

INCOME TAX (TRADING AND OTHER INCOME) ACT 2005

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 4: Savings and investment income

Chapter 2: Interest

Overview

1482. This Chapter charges to tax interest and income that is treated as interest.

Section 369: Charge to tax on interest

1483. This section charges all interest to tax, whether from a source within or outside the United Kingdom. It is based on Schedule D Cases III(a), IV and V in section 18 of ICTA.

1484. *Subsection (1)* sets out the charge to tax.

1485. This section does not reproduce the separate charging provision in section 18(3)(c) of ICTA for “income from securities which is payable out of the public revenue of the United Kingdom or Northern Ireland”. All the income which would fall into this category can be charged to tax under other provisions of this Act.

1486. Neither has the section reproduced the words “of money whether yearly or otherwise” in section 18(3) Case III (a) of ICTA.

1487. The cases of *Re Euro Hotel (Belgravia) Ltd* (1975), 51 TC 293¹ HC and *Riches v Westminster Bank Ltd* (1947), 28 TC 159 HL demonstrate that the reference to “of money” is to the debt upon which the interest itself is payable rather than the interest. Since the words “of money” add nothing to “interest” they have been dropped.

1488. The words “yearly or otherwise” follow the historical recognition by tax legislation of a distinction between yearly interest and short interest. Although the separate charging rules for these two types of interest were merged in 1918 the reference to “yearly or otherwise” was retained. The distinction between yearly and short interest is still relevant in some areas, for example the deduction of tax provisions in section 349(2) of ICTA, but as the words do not add anything to the charge to tax on “any interest...” in section 18(3)(a) of ICTA, they have not been reproduced in this section.

1489. The words in section 18(3) Case III (a) of ICTA “whether such payment is payable within or out of the United Kingdom” have not been reproduced. The place of payment is only one of a number of factors derived from case law which may be taken into account in determining the source of interest.

¹ STC [1975] 682.

1490. The section charges interest to tax whether or not it arises within the United Kingdom. Whether interest arises from a source outside the United Kingdom will, as explained, depend on a number of factors. Some of these are considered in *Westminster Bank Executor and Trustee Co (Channel Islands) Ltd v National Bank of Greece SA* (1970), 46 TC 472 HL.
1491. For individuals, unless a particular charge specifies otherwise, interest arising from a source outside the United Kingdom is taxed under Schedule D Case IV if it arises from securities outside the United Kingdom but otherwise under Case V. This treatment is confirmed by *Lord Manton's Trustees v Steele* (1927), 11 TC 549 CA and *Westminster Bank Executor and Trustee Co (Channel Islands) Ltd v National Bank of Greece SA* (1970), 46 TC 472 HL.
1492. Not all the income within this Chapter can have a foreign source and in some cases it would be most unusual for interest from a source outside the United Kingdom to arise. This is so with building society dividends and share interest from an industrial and provident society. In other cases it may be impossible for such income to have a foreign source. The following paragraphs look at foreign source income in relation to particular categories of income treated as interest under this Chapter.

Building Societies

1493. Under section 66 of FA 1988 a society incorporated under the Building Societies Act 1986 will be resident in the United Kingdom through incorporation. As long as dividends are paid by a UK resident company they have a UK source under the principle in *Bradbury v The English Sewing Cotton Company Ltd* (1923), 8 TC 481 HL.
1494. But a society may be non-resident where it satisfies a residence test in the territory of a treaty partner and the treaty awards residence to that other territory. Section 249 of FA 1994 will then apply to treat the society as non-resident. Theoretically dividends paid by a building society may therefore arise from a source outside the United Kingdom. This would be most unlikely, however, since a building society may only be incorporated under the Building Societies Act 1986 if its principal office is in the United Kingdom. With the place of incorporation and the principal office in the United Kingdom a residence test is unlikely to be satisfied in another territory.

