

Income tax: options for reform of the Accrued Income Scheme

A consultation document

Issued by Inland Revenue
17 March 2004



CONTENTS

		Page
1:	Introduction	5
2:	Reason for consultation	6
3:	Background	6
4:	Timetable	6
5:	Options for change	7
6:	Responses sought	13

Appendices:

A:	Current AIS regime	14
B:	Partial Regulatory Impact Assessment	16
C:	Code of Practice on Written Consultation	22

Comments on this Consultation Document and replies to any questions asked in it, should be sent by **17 July 2004**:

by email to: Hasmukh.Haria@ir.gsi.gov.uk

or by post to:

Hasmukh Haria
Inland Revenue
Business Tax
Room 4W1
22 Kingsway
LONDON WC2B 6NR

Tel: 020 7438 6613

Fax: 020 7438 7190

Paper copies of this document may be obtained free of charge from Hasmukh Haria at the above address.

This document can also be accessed from the Inland Revenue's Internet site:
<http://www.inlandrevenue.gov.uk>

Confidentiality

Responses to the consultation, together with the names and addresses of respondents, may be published unless confidentiality is specifically requested. We will assume that if you are replying by email, any confidentiality disclaimer that is generated by your organisation's IT system is overridden unless you specifically include a request to the contrary in the main text of your submission to us. Please note that confidentiality cannot be guaranteed where a response includes evidence of a serious crime.

Complaints

If you have any complaints about any element of the consultation process leading from the issue of this document, please contact:

Steve Webster
Inland Revenue
New Wing
Somerset House
Strand
LONDON WC2R 1LB

Tel: 020 7438 6535

Fax: 020 7438 9191

E-mail: Steve.Webster@ir.gsi.gov.uk

© Crown copyright 2004.

Published with the permission of HM Treasury on behalf of the Controller of Her Majesty's Stationery Office.

The text in this document (excluding the Royal Coat of Arms and departmental logos) may be reproduced free of charge in any format or medium providing that it is reproduced accurately and not used in a misleading context. The material must be acknowledged as Crown copyright and the title of the document specified.

Any enquiries relating to the copyright in this document should be sent to:

HMSO
Licensing Division
St Clements House
2-16 Colegate
NORWICH NR3 1BQ

Fax: 01603 723 000

E-mail: hmsolicensing@cabinet-office.x.gsi.gov.uk

1. Introduction

- 1.1 The Accrued Income Scheme (AIS) was introduced in 1985, and was designed to prevent avoidance of tax on interest arising on gilts, corporate bonds and similar securities by conversion of income into non-taxable capital (a process known as 'bondwashing'). Appendix A explains how the scheme currently works.
- 1.2 The AIS stops avoidance of tax on sales of accrued interest by effectively taxing on an accruals basis interest that has accrued but has not been paid when a security is transferred. It is a complex scheme that attempts to provide a set of rules for every situation.
- 1.3 One important feature of the AIS is the threshold, which is designed to exclude small investors who are individuals. Where individuals hold no more than £5,000 worth of securities, the AIS does not apply to them.
- 1.4 There have been numerous calls from various professional bodies for the AIS to be abolished or simplified. The chief criticisms are that the AIS is too complex, does not fit easily with self assessment, and imposes a compliance burden on many small investors who are not intending to avoid tax and currently pay little if any tax under the AIS.

2. Reason for consultation

- 2.1 Outright abolition of the AIS without replacement is not an option. It would almost certainly allow very significant avoidance to re-emerge.
- 2.2 The Government would however like to consult on various options for change to the AIS. It wants to seek views on the best way to simplify this complex area.

3. Background

- 3.1 At the time of its introduction, the AIS applied to companies, collective investment schemes, members of Lloyd's, trusts and individuals. Changes since 1993 mean that the AIS now applies only to individuals and trusts.
- 3.2 This reduction in scope presents an opportunity to review how the AIS might be simplified whilst continuing to prevent avoidance of income tax.

4. Timetable

- 4.1 Responses to the questions in paragraphs 6.1 to 6.9 below should be made by **17 July 2004**. Subject to consideration of these responses, the Government plans to issue draft clauses prior to their inclusion in Finance Bill 2005.

