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

INCOME TAX (TRADING AND OTHER INCOME) ACT 2005

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 6: Exempt income

Chapter 9: Other income

Overview

2843. This Chapter provides for exemption from income tax in respect of miscellaneous income. The income exempted under this Chapter is categorised as follows:

- interest only income;
- interest and royalty payments;
- income from occupation of commercial woodlands;
- housing grants;
- approved share incentive plan distributions;
- foreign income of consular officers and employees;
- income of non-UK residents of certain securities; and
- other income.

Section 749: Interest paid under repayment supplements

2844. This section provides an exemption from income tax for repayment supplement paid by the Inland Revenue. It is based on section 824(8) of ICTA.

Section 750: Interest from tax reserve certificates

2845. This section provides an exemption from income tax for interest from Tax Reserve Certificates ("TRCs") issued by the Treasury. It is based on section 46(2) of ICTA. (The remainder of section 46 concerns unrelated income from savings certificates, which is dealt with in Chapter 2 of Part 6 of this Act.)

2846. TRCs were introduced in 1941 as a mechanism for making payments of tax on account. Interest on TRCs is paid when the certificates are used to settle a tax liability. TRCs have not been issued since the mid-1970s, when they were replaced by Certificates of Tax Deposit. However, TRCs are still used from time to time to settle tax liabilities. In the light of this, it is not possible to regard section 46(2) of ICTA as obsolete for income tax purposes.

Section 751: Interest on damages for personal injury

2847. This section provides an exemption from income tax for interest on damages for personal injury or death. It is based on section 329 of ICTA.

2848. The source legislation deals with interest on damages awarded by reference to various enactments. *Subsection (1)* omits those statutory references. It was never intended to limit the scope of the exemption to particular enactments: the policy was to include any Act under which interest on damages for personal injury could be awarded. See *Change 121* in Annex 1.

2849. Section 329(1)(a) and (b) of ICTA limit the exemption to the interest included in a sum for which judgement is given. *Subsection (1)(a)* refers simply to "a sum awarded by a court". *Subsection (1)(b)* makes it clear that interest which may arise from the date of the award is not included in the exemption.

2850. *Subsection (1)(c)* gives statutory effect to ESC A30 (interest on damages for personal injuries (foreign court awards)). See *Change 125* in Annex 1.

2851. *Subsection (2)* is based on section 329(3) of ICTA and extends the exemption to interest in respect of payments in satisfaction of a cause of action.

Section 752: Interest under employees' share schemes

2852. This section contains an exemption from income tax in respect of interest relating to trustees of certain employees' share schemes. It is based on section 688 of ICTA.

2853. *Subsection (1)* applies the section where the trustees receive interest from a participant in the employees' share scheme and the scheme is set up to comply with certain statutory provisions. Section 688 of ICTA refers to the trustees receiving interest from "employees and directors" of the company. This reflects the wording of section 54(1) of the Companies Act 1948 (the relevant company law enactment when what became section 688 first came into force). However, the relevant company law enactment is now section 153(4)(b) of the Companies Act 1985. That provision refers to "the provision by a company, in good faith in the interests of the company, of financial assistance for the purposes of an employees' share scheme."

2854. Subsection (1) of the section brings the wording of this exemption into line with the corresponding company law enactment. See *Change 126* in Annex 1.

2855. *Subsection (2)* provides that the trustees will be exempt from tax charged under Chapter 2 of Part 4 of this Act on the interest they receive if the scheme requires the trustees to pay to the company an equivalent amount as interest. Section 688 of ICTA refers to an exemption from tax "under Case III of Schedule D". But the reference in the section to Chapter 2 of Part 4 of this Act will include foreign source interest. It would be possible for UK resident trustees to receive interest from non-UK resident employees etc. In such circumstances, it would be illogical to treat the foreign source interest as outside the scope of the exemption. See *Change 127* in Annex 1.

Section 753: Interest on repayment of student loan

2856. This section provides an exemption from tax for interest paid to borrowers of student loans in respect of refunds of over-repayments of such loans. It is based on section 331A of FA 1999.

