidencing the debt (as is the case for 'specialty debt').

### 'Yearly interest'

3.2 A number of responses acknowledged that the terms 'yearly' and 'short' in relation to interest are now somewhat arcane. However, most respondents argued that the proposals did not represent an improvement over the current position, and favoured the retention of the concept of 'yearly interest'.

3.3 The distinction between 'yearly' and 'short' interest was felt to be well established and well understood despite its complex history. Some respondents felt that legislative changes in this area would give rise to new case law complexity and would not achieve a genuine simplification.

3.4 Many respondents argued that the proposals would have a significant impact on a wide range of commercial practices which currently rely on the exemption for 'short' interest, including:

- intra-group cash pooling arrangements and intra-group funding arrangements generally;
- the issue by companies of commercial paper; repo, stock lending and other collateral arrangements;
- short term bridging finance;
- late payments due under property leases;
- payments made under reinsurance agreements;
- payments of certain types of derivative;
- payments made under certain securitisation arrangements.

3.5 It was argued that additional exemptions would be required to ensure that such 'short' interest was not affected, and that existing statutory exemptions (such as that applying to amounts paid in the ordinary course of a banking business, and payments of 'trade interest') might need to be modified, which would add complexity to the tax system.

3.6 The negative impacts of requiring deduction at source in a wider range of circumstances were said to include an increase in the cost of short-term external funding, the cost to businesses of restructuring to use other types of instrument not

subject to withholding, and the possibility that the UK would be seen as a less attractive base for treasury operations.

3.7 Some respondents suggested that the proposals appeared to go against the grain of recent policy in this area which has been to reduce the incidence of applying withholding tax in a business context. A number of respondents suggested that the policy direction should be to extend, not restrict, circumstances in which gross payment is permitted.

3.8 Scepticism was expressed as to whether the changes would in practice generate any benefit to the Exchequer, since payments made between UK businesses commonly do not require deduction, and in a cross-border context double taxation treaties often reduce withholding rates to nil. However, as treaty applications are time consuming there would be an increase in the administrative burden on many companies and a cash-flow disadvantage while the clearances are sought.

3.9 Some respondents suggested that the existing 'passport' system in Chapter 8 of Part 15 ITA should be extended.

### Arising in the UK

3.10 There were few comments on the treatment of specialty debt. One response suggested that a targeted anti-avoidance rule would be the appropriate means by which to address problems in this area.

3.11 In the course of meetings with interested parties on deduction of tax from yearly interest arising in the UK, the issue of the statutory definition of the term was discussed. There was some support for the view that the existing statute and case law in this area lacked clarity, and that the principal consideration in determining the source of the payment should be the residence of the payer, as suggested in a previous consultation in 2003, or the jurisdiction of enforcement. However, there was concern that changes in the definition may not be compatible with double taxation treaties, and could present particular difficulties for individuals and partnerships, and there was no consensus on the approach to be taken in any legislation.

3.12. Some respondents suggested that the issue would be better dealt with by improvements to HMRC guidance.

### Proposals

3.13 The Government does not intend to proceed with the abolition of the concept of yearly interest as set out in the consultation.

3.14 As explained in Chapter 2 above, the Government proposes legislation in Finance Act 2013 to make it clear that the requirement to deduct income tax from interest applies to compensation payments made to individuals, including payments made by banks in the ordinary course of their business. This would be subject to a secondary legislative power to disapply this rule in cases where its application might be difficult.

3.15 The Government acknowledges the representations made in a number of responses on the need to look at circumstances in which tax is withheld from interest in a cross-border context and will consider this further.

3.16 The Government proposes legislation in Finance Bill 2013 to clarify the treatment of 'specialty debt', to make it clear that the meaning of 'arising in the UK' would be determined without reference to the location of any agreement or deed evidencing such a debt.

3.18 HMRC will make changes to its guidance in the Savings and Investment Manual (SAIM) to set out more clearly its view of 'short' loans that are repeatedly rolled over.

## 4. Quoted Eurobonds

4.1 The consultation document sought views on a proposal to restrict the exception from the duty to deduct interest given at section 882 of ITA for Quoted Eurobonds, so that it would not apply where the Eurobond is issued to a fellow group company and listed on a stock exchange on which there is no substantial or regular trading in the Eurobond.