5. Options for change

- 5.1 This consultation puts forward three options for change. Combinations of these options are also discussed. But it also seeks views on other ways in which the AIS might be improved.

Increase existing threshold

- 5.2 The simplest measure would be to increase the current threshold in relation to size of holdings of securities which applies to individuals. The current £5,000 figure has remained unaltered since the AIS was introduced in 1985. If that figure were simply inflation proofed, it would now be about £10,000.
- 5.3 One point that is often overlooked is that since the AIS was introduced, PEPs and their successors, ISAs, have been introduced. Since 1999, investors have been able to invest up to £7,000 a year in securities tax efficiently. This allows small investors to hold, completely free of tax, considerably more in securities than the current AIS threshold of £5,000.
- 5.4 While simply increasing the current threshold would remove more individuals from the scope of the AIS, the essential complexity would remain for those still subject to it. And there would be no simplification at all for persons other than individuals where the threshold does not apply.
- 5.5 The Government would like to know if increasing the existing threshold for individuals to £10,000 would achieve worthwhile deregulatory and compliance benefits. If £10,000 was not considered to be a sufficient increase, would respondents say, with reasons, what figure they consider appropriate.

Change the nature of the threshold

- 5.6 The current threshold is an 'all or nothing' provision, and if an individual's holding of securities exceeds the £5,000 figure, then the AIS bites on each and every transfer however small. The total tax at stake can be trivial.
- 5.7 An alternative approach would be to provide an 'activity' threshold for individuals which would mean that the AIS applied only if that individual transferred a certain amount of securities in any year of assessment. A transfer for this purpose would include both a sale and a purchase, so purchasing securities for £5,000 and selling them in the same year would represent £10,000 of transfers in deciding whether the threshold had been reached. If the limit was exceeded, the AIS would apply to all transfers in the year.
- 5.8 This approach would mean that the AIS need only apply where any adjustment was potentially significant.
- 5.9 If this approach was thought worthwhile, would a limit of £20,000 be broadly in keeping with the current de-minimis holding in terms of numbers of bondholders that would fall under the limit?
- 5.10 The Government would like to know if an activity threshold would be a better approach, and if so whether £20,000 is an appropriate figure. If respondents considered that a higher figure was appropriate, would they please provide reasons to support the figure put forward.

Measuring the value of securities for threshold purposes

- 5.11 At present, the 'holdings' threshold applies by reference to the nominal value of securities rather than their market value. This makes it much easier to measure whether an individual is above or below the threshold, and prevents any inadvertent breach of the

threshold because a change in interest rates caused a temporary increase in the value of the securities held.

- 5.12 If a change to an activity threshold were made, it might be easier to measure the value of transfers by reference to proceeds rather than nominal value. Do respondents agree and can they see any drawbacks to that?

Change of approach: comparison of transfer value with clean price

- 5.13 Where a security is sold, the price can be quoted 'clean' or 'dirty'. The clean price excludes the value of any accrued interest, while the dirty price includes that value.
- 5.14 Building on that concept, an alternative approach for the AIS would be to compare the clean price with the transfer value. Where a security is transferred for a price exceeding the clean price, the difference would be treated as a receipt of interest by the transferor and as a relief for the transferee, which can be set against interest arising on the securities. Where a security is transferred for a price less than the clean price, the difference would be treated as a receipt of interest by the transferee and as a relief for the transferor, which can be set against interest arising on the securities.
- 5.15 Interest treated as received by the transferor would be treated as arising at the date of transfer of the security. Interest treated as received by the transferee would be treated as arising at the next interest payment date on the securities or, if earlier, the date the transferee disposes of the securities.
- 5.16 Replacing the formula for calculating the accrued interest by a simple comparison between two amounts should enable many of the current rules covering special situations to be discarded. And treating taxable amounts as interest would bring the chargeable amounts within the normal Taxes Acts rules, so that a number of

the current rules such as exemptions for charities and pension funds, and those dealing with unremittable income would not be needed.