Open-ended Investment Companies

1495. The definition of an open-ended investment company in section 468(10) of ICTA carries a limitation that the company should be incorporated in the United Kingdom under the OEIC regulations of 1996. Section 468(10) of ICTA is inserted in section 468 of ICTA by Regulation 10(4) (Open-ended Investment Companies (Tax) Regulations 1997 [SI 1997/1154](#)). All open-ended investment companies within the definition in section 468(10) of ICTA are therefore subject to the company residence rule in section 66 of FA 1988 (“regarded for the purposes of the Taxes Acts as resident”). Open-ended investment company interest distributions treated as made by a UK resident company will be UK source income. Although, as explained in connection with industrial and provident societies, it may be theoretically possible for section 249 of FA 1994 to make such companies non-resident, this is most unlikely in practice.

Authorised Unit Trusts

1496. It is possible for the FSA to recognise a non UK unit trust scheme for marketing into the UK. However, only those UK tax resident unit trusts that are “authorised” by the FSA come within section 468 of ICTA. Section 468(1) of ICTA provides that the Tax Acts apply to UK authorised unit trusts and shall have effect as if the trustees of the authorised unit trust were a company resident in the United Kingdom. Although the application of section 468(1) of ICTA is by reference to the trustees' income (and relief for capital expenditure), the treatment of the trustees as a UK resident company carries through for the purposes of taxing interest distributions treated as made to unit holders.

That is because section 468L(2) of ICTA provides that the Tax Acts shall have effect as if such interest distributions were made “by the company referred to in section 468(1)”. As these distributions are treated as made by such a company, that is a UK resident company, they can only be UK source income.

Industrial and Provident Societies

1497. Under section 66 of FA 1988 a society registered under the Industrial and Provident Societies Acts will be resident in the United Kingdom through incorporation. A society may, however, be non-resident where it also satisfies a residence test in the territory of a treaty partner of the United Kingdom and the treaty awards residence to that other territory. Section 249 of FA 1994 will then apply to treat the society as non-resident.
1498. Section 486(4) of ICTA provides that share or loan interest is chargeable under Schedule D Case III. Theoretically therefore payments by a registered society may arise outside the United Kingdom but be charged under Schedule D Case III and not able to benefit from treatment specific to Schedule D Cases IV and V. For the sake of consistency this section treats such income arising outside the United Kingdom as relevant foreign income and therefore able to benefit from the special rules in Part 8 of this Act. See *Change 131* in Annex 1.
1499. Section 18(3)(b) of ICTA charges “all discounts” to tax under Case III. Although these words could be read as embracing discounts that arise outside the United Kingdom, it has long been the practice to charge discounts with a foreign source under Schedule D Cases IV or V. There is however little direct authority in case law for this approach, although it is fully accepted by the commentaries.

Section 370: Income charged

1500. This section sets out the amount of interest charged to tax on sources both within and outside the United Kingdom. It is based on sections 64, 65 and 68 of ICTA.
1501. *Subsection (1)* sets out the amount of interest charged to tax. This is the full amount of interest arising in the tax year.
1502. Section 64 of ICTA sets out the basis of assessment for income chargeable under Schedule D Case III. It requires that income tax should be computed “...on the full amount of the income...without any deduction”. There are no specific provisions allowing deductions from the amount charged to tax under Schedule D Case III and it is not clear what such deductions would represent. There are no rules allowing expenditure in earning Schedule D Case III income. The words “full amount of the income” carry some weight in suggesting that the amounts chargeable are without deduction.
1503. In relation to certain sources of income falling within Schedule D Case III, for example interest on savings bank deposits or private loans, the phrase “without any deduction” will not usually have any significance, as interest in such cases necessarily represents net income. There may, however, be such items as costs of collection but these cannot be deducted. Likewise in the case of discounts no set off can be made for losses incurred where the assessment is made under Schedule D Case III.
1504. The charging provision for Schedule F in section 20(1) of ICTA, which charges “all dividends and other distributions...of a company resident in the United Kingdom” does not state that the dividends are without any deduction. The words would be superfluous since no provision exists to give deductions from dividends from UK companies.
1505. For these reasons it is thought that the words are superfluous in the context of Schedule D Case III and they have therefore been omitted.
1506. The omission of these words also affects the following ‘income charged’ sections in this Act which are based on Schedule D Case III, section 424 (Chapter 7 of Part 4 of this Act, purchased life annuities) and 684 (Chapter 7 of Part 5 of this Act, annual payments not

otherwise charged). In each case the income charged is expressed as: “Tax is charged under this Chapter on the full amount of the [annuity payments] [annual payments] arising in the tax year”.