Section 754: Redemption of funding bonds

2857. This section provides that, where the issue of funding bonds results in a charge to tax as interest under section 380 of this Act, any interest paid on the subsequent redemption of the funding bonds is exempt from tax. The exemption also applies where the deemed interest on the funding bond was charged to corporation tax but on redemption the bond was held by an income tax payer. The section is based on section 582 of ICTA.

Section 755: Interest on foreign currency securities etc. owned by non-UK residents

2858. This section is based on section 581 of ICTA. It provides an exemption from income tax for interest on certain foreign currency securities, or loans, beneficially owned by people who are not resident in the United Kingdom. The exemption is available only if the Treasury make an appropriate direction.

2859. Section 581(1)(a) of ICTA provides that, if a Treasury direction is made, interest on this type of security or loan is not subject to deduction of tax at source. This provision is not rewritten in this Chapter. It is rewritten as a new section 581A of ICTA (see paragraph 242 of Schedule 1 to this Act).

2860. The meaning of "foreign currency" in this section is dealt with separately in section 756.

2861. *Subsection (1)* sets out the interest within the scope of the exemption for the purposes of this section. Section 581 of ICTA originally applied only to securities issued by local authorities. It was later extended to cover securities issued by, or loans made to, statutory corporations by adding section 581(4) of ICTA.

2862. *Subsection (2)* sets out the conditions to be met if the exemption is to apply. The reference to "eventual repayment" in subsection (2)(b) of the section (and based on section 581(4) of ICTA) is relevant only for a loan with no immediate entitlement to repayment.

2863. *Subsection (3)* of the section is an anti-avoidance provision. Section 581(3) of ICTA is very widely drafted: "where any income of any person is by virtue of any provision of the Income Tax Acts to be deemed to be income of any other person, that income shall not be exempt ...". In fact, there are only two sets of provisions under which this type of income could be deemed to be income of another person. The relevant provisions are listed in subsection (3) of the section.

2864. *Subsection (4)* reflects the effect of the devolution settlements. See *Change* 19 in Annex 1.

Section 756: Which securities and loans are foreign currency ones for section 755

2865. This section defines "foreign currency securities" for the purposes of section 755. It is based on section 581 of ICTA. Although the basic proposition in *subsection (1)* is quite straightforward, there are four qualifications to this proposition, set out in *subsections (3)* to *(6).*

2866. The source legislation, introduced during the exchange control era, refers to securities and loans "expressed in a currency other than sterling". However, there could be more than one interpretation of the word "expressed". In this context, the logical interpretation is that "expressed" means "repayable". This is in line with the exchange control definition of a foreign currency security, and with the reference to securities "expressed" in a particular currency in other contexts in the Tax Acts. This section is therefore drafted in terms of the currency used for repayment.

Section 757: Interest and royalty payments: introduction

2867. This section acts as a general introduction to sections 758 to 767. It is based on section 97 of FA 2004.

2868. Sections 757 to 767 rewrite most of Chapter 6 of Part 3 of FA 2004 which implements the European Union Interest and Royalties Directive (Council Directive 2003/49/EC of 3 June 2003).This directive provides for the elimination of source state taxation on interest and royalty payments between associated companies in different member States of the European Union.

2869. These sections therefore exempt from income tax certain interest and royalty payments made between associated companies where the beneficial owner is a company of another member State or a permanent establishment of such a company in a member State other than the United Kingdom. Although the person beneficially entitled to the income will be a company, the exemption is from income tax. This is because non-UK resident companies are only within the charge to corporation tax on such payments if they trade in the United Kingdom through a permanent establishment here and the interest or royalties are attributable to the permanent establishment.