- 5.17 The only new general rule that would be required would be a market value rule applying to transfers of securities between connected persons.
- 5.18 The Government would like to know if there are advantages in adopting this approach and whether it would enable the AIS to be simplified. What drawbacks do respondents see in this approach?
- 5.19 Where securities are sold in a market that quotes both clean and dirty prices, or bargain notes show accrued interest, it would be a simple matter to ascertain the difference between the transfer value and the clean price. Where information on the clean price was not readily available or could not be easily calculated, the Revenue would normally accept that the clean price was the transfer value less the amount of accrued interest calculated on a straight line or other reasonable commercial basis.
- 5.20 The Government would like to know if respondents consider that this is a simple and workable approach to calculating the tax charge or relief under the AIS. Are there situations where such an approach would give rise to compliance difficulties as a result of lack of easily available information?

Combination of new approach with new threshold

- 5.21 If the approach outlined at paragraph 5.14 above was to be adopted, it is considered that the smallest investors should remain outside the AIS. The current form of holdings based threshold could be retained, or the alternative activity based threshold could be adopted.

- 5.22 Would respondents favour a 'holdings' or an 'activity' threshold for individuals, and would the proposed size of any threshold need to be the same for this alternative approach?

Alternative approaches

- 5.23 In considering alternative approaches, the following ideas have already been considered, or suggested in the past.
- i) A full accruals basis as currently applies to companies. This approach would be a fundamental change to the taxation of interest for income tax purposes, and would be difficult for individuals to comply with (for instance having to calculate accruals every 5th April).
 - ii) Applying the AIS only where a security is held for a short period (say 18 months or less). This would do nothing to remove the complexity of the current scheme. Neither would it prevent significant avoidance by very wealthy individuals or trusts with very large holdings of securities, because they would have sufficient securities to churn a proportion of their holdings at a frequency just longer than the threshold applied.
 - iii) Using the same approach as currently applies to discounted securities. While this has the benefit of simplicity, it is again a fundamental change to the basis of taxation of interest-bearing securities and would mean that gains that currently are not taxable might be charged.
 - iv) Bring all securities within the capital gains net. However, this would be a reversal of the aim of the AIS, which is to prevent conversion of income into more lightly taxed capital gains. It would also constitute a fundamental change to the taxation of securities, and might have

unwelcome effects beyond the confines of reform of the AIS.

- 5.24 The Government would be interested in hearing of any other alternative approaches that might be considered to replace or simplify the current AIS.

6. Responses sought

- 6.1 Do respondents consider simply raising the current threshold for individuals would achieve worthwhile compliance benefits (paragraph 5.5)?
- 6.2 Would an increase of that threshold to £10,000 be appropriate (paragraph 5.5)?
- 6.3 Would change to an 'activity' threshold be a better approach to avoiding trivial adjustments (paragraph 5.10)?
- 6.4 If so, would £20,000 be an appropriate figure (paragraph 5.10)?
- 6.5 If a change to an 'activity' threshold were made, would it be sensible to measure activity by reference to transfer proceeds rather than nominal value of the securities (paragraph 5.12)?
- 6.6 Would a change to a scheme based on the difference between the transfer value and the clean price be a sensible and simple option, and are there any drawbacks (paragraph 5.18)?
- 6.7 Do respondents consider the information needed could be easily obtained or calculated and what problems might arise (paragraph 5.20)?
- 6.8 If the approach set out at paragraphs 5.13 to 5.20 were adopted, what form of threshold for individuals would respondents prefer and would the same size of threshold be appropriate (paragraph 5.22)?
- 6.9 Do respondents have any other ideas for reform of the AIS, other than those already considered (paragraphs 5.23 and 5.24)?