1507. The word “arising” has been the subject of a number of tax cases. “Arising” includes received and also credited to a bank account (*Parkside Leasing v Smith* (1984), 58 TC 282² HC). However, “arising” has a wider meaning than this. For example, it was held in *Dunmore v McGowan* (1978), 52 TC 307³ CA, to include the “swelling of a person’s assets”, even where the person had no immediate right of access to the income. In view of the wide meaning given to “arising”, and the fact that it is a term with which practitioners are familiar, the word has been retained.
1508. *Subsection (2)* makes subsection (1) subject to the rules in Part 8 of this Act. This enables income that is non-UK source and which would have been charged under Schedule D Cases IV or V to obtain the benefit of the special rules for such income.

Section 371: Person liable

1509. This section states who is liable for any tax charged. It is based on section 59(1) of ICTA.
1510. Section 59 of ICTA gives the person chargeable as the person “receiving or entitled to” the income.
1511. The phrase “receiving or entitled to” has been considered at length by the courts, although no clear definition of it has emerged. In early cases the courts placed greater emphasis on the concept of receipt than on entitlement - see, for example, *Dewar v Commissioners of Inland Revenue* (1935), 19 TC 561 CA. Later, equal importance was attached to each part of the phrase - see, for example, *Aplin v White* (1973), 49 TC 93⁴ HC. The most recent cases, such as *MacPherson v Bond* (1985), 58 TC 579⁵ HC, and *Peracha v Miley* (1990), 63 TC 444⁶ CA, have hinged on whether or not any benefit has accrued to the taxpayer.
1512. As the phrase is well established in case law, it is retained in the rewritten legislation. It is not, however, considered appropriate to include any further explanation of the phrase because of its wide interpretation by the courts.

Section 372: Building society dividends

1513. This section treats building society dividends as interest. It is based on section 477A of ICTA.
1514. *Subsection (1)* provides that any building society dividend is to be treated as paid by way of interest for the purposes of this Act. See *Change 80* in Annex 1. The wording “for the purposes of this Act” is necessary here since building society dividends are not treated as interest for all income tax purposes. They are treated as dividends for the purposes of deducting tax, by virtue of regulations made under section 477A(1) of ICTA (regulation 3(1) of the Income Tax (Building Societies) (Dividends and Interest) Regulations 1990 [SI 1990/2231](#)) or by virtue of section 349(3A) of ICTA.

Section 373: Open-ended investment company interest distributions

1515. This section and the two sections that follow provide investors, who are liable to income tax, with the information required to determine their taxable income from the open-ended investment company (OEIC). The tax provisions relevant to the OEIC, which is liable to corporation tax, are not in this Act.

² STC [1985] 63.
³ STC [1978] 217.
⁴ STC [1973] 322.
⁵ STC [1985] 678.
⁶ STC [1990] 512.

These notes refer to the Income Tax (Trading and Other Income) Act 2005 (c.5) which received Royal Assent on 24 March 2005

1516. This section is based on section 468L of ICTA and the Open-ended Investment Companies (Tax) Regulations 1997 [SI 1997/1154](#). These regulations provide that the tax treatment of investors (shareholders) in an OEIC generally follows the tax treatment of investors (unit holders) of an authorised unit trust (AUT). For an outline of the treatment of investors in an AUT see the commentary on section 376.
1517. The section provides for amounts that are not interest and would otherwise be something else to be treated as interest received by the investors. The amounts so treated are charged to tax by section 369 and are subject to the deduction of tax rules in section 349 of ICTA as amended by section 468L(4) of ICTA.

Section 374: Date when interest payments under section 373 made

1518. This section is based on sections 468H and 468L of ICTA and the Open-ended Investment Companies (Tax) Regulations 1997 [SI 1997/1154](#). It applies to the amounts treated as interest.

Section 375: Interpretation of sections 373 and 374

1519. This section is based on sections 468H and 832 of ICTA and the Open-ended Investment Companies (Tax) Regulations 1997 [SI 1997/1154](#).
1520. The regulations contained in [SI 1997/1154](#), in so far as they apply to invoke the AUT rules for the tax charge on OEIC investors liable to income tax, are rewritten in the preceding sections. The regulations remain in place in respect of investors liable to corporation tax and all other aspects concerning OEICs. A saving has been made in Part 5 of Schedule 2 to this Act to preserve the power in section 152 of FA 1995 so that regulations may continue to be made for achieving any purpose that could be achieved by such regulations before enactment of these sections.