2870. Income tax on interest and royalty payments would, apart from this exemption, be collected by deduction under section 349 of ICTA. Section 105(5) of FA 2004 introduced a new subsection (7) in section 349 of ICTA which provides that the latter section is subject to the exemption rewritten in these sections. The general disregard section in Chapter 10 of Part 6 of this Act ensures that, without a specific provision to the contrary, an amount that is exempt under Part 6 is disregarded for all other income tax purposes and this will include section 349 of ICTA. Section 349(7) of ICTA is not therefore amended to refer to the interest exemption but it continues to refer to section 101 of FA 2004 (dealing with the deduction of tax from royalty payments under section 349 of ICTA) which is not rewritten (see commentary on section 762).

Section 758: Exemption for certain interest and royalty payments

2871. This section gives the exemption and conditions for that exemption. Three conditions must be satisfied for the royalties exemption to apply and four for the interest exemption. The section is based on section 98 of FA 2004.

2872. *Subsection (1)* gives the exemption. Section 105(4) of FA 2004 inserts into section 18 of ICTA a subsection which makes the charge under that section subject to the exemption rewritten here. This is not rewritten as it is not considered necessary given the wording of subsection (1) of this section.

Section 759: The person making the payment

2873. The first condition in section 758 is that the payer of the interest or royalties is in the United Kingdom, whether as a UK permanent establishment of a company resident in another member State or a company resident in the United Kingdom (other than its permanent establishment outside the United Kingdom). The purpose of this section is to identify the payer (and thus ensure that the payer is in the United Kingdom) where the paying company has a permanent establishment in another territory. The criterion is where the payments are deductible against tax. If they are deductible against the profits of the permanent establishment in the territory where it is situated it is the permanent establishment that is treated as the payer. The section is based on section 99 of FA 2004.

Section 760: The person beneficially entitled to the payment

2874. The second condition in section 758 is that the person beneficially entitled to the income in respect of the payment is a European Union company other than such a company's permanent establishment in the United Kingdom or in a non-member State. The purpose of this section is to identify the beneficial owner where a European Union company has a permanent establishment in the United Kingdom or a non-member State and to ensure that the condition is satisfied. The section is based on section 99 of FA 2004.

Section 761: Meaning of "25% associates"

2875. The third condition in section 758 is that the payer and beneficial owner should be 25% associates. This section explains what is meant by a 25%. It is based on section 99 of FA 2004.

Section 762: Interest payments: exemption notices

2876. This section enables regulations about exemption notices to be made. These notices are required by the fourth and final condition in section 758 for the interest exemption. The section is based on section 100 of FA 2004.

2877. No exemption notice is required for royalty payments. Section 101 of FA 2004 is not rewritten in this Act as it relates to the deduction of tax. Section 102 of FA 2004 provides for claims for the repayment of tax deducted from interest or royalties paid. This section has not been rewritten.

Section 763: Special relationships

2878. This section provides that the exemption will not apply where the interest or royalties have not been paid between independent parties acting at arm's length. This is achieved by reference to a "special relationship" (a term used in double taxation treaties) between the payer and the beneficial owner of the income such that the payments will not be at arm's length. The section is based on section 103 of FA 2004.

2879. *Subsection (3)* provides that where a claim to relief under a double taxation treaty would provide greater relief from tax than is available under this exemption the company may chose to claim relief under the treaty.

Section 764: Application of ICTA provisions about special relationships

2880. This section ensures that the special relationships rule in section 763 is construed in the same way as similar rules in double taxation treaties. (Sections 808A and 808B of ICTA deal with the construction of the term "special relationship" in such treaties.) The section is based on section 103(2) to (4) of FA 2004.

Section 765: Anti-avoidance

2881. This section prevents exemption from tax being given if the purpose or one of the main purposes of the payments is to avoid tax. The wording is based on similar provisions in double taxation treaties. The section is based on section 104 of FA 2004.

2882. *Subsection (1)* applies to interest payments. Because it looks at the purposes of the person concerned with the creation or assignment of the debt, the section may apply where the interest payments are paid indirectly to a person not entitled to the exemption, for example where a payment is dog-legged through a European Union company to a non-European Union company.