4.2 The responses from the consultation were largely against the changes as they would make it more difficult to raise funds and therefore make the UK less competitive than other jurisdictions. Respondents raised a number of particular concerns as follows:

- The well-established Eurobond market in the UK could be undermined. This would weaken London's competitive position, reduce inward investment in the UK, and put the UK at a disadvantage compared to competing jurisdictions.
- The change would add to compliance costs, as businesses sought to restructure existing arrangements.
- Clearing and paying agents' systems would need to be re-designed to manage withholding tax arrangements, and an exemption would be required for quoted Eurobonds held on trading account by a holding company
- Redemption of existing quoted Eurobonds could be triggered, and grandfathering rules would be needed to provide certainty and stability to existing arrangements.

4.3 The positive Exchequer effect set out in the Impact Assessment was questioned by respondents who expressed the view that treaty relief would often be available in cases where the exemption was currently used. It was also thought likely that any restriction in the application of the exemption would result in an increasing use of non-interest bearing instruments not subject to withholding obligation. The need to apply for treaty relief would itself represent an additional compliance burden.

4.4 On the specific proposal that the restriction would apply where intra-group bonds are listed on stock exchanges where there is no 'regular or substantial trading', a number of respondents said that such instruments are often part of a chain of bonds through which third party finance is raised, and are listed on such exchanges to take advantage of lower regulatory costs. It was argued that a 'regular or substantial trading' test would be difficult to frame, hard to administer, and impose a compliance burden.

4.5 Some respondents felt that the concept of an 'intra-group' quoted Eurobond would be difficult to define; many favoured a narrow wording based on an existing statutory definition such as that used capital gains.

4.6 Particular difficulties were said to arise for syndicated funds using certain types of entity and special purpose vehicles, where information about the syndicated lenders would be hard to obtain to satisfy treaty requirements at the time of the transaction.

4.7 Respondents queried the practicality of a restriction of the exemption based on the identity of bond holders, which may be difficult to ascertain using current clearing systems and the large number of bearer instruments in use. The restriction would require an assessment of whether interest has a UK source, and the volume and frequency of trading was said to be outside the control of the issuer.

4.8 Some respondents suggested that the restriction of the exemption would be a disproportionate response to a relatively discrete problem, and that avoidance in this area would be better addressed through existing legislation (such as that on thin capitalisation, transfer pricing, worldwide debt cap, etc.), or by a TAAR to address arrangements that have a tax avoidance purpose. Alternatively, it was said that the issue should be addressed by excluding particular territories from the list of recognised stock exchanges.

## Proposals

4.9 In light of the responses the Government does not intend to proceed with the proposed restriction. However, as with the proposal on 'yearly interest', the Government has noted the representations made on the wider question of the extent to which tax is withheld from interest in a cross-border context, and will consider this further.

## 5. Interest in kind and funding bonds

5.1 The consultation document sought views on the following proposals on interest paid in kind and on funding bonds:

- Where any non-cash interest is payable, tax would be paid in cash to HMRC on the 'grossed up' amount of the non-cash interest, in accordance with the formula in section 998 of ITA.
- The cash equivalent of the non-cash consideration would be valued as the higher of:
  - The face value of the goods, services or vouchers;
  - The maximum retail price of the goods or services supplied or for which vouchers may be exchanged;
  - The cost of the goods or services supplied or for which vouchers may be exchanged.
- Chapter 12 of Part 15 ITA would be amended so that tax to be deducted from funding bonds would be payable to HMRC in cash.

### Interest in kind

5.2 Respondents broadly supported the proposals, but felt the formula proposed was unnecessarily complex, and might impose an administrative burden on both the payer and recipient where amounts do not have an easily identifiable cash equivalent. There was also concern that there should be symmetry between the deduction allowed to a business and the amount taxable on the recipient.

5.3 Some respondents suggested that valuation of the non-cash consideration should be based on the face value of the voucher at the time that the voucher is issued with the same amount given as a deduction for the issuer. They also suggested that where the interest comprises vouchers and cash, and the tax can be met from the cash element, there should be no need for grossing up in respect of the vouchers.

### Funding bonds

5.4 Most responses from the consultation were against the introduction of a requirement to pay over tax deducted from funding bonds in cash.

5.5 Respondents generally saw funding bonds as distinguishable from vouchers and other forms of interest-in-kind paid by retail institutions. They were of the view that the benefit to businesses that issue funding bonds because they are in financial difficulties should outweigh the consideration of the administrative cost to HMRC of managing the bonds.

5.6 It was argued that payment of the tax in cash would favour HMRC over other creditors, and in some cases would breach banking covenants. A number of respondents argued that grandfathering rules would be needed to ensure continuity of treatment for current arrangements.

