CHAPTER 3

THE TAXATION OF BANK INTEREST

3.1 Introduction

The centre column in the proforma is used for the taxation of bank interest. Interest is added to non-savings income to increase net income and to thereafter increase taxable income, but we keep interest separate from non-savings income because bank interest may be taxed at different rates.

Bank interest will either be received **gross** or it will be received **net**.

By "**gross**" we mean that the interest is received with **no tax** having been deducted at source. Therefore the taxpayer receives the gross amount.

By "**net**" we mean the bank or building society will **withhold tax** before paying the interest to the taxpayer. The taxpayer therefore receives the net amount, after tax has been deducted.

Where interest is received gross, this gross amount is entered into the centre column in the income tax computation. This gross amount is the same as the interest actually received.

However, where interest is received net – ie, the taxpayer receives taxed income - it is important to remember that we **always enter the gross amount in the income tax computation.** Therefore, when interest is received net we need to convert this into a gross figure by a process known as **"grossing up"**. We will deal with grossing up later.

3.2 Interest received gross

One type of interest that is received gross – ie, received without deduction of tax – is interest credited to **National Savings & Investments (NS&I) accounts,** such as Easy Access Savings accounts and Investment accounts.

Other types of interest received gross include interest received on **3½% War Loan** and interest on **government stocks or "gilts"**.

Interest on "qualifying time deposits" or "money market accounts" is also received gross.

Any interest credited to an offshore bank account is not taxed as interest income, but is instead taxed as foreign income. This interest will be credited gross because foreign banks will not withhold UK income tax.

Non-taxpayers can elect to receive any bank or building society interest gross by filling in a form R85 and sending it to their bank or building society. Non-taxpayers will be taxpayers whose income is below the personal allowance. Typically these will be children or elderly taxpayers.

3.3 Interest received net

Most interest paid in the UK is paid net of tax, so the taxpayer will receive taxed income. Taxed income will include interest credited to a UK bank account (except for a National Savings account) and interest credited to a building society account.

This interest will be received after tax has been deducted at source at the basic rate of 20%. For example, if a taxpayer receives net interest of £800 on a building society account, tax of £200 would have been deducted at source.

The gross amount – i.e. the amount before any tax was deducted - would have been £1,000. You will see therefore, the tax at 20% (i.e. £200), was deducted from the gross interest of £1,000, to give net interest received of £800.

	£
Gross interest	1,000
Tax deducted at source at 20%	(200)
Net interest received	£800

Where you are given the net figure in a question, it is important to **"gross it up"** before entering the gross figure into the tax computation. In this example, we take the net figure of £800, and gross it up by multiplying by **100 over 80** to give us the gross figure of £1,000.

$$\pounds 800 \times \frac{100}{80} = \pounds 1{,}000$$

It is this £1,000 that goes into a centre column - the interest column - in the tax computation.

If you are told the amount of interest a taxpayer has actually received, in most cases this will be the net amount so we need to gross this up and put the gross amount into the tax computation.

3.4 Taxation of interest

Bank interest is always taxed after non-savings income – i.e. after any employment income or rental income. There are four possible rates of tax applying to interest in 2010/11 - **10%, 20%, 40% or 50%.** ITA 2007, s.16

In most instances, interest will be taxed at the same rates as non-savings income, i.e. at 20% within the basic rate band, at 40% above the higher rate threshold and at 50% above the additional rate threshold.

Illustration 1

Mr Banks received the following income in 2010/11:

	£
Salary (PAYE deducted £5,000)	35,000
Building Society interest	11,200

His tax due is calculated as follows:

	Non Savings	*Interest*
	£	£
Income from earnings	35,000	
Interest		
(£11,200 x $\frac{100}{80}$)	______	14,000
Net Income	35,000	14,000
Less: Personal allowance	(6,475)	______
Taxable Income	£28,525	£14,000

Tax	£
28,525 @ 20%	5,705
8,875 @ 20%	1,775
37,400	
5,125 @ 40%	2,050
Tax liability	9,530
Less: PAYE deducted	(5,000)
Tax deducted on interest (£14,000 @ 20%)	(2,800)
Tax due	**£1,730**

3.5 The 10% "starting rate"

The 10% "starting rate" used to apply for all forms of income, but it was abolished for non-savings income from 2008/09 to make way for the basic rate to be reduced from 22% to 20%.

However, the 10% starting rate still applies for interest income in 2010/11, but **only where taxable non-savings income is less than £2,440**.