Section 766: Interest and royalty payments: interpretation

2883. This section explains various terms used in the sections for this exemption. It is based on section 97 of FA 2004.

Section 767: Power to amend references to the Directive by Order

2884. This section allows the Treasury to amend the provisions for this exemption where that is appropriate for implementing any amendment to, or replacement of, the Directive adopted after 8 April 2004, the date when the clauses for Finance Bill 2004 were finalised. The section is based on section 97 of FA 2004.

2885. *Subsection (2)* enables references in section 101 of the FA 2004 to be amended where necessary as a result of amendments to the Directive. This is necessary as section 101 of that Act has not been rewritten (see commentary on section 762).

2886. Section 97(4) of FA 2004, which allows a first Treasury order to take effect before the making of the order, has not been rewritten as it would apply only if the Directive had been amended before Royal Assent to Finance Bill 2004 in a way that affected Chapter 6 of Part 3 of that Act.

Section 768: Commercial occupation of woodlands

2887. This section exempts income arising from the occupation of commercial woodlands from any charge as miscellaneous income. It is based on paragraph 3(2) of Schedule 6 to FA 1988.

2888. A consequence of this exemption is that no loss relief is available under section 392 of ICTA (losses from miscellaneous transactions). A requirement of that section is that any profit on the transaction would be liable to income tax.

2889. This section is complemented by sections 11 and 267 of this Act. The combined effect of these three sections is that income from the occupation of commercial woodlands is ignored for income tax purposes.

2890. The definition of "commercial woodlands" in *subsection (2)* is supplemented by the definition of "woodlands" in section 876 of this Act.

Section 769: Housing grants

2891. This section exempts from income tax grants paid under legislation intended to assist in providing, maintaining or improving housing. It is based on section 578 of ICTA.

2892. *Subsection (1)* reflects the effect of the devolution settlements. See *Change* 19 in Annex 1.

2893. *Subsection (2)* makes it clear that the expenditure need not be incurred by any particular person and that it may be current or future expenditure.

Section 770: Amounts applied by SIP trustees acquiring dividend shares or retained for reinvestment

2894. The commentary on the SIPs legislation in Chapter 3 of Part 4 of this Act explains the background to approved share incentive plans. This section is based on sections 493(1) and 496(1) of ITEPA. Without these exemptions a tax liability would arise under Chapter 3 of Part 4 of this Act (in respect of cash dividends paid by UK resident companies) or under Chapter 4 of Part 4 of this Act (in respect of cash dividends paid by non-UK resident companies). As the tax liability arises under this Act, the exemptions are rewritten in Part 6 of this Act rather than retained in ITEPA. Signposting provisions to this exemption are in sections 493 and 496 of ITEPA.

2895. The references to tax credits in subsection (2) of sections 493 and 496 of ITEPA are not rewritten in this section. The rewrite of section 231 of ICTA in this Act (see section 397) makes it unnecessary.

Section 771: Relevant foreign income of consular officers and employees

2896. This section exempts from income tax the relevant foreign income of consular officers and employees who satisfy particular conditions where an Order in Council has directed that the section should apply to give effect to a bilateral international convention with a foreign state. The provision is applicable only to a dozen or so conventions and it is unlikely that further Orders in Council will be made. The Consular Relations Act 1968 has made the use of such bilateral conventions unnecessary. "Relevant foreign income" is defined in section 830 of this Act. The section is based on section 322 of ICTA.

2897. *Subsection (1)* provides that the relevant foreign income of a consular officer or employee of a foreign state in the United Kingdom is exempt from tax if an Order in Council directs that the section applies to that state to give effect to a reciprocal arrangement and the individual concerned meets certain conditions. "Reciprocal arrangement" is the term used by section 302 of ITEPA which rewrites the employment income aspects of section 322 of ICTA. "Reciprocal arrangement" is defined in *subsection (5)*.

2898. *Subsection (2)(b)* refers to "a British overseas territories citizen". This rewrites section 322(1)(a) of ICTA "a British Dependent Territories citizen". Section 2(3) of the British Overseas Territories Act 2002 requires any reference to a British Dependent Territories citizen be read as a reference to a British overseas territories citizen. The change of name has been incorporated into this section.