5.7 A similar argument was made in relation to the use of funding bonds in private equity arrangements. As in many such cases gross payment would be permitted under Double Taxation Agreements (DTAs), it was argued that the only effect of such a change would be to encourage a move to alternative structures.

5.8 Some respondents said further detail was needed on how such a change would interact with the loan relationship rules for deductible amounts of interest and the current requirement to retain part of the funding bonds.

5.9 Some respondents suggested alternative approaches to the current rules on funding bonds, including a reporting requirement, basing the calculation of interest on the market value of the bonds and not their face value, collecting the tax from the lender rather than the borrower, and an obligation to pay tax as and when the funding bonds are redeemed without the need to deliver the bonds to HMRC.

## Proposals

5.10 The Government remains of the view that legislation to clarify the rules on deduction of tax from interest in kind is appropriate, but acknowledges the need to avoid complexity in this area.

5.11 The Government will not proceed with the proposal to require tax on a funding bond to be paid to HMRC in cash, but proposes instead to introduce a requirement on the issuer of a funding bond to state its valuation on issue.

5.12 Similarly a person paying interest in kind will be required to issue a certificate under section 975 of ITA, whether or not the recipient requests it, to ensure that there is no doubt about the 'gross amount' of the interest paid for the purposes of sections 982 and 998 of ITA.

5.13 The Government therefore proposes legislation in Finance Bill 2013 to:

- Amend Part 4 of ITTOIA so that where interest is paid in the form of goods or services, the interest should be treated as the value of those goods or services – that is, the retail or market price. Where a voucher is issued, the interest should be the face value of the voucher or (to cater for vouchers issued with no or almost no face value) the cash equivalent of the goods or services for which the voucher can be exchanged.
- Distinguish interest-in-kind and funding bonds so that the current treatment of funding bonds will be retained.
- Amend section 975 of ITA to require a person paying interest in kind or by funding bond to issue a certificate of the value of the bond, whether or not the recipient requests it.

## 6. Disguised interest

6.1 The consultation document sought views on a proposal to introduce a disguised interest rule for income tax purposes, in Part 4 of ITTOIA, which would be modelled broadly on the corporation tax provisions in Chapter 2A of Part 6 of CTA 2009, to address arrangements which produce returns that are economically equivalent to interest.

6.2 The responses from the consultation expressed some support for the introduction of a rule that aligned the income and corporation tax rules, but also raised a number of concerns.

6.3 Some respondents suggested that existing rules on the accrued income scheme (AIS) and deeply discounted securities (DDS) should be repealed or simplified if disguised interest legislation were to be introduced.

6.4 Others argued that a disguised interest rule should apply only where one of the main purposes is to avoid the income tax charge on interest, and some concerns were expressed about the interaction of a principle-based disguised interest rule with the proposals for a general anti-abuse rule (GAAR).

### Proposals

6.5 The Government proposes legislation for Finance Bill 2013 to:

- Introduce a disguised interest rule for income tax, modelled broadly on the corporation tax rule in Chapter 2A of Part 6 CTA 2009.
- Repeal Chapter 12 of Part 4 ITTOIA (disposals of futures and options involving guaranteed returns).
- Repeal sections 597 to 606 of ITA and Chapters 5 and 6 of Part 7 ITA (income tax rules on repos and quasi-stock lending arrangements).

6.6 The repo and quasi stock lending rules for income tax already aim to tax interest-like returns in the same way as interest and will become unnecessary as a result of introduction of a generic disguised interest rule. The proposed introduction of a disguised interest rule will complement the simplification of income tax rules on manufactured payments as set out in the consultation document 'Proposed changes to tax rules on manufactured payments' published on 27 March 2012.

6.7 A disguised interest rule would also facilitate the simplification of the current legislation on DDS (Chapter 8 of Part 4 of ITTOIA), and the AIS (Part 12 of ITA). The Government proposes the publication of a consultation document on the simplification of the DDS and AIS rules, following the introduction of the disguised interest rule. Subject to final Ministerial decision, this work will proceed to a Finance Bill 2014 timetable.

6.8 The legislation will charge to income tax a return produced for a person by arrangements that are economically equivalent to interest. The term 'economically equivalent to interest' would broadly follow the definition used in Chapter 2A of CTA 2009. That is, it would apply if:

- It is reasonable to assume that it is a return by reference to the time value of money.
- It is at a rate reasonably comparable to what is, in all the circumstances, a commercial rate of interest.
- At the relevant time there is no practical likelihood that it will cease to be produced in accordance with the arrangements.