Appendix A: Current AIS regime

1. The relevant legislation is at Chapter II Part XVII Income and Corporation Taxes Act 1988. Broadly, the current AIS works by taxing interest on a security, arising for a period in which that security is transferred, on an accruals basis. The basic rules for doing this work by apportioning the interest between seller and purchaser on a straight-line time basis.
2. As a result of this process, one party is treated as receiving an amount taxable under Case VI of Schedule D, and the other party is entitled to relief on the same amount (as a reduction in the amount of interest on which they are taxed). Complete symmetry is not always achieved, since one party may not be within the ambit of the AIS (for instance a company).
3. Because the AIS achieves its objectives by use of a formula, it has to define all terms used, such as “settlement day”, “interest period” and “transfers with or without accrued interest” etc. And since the AIS also has to cover all types of securities and likely situations involving transfers, the rules are inevitably complex.
4. In particular, because the interest period might end in a different year of assessment from that in which the transfer of the security takes place, the rules dealing with when and how charges and reliefs are dealt with are difficult to follow.
5. Another important feature of the AIS is the threshold that applies to individuals only. Under this, the AIS does not apply to an individual with holdings of securities of £5,000 or less. This limit has remained unaltered since the AIS was introduced in 1985. There is no equivalent threshold for trusts, as that would enable the AIS rules to be circumvented by fragmentation of holdings between a number of trusts.

6. The AIS contains numerous exceptions where it is inappropriate for it to apply. These include where the transaction in question forms part of a trading activity (as interest is taxed on an accruals basis under normal commercial accounting applied to trading activities), and where the transfer is one of the legs of a stock lending or sale and repurchase (repo) transaction.

7. The AIS also has several special rules to cope with particular situations. For instance, there are rules dealing with variable rate securities, unrealised interest and interest in default, gilt strips and new issues of securities.

Appendix B: Partial Regulatory Impact Assessment (RIA)

Consultation on the Accrued Income Scheme

Purpose and intended effect of the measure

The policy objectives

1. To make the accrued income scheme (AIS) simpler, and easier for individuals and trusts to comply with when completing their tax returns. The AIS applies where a person buys or sells securities on which interest has accrued but not been paid.

Background and introduction

2. The AIS is an anti-avoidance measure. It is designed to prevent avoidance of income tax through conversion of income into non-taxable capital by selling securities just before an interest payment date and buying them back shortly afterwards at a lower price.

3. The AIS was introduced in 1985 and is generally regarded as difficult to understand and comply with. But it applies widely to any individual or trust who buys or sells even a single security in a year of assessment. There is a threshold for individuals to exclude those with small holdings of securities. The purpose of the consultation is to seek views and make outline proposals on how the AIS might be made simpler whilst maintaining defences against tax avoidance.

The risks being addressed

4. The risks are that individuals and trusts do not fully understand the complexities of the AIS and consequently do not apply it correctly when completing their tax returns, or may even ignore it entirely. Making the AIS simpler should reduce that risk.

Options

5. Do nothing. The current AIS regime was introduced in 1985, and has been the subject of pressure for reform for many years on grounds of complexity and that many people do not apply it correctly. Doing nothing would continue this difficult compliance burden.
6. The consultation document offers three options.
 - The first is a simple increase in the existing threshold. Whilst this would have the effect of removing more individuals from the scope of the AIS, it would have an Exchequer cost and would do nothing to remove the complexity for those still covered by the AIS.
 - The second option is a new form of threshold that would prevent the AIS applying to small transactions where the tax at stake was trivial. Again while this would provide a measure of deregulatory simplification, there would be Exchequer cost if the size of the threshold were made significantly larger than the equivalent current figure and the underlying complexity of the AIS would remain.
 - The third option is a complete change to the way the AIS identifies accrued interest that needs to be taxed. This approach would do away with the need for many of the current complex rules and make the scheme easier to comply with. This could be combined with a change to the threshold applying to individuals on either basis set out above.
7. The consultation also invites alternative ideas for reform.

Business sectors affected

8. The AIS applies to individuals and trusts rather than to businesses themselves. In particular it does not apply to retail bond funds. But the AIS does apply to general trustees, and will affect professional firms acting as advisors to individuals and trustees.

Issues of equity and fairness

9. The AIS applies to individuals and trusts who buy or sell securities on which interest has accrued but is unpaid. Any replacement would have the same scope. It does not apply differently to any particular sector or class of individuals or trusts. It is not considered that this measure adversely affects equality of opportunity under Section 75 of the 1998 Northern Ireland Act.

Benefits

10. A reformed AIS would be simpler, and easier for individuals and trusts to comply with in completing their tax returns. It should reduce the frequency and cost of professional advice needed, and should also minimise the risk that tax is lost through non-compliance.