Section 772: Further provisions about Orders under section 771

2899. This section makes further provisions for Orders in Council under section 771. It is based on section 322 of ICTA.

Section 773: Income from Inter-American Development Bank securities

2900. This section provides an exemption from income tax, in certain circumstances, relating to income from a security issued by the Inter-American Development Bank. It is based on section 583 of ICTA.

2901. *Subsections (2)* to *(4)* set out the circumstances which must all apply if the income is to be exempt. The exemption applies in respect of any income from a security issued by the Bank (including dividends or interest).

Section 774: Income from securities issued by designated international organisations

2902. This section provides an exemption from income tax, in certain circumstances, relating to income from a security issued by designated international organisations. It is based on section 324 of ICTA.

2903. *Subsections (2)* to *(4)* set out the circumstances which must all apply if the income is to be exempt. The exemption applies in respect of any income from a security issued by the relevant designated organisation (including dividends or interest).

Section 775: Income towards reducing the national debt

2904. This section provides an exemption from income tax, in certain circumstances, in respect of income arising from property held in trust where the trust funds are to be used for the reduction of the national debt. It is based on section 514 of ICTA.

Section 776: Scholarship income

2905. This section is based on section 331 of ICTA.

2906. *Subsection (1)* sets out the exemption and *subsection (2)* points the way to section 215 of ITEPA. Section 215 of ITEPA provides that if the scholarship income is employment-related, the scholarship exemption applies only to the holder of the scholarship. But such income is also exempt from tax if the conditions set out in section 213 of ITEPA (scholarships provided by trust funds etc) are fulfilled.

Section 777: VAT repayment supplements

2907. This section exempts VAT repayment supplement from tax. It is based on section 827(2) of ICTA. The supplement does not have the character of interest. So the exemption is in this Chapter rather than with the exemptions for interest.

Section 778: Incentives to use electronic communications

2908. This section exempts from tax incentives provided under regulations to make use of electronic communications. It is based in section 143 of FA 2000.

Section 779: Gains on commodity and financial futures

2909. This section is based on section 128 of ICTA. That section was introduced as section 72 of FA 1985. It was part of changes which removed gains on commodity and financial futures from the scope of income tax or corporation tax under Schedule D (unless chargeable as trade profits) and charged them instead as capital gains under section 143 of TCGA. This is an unusual instance of an item which is naturally income being charged instead as a capital profit (most "deeming" legislation is designed to tax capital profits as income).

2910. Section 80 of FA 1997 reversed the FA 1985 change to the extent of gains charged to tax thereafter under Schedule 5AA to ICTA (guaranteed returns on transactions in futures and options, rewritten in Chapter 12 of Part 4 of this Act).

2911. The only Cases of Schedule D which could apply to the gains covered by section 128 of ICTA, where the gain is income on first principles (and disregarding the exemption the section provides), are Schedule D Cases V and VI. As the relevant charging function of those Cases is rewritten in Chapter 8 of Part 5 of this Act, the section is expressed as an exemption from the charge under that Chapter.

2912. Together with the "priority sections" (sections 575 and 576), which award priority to a charge under Part 2 or under Chapter 12 of Part 4 of this Act, expressing the exemption in that way ensures that any gains not falling within that Part or Chapter are not charged to income tax. That leaves the way clear for gains covered by this exemption to be taxed under section 143 of TCGA.

2913. The section imports the definitions provided by section 143 of TCGA.

Section 780: Disabled person's vehicle maintenance grant

2914. This section is based on section 327 of ICTA and exempts from income tax grants made in respect of a disabled person's vehicle.

Section 781: Payments under New Deal 50plus

2915. This section is based on section 84 of FA 2000 and exempts from income tax certain payments made to a person participating in the New Deal 50plus scheme.

Section 782: Payments under employment zone programme

2916. This section is based on section 85 of FA 2000 and exempts from income tax payments made to a person participating in an employment zone programme.