6.11 Any income that is taxed both under the disguised interest rule and any other income tax provision (for example, the rules on DDS, AIS and alternative finance), would be taxed under that other provision.

6.12 The rules would contain a 'just and reasonable' provision, to avoid double taxation.

## 7. Summary of proposals and next steps

7.1 The Government proposes legislation in Finance Bill 2013 to make it clear that the rules in Chapter 3 of Part 15 ITA apply to interest included in compensation payments to individuals, including amounts paid by banks, subject to a regulation-making power to disapply this rule.

7.2 The Government does not intend to proceed with the abolition of the concept of yearly interest as set out in the consultation. It does, however, acknowledge the representations made in a number of responses on the need to look at circumstances in which withholding from interest is applied in a cross-border context and will consider this further.

7.3 The Government also proposes legislation in Finance Bill 2013 to clarify the treatment of 'specialty debt', to make it clear that the meaning of 'arising in the UK' would be determined without reference to the location of any agreement of deed evidencing the debt.

7.4 The Government does not intend to proceed with the restriction of the quoted Eurobond exemption as proposed in the consultation document.

7.5 Otherwise, the Government therefore proposes legislation in Finance Bill 2013 to:

- clarify the valuation of interest-in-kind;
- distinguish interest in kind and funding bonds;
- require a person paying interest by interest in kind or funding bond to issue a certificate of the value of the bond.

7.7 The Government also proposes legislation for Finance Bill 2013 to introduce a disguised interest rule for income tax, modelled broadly on the corporation tax rule in Chapter 2A of Part 6 of CTA 2009. There will be further consultation on the potential for consequential simplification of the rules on deeply discounted securities and the accrued income scheme, in accordance with the timetable for Finance Bill 2014.

7.8 The draft legislation described in this document will be included in the draft clauses for Finance Bill 2013 which will be published later in 2012, in accordance with the normal policy-making process. Where possible, HMRC will discuss the development of this draft legislation with interested parties.

7.9 Further comments on the proposals set out in this response document should be sent by:

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- telephone 020 7147 2608
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- post: Tony Sadler, Room 3c04, 100 Parliament Street, London SW1A 2BQ.

## Annexe A: List of respondents

HMRC does not normally identify the names of individuals who contribute to a consultation, or those of other respondents who specifically ask not to be identified. Some respondents made combined responses – each respondent has been listed separately in the table below.

Allen & Overy LLP  
Alternative Investment Management  
Association  
Alvarez and Marsal  
Anglo American Plc  
Ashurst LLP  
Aspen Insurance UK Ltd  
Association for Financial Markets in Europe  
Association of British Insurers  
Association of Investment Companies  
AstraZeneca  
Aviva PLC  
Barclays Bank PLC  
BDO LLP  
Berwin Leighton Paisner LLP  
BP plc  
British American Tobacco  
British Bankers' Association  
British Private Equity and Venture Capital  
Association  
Burberry Group plc  
Chartered Institute of Taxation  
Clifford Chance LLP  
Daiwa Capital Markets Europe Ltd  
Deloitte LLP  
Deutsche Post DHL  
Ernst & Young LLP  
Esso UK Ltd  
Freshfields Bruckhaus Deringer  
GlaxoSmithKline  
Grant Thornton UK LLP  
Henleydown Consulting Ltd  
Institute of Chartered Accountants in  
England and Wales  
International Capital Market Services  
Association  
KPMG LLP  
Linklaters LLP  
Lloyds Banking Group plc  
Nationwide Building Society  
New Zealand Bankers' Association  
Northern Gas Networks Limited

Omnicom Europe Ltd  
Pinsent Masons LLP  
PricewaterhouseCoopers  
Qioptiq Group  
Rio Tinto plc  
RSM Tenon  
Shell International Limited  
Simmons & Simmons LLP  
Slaughter & May  
Spectris plc  
Swiss Re  
Tata Steel UK Limited  
Taylor Wessing LLP  
Thames Water  
The Association of Corporate Treasurers  
The Association of Private Client Investment  
Managers and Stockbrokers  
The British Property Federation  
The City of London Law Society  
The Confederation of British Industry  
The International Securities Lending  
Association  
The International Swaps and Derivatives  
Association  
The Law Society  
The Phoenix Group  
The Society of Trust and Estate Practitioners  
The SSP Group  
The Wellcome Trust  
Travers Smith LLP  
TUI Travel PLC  
Weil, Gotshal & Manges  
Zurich Financial Services Limited