Where taxable non-savings income is less than £2,440 and the taxpayer has some interest;

1) the taxable non-savings income (if any) is taxed at 20%; &
2) the difference between the taxable non-savings income and £2,440 is taxed at 10%.

Any interest income thereafter is taxed at 20%, 40% or 50% as normal.

Illustration 2

Mrs Robertson has a part-time job paying £130 a week. Her only other income is building society interest of £36,000 per annum.

Her tax due for 2010/11 is:

	Non Savings	*Interest*
	£	£
Part-time job (52 x £130)	6,760	
Interest (£36,000 x $\frac{100}{80}$)		45,000
Less: PA	(6,475)	______
Taxable Income	285	45,000

Tax	£
285 @ 20%	57
2,155 @ 10%	215
2,440	
34,960 @ 20%	6,992
37,400	
7,885 @ 40%	3,154
Tax liability	10,418
Less: Tax on interest (£45,000 @ 20%)	(9,000)
Tax due	**£1,418**

3.6 Disclosure of overseas bank interest

UK banks and building societies have an obligation to notify HMRC of any interest credited to accounts of UK resident taxpayers. HMRC use this information to cross-check against tax returns to ensure that all interest has been fully disclosed.

However, where a UK taxpayer has an **overseas bank account**, historically there was **no way for HMRC to obtain information** regarding interest credited to those accounts. This gave rise to a loss of tax where UK resident taxpayers had (allegedly) failed to declare overseas bank interest.

As a result of cross-border co-operation between EU Tax Authorities, the EU Savings Directive was implemented from 1 July 2005. The Directive applies to all EU Member States and related territories.

As a result, EU member countries had to decide whether to either;

1) **exchange information relating to bank interest** credited to accounts held by persons who are not resident for tax purposes in that country, but who are resident for tax purposes in another EU country; or

2) **apply a "special withholding tax"** on such bank interest as well as deducting local tax, if any.

The tax withheld from the overseas bank interest is given as a credit when calculating UK income tax (it is treated as a payment on account of UK tax). Should a taxpayer be in a repayment position, he will be able to obtain a repayment of this tax from HMRC.

It is possible to **apply to HMRC for a Certificate** to avoid this withholding tax. The foreign bank will thereafter pay the interest gross. The individual will then authorise a paying agent to report details of the savings income to its tax authority, who will in turn supply it to HMRC.

At present, **Austria, Belgium and Luxembourg apply the special withholding tax** while **other EU members exchange information**.

Example 1

Indicate whether the following sources of interest are received net or gross:

	Net	*Gross*
a) Nat West Bank Interest		
b) Interest on National Savings Investment account		
c) Interest on gilt		
d) Interest on debenture stock		
e) Interest on money market deposit		

Example 2

Mr Lloyd received the following income in 2010/11:

	£
Rent from overseas property	17,000
Building Society interest	16,000
Interest on 3½% War Loan	10,000

Calculate Mr Lloyd's tax due.

Example 3

Mr Barclay received the following income in 2010/11:

	£
Earnings from employment (gross)	140,000
(PAYE deducted £47,720)	
Bank interest	25,000

Calculate Mr Barclay's tax due.

Answer 1

	Net	Gross
a) Nat West Bank interest	✓	
b) NS&I Investment account		✓
c) Interest on gilt		✓
d) Interest on debenture stock	✓	
e) Interest on money market deposit		✓

Answer 2

	Non Savings	*Interest*
	£	£
Foreign income	17,000	
Building Society Interest		
(16,000 x $\frac{100}{80}$)		20,000
Interest on 3½% War Loan	_____	10,000
Net Income	17,000	30,000
Less: Personal allowance	(6,475)	_____
Taxable Income	£10,525	£30,000

Tax	£
10,525 @ 20%	2,105
26,875 @ 20%	5,375
37,400	
3,125 @ 40%	1,250
Tax liability	8,730
Less: tax deducted on interest	
(£20,000 @ 20%)	(4,000)
Tax due	**£4,730**

Answer 3

	Non Savings	*Interest*
	£	£
Employment income	140,000	
Bank Interest		
$(25{,}000 \times \frac{100}{80})$		31,250
	140,000	31,250
Less: Personal allowance (withdrawn in full)	-	-
Taxable Income	£140,000	£31,250

Tax	£
37,400 @ 20%	7,480
112,600 @ 40%	45,040
150,000	
21,250 @ 50%	10,625
Tax liability	63,145
Less: PAYE	(47,720)
Less: tax deducted on interest (£31,250 @ 20%)	(6,250)
Tax due	**£9,175**