Section 376: Authorised unit trust interest distributions

1521. This section and the two sections that follow provide investors, who are liable to income tax, with the information required to determine their taxable income from the authorised unit trust (AUT). The tax provisions relevant to the AUT are not in this Act. This is because the AUT trustees are treated as a company liable to corporation tax under section 468(1)(a) of ICTA.
1522. This section is based on section 468L of ICTA which is part of the special tax rules for AUTs. These rules provide that AUTs are *treated for tax purposes* as though *all* of the money shown in their distribution accounts, as available for distribution or in the case of investors holding accumulation units, for adding to the capital value of their share of the fund, is *actually paid out* to unit holders. This means that the investors are taxed when they receive the benefit of the distribution made by the AUT rather than when they sell their units.
1523. The investors are treated as receiving a payment of interest or a dividend depending on how the AUT has allocated the money in its accounts. There are various rules which determine how and when this allocation can be made by the AUT.
1524. The amounts treated as interest are charged to tax by section 369 and are subject to the deduction of tax rules in section 349 of ICTA as amended by section 468L(4) of ICTA. The amounts treated as dividends are dealt with in section 389.

Section 377: Date when interest payments under section 376 made

1525. This section is based on sections 468H and 468L of ICTA. It applies to the amounts treated as interest.

Section 378: Interpretation of sections 376 and 377

1526. This section is based on sections 468H and 832 of ICTA.

Section 379: Industrial and provident society payments

1527. This section provides that share interest from industrial and provident societies is treated as interest. It is based on section 486 of ICTA.

1528. Section 486(4) of ICTA provides that share or loan interest is chargeable under Schedule D Case III. The definition of “share interest” in section 486 of ICTA is “any interest, dividend, bonus or other sum...”. This section treats the dividend, bonus and other sums as interest. See *Change 81* in Annex 1.

1529. *Subsections (2) to (5)* are definition subsections. The reference to “the Department of Agriculture for Northern Ireland” in section 486(12) of ICTA is rewritten in subsection (5) as the “the Department of Agriculture and Rural Development”, its current title.

1530. The closing words of section 486(12) of ICTA (“and references to the payment of share interest or loan interest include references to the crediting of such interest”) are not rewritten. They are relevant to the rules within that section on the deduction of tax rather than the charge.

Section 380: Funding bonds

1531. This section provides for an issue of funding bonds in respect of a liability to pay interest to be treated as a payment of interest. It is based on section 582 of ICTA.

1532. There is one specific situation where a funding bond is chargeable to tax under Schedule D Case VI rather than Schedule D Case III. Section 582(2)(a) of ICTA provides that where funding bonds are issued some bonds have to be retained on account of income tax. However, section 582(2)(b) of ICTA provides that where it is “impracticable” to do this the recipient is chargeable to tax under Schedule D Case VI on the amount of interest treated as having been paid by the issue of the bonds. This section charges this income also as interest for income tax purposes. One consequence is that all funding bond interest will be included in what was Schedule D Case III income in section 1A of ICTA as consequentially amended. See *Change 82* in Annex 1.

1533. Relief for losses under the former Schedule D Case VI provisions will still be available under section 392 of ICTA.

1534. Section 582(1) of ICTA treats the issue of funding bonds as a payment of interest and they are taxed accordingly. The deemed interest is equal to the value of the bond at the time of issue. This section clarifies that the value which applies is the market value of the bond and not its nominal value. If the value were the nominal value a change in value could only occur in the unlikely circumstance of a change in the face value of the bond after issue. Moreover, tax could be easily avoided by issuing bonds with a low face value but repaying at a premium.

Section 381: Discounts

1535. This section treats discounts taxed under Schedule D Case III(b) as interest. It is based on section 18 of ICTA.

1536. Although section 18 of ICTA includes discounts as a separate category of charge without treating them as interest, this section provides for them to be charged as if they were interest. See *Change 83* in Annex 1.