Policy costs

11. There should be a reduction in compliance costs consequent on the simpler rules of any new accrued income scheme, particularly if an increased threshold removed more individuals out of the scheme.

12. Any increase in the threshold will mean that more people will be taken out of its ambit and so they or their advisors will not need to calculate the charges and reliefs that would otherwise arise under the scheme.

13. If the option under the third bullet of paragraph 6 above were to be adopted, then holders of bonds or their advisors would have a much simpler task in calculating the accrued interest to be taxed or relieved rather than, as at present, having to work their way through the complicated formulae which apply in different special situations.

14. The Revenue would like to hear views on the scale of likely time and cost savings that might arise under the three options for reform, particularly to small firms of advisors and to professional trustees.

Implementation (compliance) costs

15. None expected, other than those of learning the new simpler rules, but views are welcome.

Exchequer effect/ distributional impacts

16. There should be no net cost or yield from any change in approach, although there would be a cost if the threshold for individuals is raised.

Small Business impacts

17. There should be no impact on small business, other than reduction in compliance costs of professionals acting as trustees or as advisors to individuals and trustees, which might possibly lead to a small reduction in fees charged.

18. The Revenue would like to hear from such small firms on the likely scale of both cost savings and fee reductions charged to clients.

Other costs and benefits (public & private sector)

19. No additional costs expected, but a reduction in Revenue costs of monitoring compliance with the AIS.

Unintended consequences

20. None identified.

Other impacts

21. None identified.

Devolution

22. No issues identified.

Human Rights

23. The policy should have the same coverage and effect as the current AIS scheme, and no HR issues have been identified.

E-policy

24. None identified.

Environmental impacts

25. None identified.

Rural proofing

26. There are no rural issues arising from this policy initiative.

Competition assessment

27. The competition filter shows that this policy is not expected to give rise to competition issues. The policy change applies in the same manner to all individuals and trusts who buy or sell securities, but will not affect the professional retail bond fund markets.

Securing compliance

28. The aim of the change is to make the new AIS easier to understand and consequently improve compliance with the scheme. Any increase in the threshold for individuals will take out those cases where the tax at stake is trivial, and thus eliminate an area where compliance is currently patchy.

Consultation

29. The AIS is a high profile provision that has been the subject of calls for reform for a number of years. Consultation is needed to seek views on whether the options offered for reform in what is a complex and difficult area would work. In view of the complexity, alternative ideas for reform are also being sought.

Monitoring and evaluation

30. The overall impact of any new AIS would be similar to the current scheme. The effectiveness of the new scheme would be measured by feedback through professional organisations and review of tax return entries.

Summary and recommendation

31. The policy change is expected to make compliance with the AIS much easier for people making tax returns, while maintaining defences against systematic tax avoidance. The Revenue would like to know if respondents consider the options offered for reform would achieve these objectives, and what compliance cost savings might be expected to arise, particularly to small business.

Contact point

Hasmukh Haria
RP Business Tax
020 7438 6613
E-mail: Hasmukh.Haria@ir.gsi.gov.uk

Appendix C: about the consultation process – code of practice on written consultation

Consultation Criteria:

- C.1 Timing of consultation should be built into the planning process for a policy (including legislation) or service from the start, so that it has the best prospect of improving the proposals concerned, and so that sufficient time is left for it at each stage.
- C.2 It should be clear who is being consulted, about what questions, in what timescale and for what purpose.
- C.3 A consultation document should be as simple and concise as possible. It should include a summary, in two pages at most, of the main questions it seeks views on. It should make it as easy as possible for readers to respond, make contact or complain.
- C.4 Documents should be made widely available, with the fullest use of electronic means (though not to the exclusion of others), and effectively drawn to the attention of all interested groups and individuals.
- C.5 Sufficient time should be allowed for considered responses from all groups with an interest. Twelve weeks should be the standard minimum period for a consultation.
- C.6 Responses should be carefully and open-mindedly analysed, and the results made widely available, with an account of the views expressed, and the reasons for decisions finally taken.
- C.7 Departments should monitor and evaluate consultations, designating a consultation co-ordinator who will ensure the lessons are disseminated.

The Inland Revenue confirms that, where possible, these consultation criteria have and will continue to be followed.