

Income tax rules on interest
HM Revenue and Customs draft legislation for inclusion in Finance Bill 2013
(‘Disguised interest’ and ‘Payments of interest’)

Comments by the Low Incomes Tax Reform Group

Who we are

1. The Low Incomes Tax Reform Group (LITRG) is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low income workers, pensioners, migrants, students, disabled people and carers.
2. LITRG works extensively with HM Revenue & Customs and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.
3. The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT’s primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

General comments

4. As in our response to the original consultation dated 22 June 2012, we have only made relevant comments on the taxation of the 'interest' components of compensation payments and disguised interest.

Payments of interest

5. Without a wider review of the basic principles, we are disappointed with the decision to treat 'interest' which is received as part of a one-off payment of compensation as 'yearly interest'; and for this 'interest' element to be consequently taxed at source. HMRC's response to the 2012 consultation¹ says at para 2.11:

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

6. This misses the points we made in our consultation response dated 22 June 2012², ie that we believe many payments of compensation wrongly have elements of them categorised as 'interest' and that the rules (as set out in HMRC guidance rather than legislation, with that guidance not being consistent with case law) are not clear. Compensation payments might be calculated using an assumed rate of 'interest' as a proxy to recompense the claimant for their loss. Under the proposed legislation, this 'interest' calculation could then be used by HMRC as an actual interest payment which is then taxed at source. We therefore reiterate our concerns from our original consultation response, which used the recent payments of compensation on Payment Protection Insurance policies as an example.
7. The draft legislation gives HMRC the ability to make regulations not to apply tax deduction in prescribed circumstances, but we are not clear what those circumstances are and the Explanatory Note gives no indication of what that regulation-making power might be used for. If the purpose of the new rules is, as stated, to 'clarify the application of the legislation and ensure that the rules on deduction of income tax operate in a consistent manner' (para 14 of the Explanatory Note), we query why a regulation-making power to disapply the rules is considered necessary or even desirable. Without having the purpose explained,

¹ See

http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?nfpb=true&pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PRO D1_032340

² See

[http://www.litr.org.uk/Resources/LITRG/Documents/2012/07/20120622_LITRG_response_Possible_changes_to_income_tax_rules_on_interest\(final\).pdf](http://www.litr.org.uk/Resources/LITRG/Documents/2012/07/20120622_LITRG_response_Possible_changes_to_income_tax_rules_on_interest(final).pdf)

respondents to this consultation therefore cannot say whether or not they agree to the power being included and likewise Parliament will not be able to judge its appropriateness in passing the Finance Bill 2013. The Explanatory Note must be clear as to what this is intended for.

8. Also if the assumed 'interest' is to be treated as taxable, we would also expect that the individual should have the option to elect for gross payment if they are a non-taxpayer, ie applying the Form R85 procedure to these payments. Our January 2013 report *Banks, building societies, HMRC and their non-taxpaying customers: a plea for better service* highlighted that many people on low incomes overpay tax on their savings as they are not provided with the correct Form R85 and the relevant guidance.¹ Clear guidance is needed for when the R85 can and cannot be used in relation to payments of interest of whatever kind from financial institutions and we would be willing to engage in discussions with HMRC about what is needed.

Disguised interest

9. We are disappointed in the decision to introduce disguised interest legislation for individuals in the form proposed. The draft legislation appears to be broadly worded and when coupled with the definition of 'interest in kind' we could envisage that it might be used to question informal loans which are not subject to interest, for example between family members. Many low-income families might, for example, lend money between themselves and then come to informal arrangements to pay the money back in kind. They might go to great lengths to 'repay' the original loan and the kindness shown to them by providing goods or their own personal services to the lender to a greater value than the amount loaned. On reading the draft legislation, it seems that such arrangements could be deemed to include an implied 'interest' element which would be subject to tax. We cannot think that this is the real intention of the legislation.
10. Whilst the draft legislation does set out that the rules are only to apply in limited circumstances (draft Section 381A(4)), we think that this could be strengthened by reflecting in the law that the purpose of the new legislation is 'to address income tax avoidance in relation to interest' (see HMRC's original consultation of 27 March 2012, para 1.2 final bullet²).

¹ See http://www.litrg.org.uk/Resources/LITRG/Documents/2013/01/R85_MS_report_Jan13.pdf

² See http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?nfpb=true&pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PRO D1_031986

11. The above point should be addressed by specifying in the draft legislation that the meaning of 'arrangement' is one where the primary purpose or one of the main purposes was to avoid tax. This would bring it into line with other targeted anti-avoidance rules. If the draft legislation is not changed (and we think it most certainly should include this important safeguard), then at the very least HMRC guidance ought to make clear that the purpose of the legislation was not to catch the types of informal arrangements between family and friends such as we describe above.

LITRG

5 February 2013