Simple interest

Following the deadline for payment protection insurance claims, which passed last year, David Massey and Amy Lawton explain that tax problems can arise when compensation payments are made.

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Perhaps we have led sheltered lives, but the extent of the mis-selling of payment protection insurance (PPI) and the tax problems associated with the compensation took us by surprise when our experiences at the North West Tax Clinic prompted us to explore the issue further. This article also draws on experiences reported in online discussion forums and on social media, in particular HMRC's community forums (community.hmrc.gov.uk) and its customer support Twitter feed @HMRCcustomers. These sources have confirmed that our clients' problems were far from unique.

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According to the latest figures released by the Financial Conduct Authority (FCA), some £38bn has been paid to customers as refunds and compensation for mis-sold PPI. While recent, these figures only go up to December 2019 and do not include many of the last-minute claims that will have been submitted in response to the FCA's deadline of 29 August last year prompted by animatronic Arnie's exhortation to 'Do it now!'.

The substantive refund is not chargeable, but the compensatory interest on that refund is taxed as savings income. Basic rate tax is deducted from this interest (under ITA 2007, s 874 (5A)) even if the payer is a building society (s 875) or a bank (s 878 (1A)).

Key points

- Do not assume that the taxable element of a client's PPI compensation payment will be trivial.
- Few individuals will have paid the correct tax.
- The payment received may not be the same as that shown in the documents.
- The time limit for repayment claims for 2016-17 is 5 April 2021.

The reform of the taxation of savings income in 2016-17 means that very rarely will this deduction represent the actual liability of the taxpayer. The introduction of the £1,000 savings allowance (ITA 2007, s 12B) means that most claimants will be entitled to a repayment. Others will face liabilities at the higher or additional rates. The calculations for ***Alice and Daniel*** illustrate two extreme examples. The deadline for making repayment claims for the first year where this allowance was available (2016-17) is 5 April 2021.

Payment protection insurance

PPI can be a valuable form of protection. It can cover payments on a loan if the borrower becomes unable to make them through the likes of redundancy or illness. However, too often, PPI was sold to those who could never benefit from it – for example, those who were self-employed or already had a disqualifying medical condition.

Another type of mis-selling was recognised by the Supreme Court in *Plevin v Paragon Personal Finance Ltd* [2014] UKSC 61. Mrs Plevin had taken out a loan of £34,000 and a PPI premium of almost £6,000 was added to this. From this premium, 71.8% was paid by the insurer in commission to the lender and the introducer. These details were not disclosed to Mrs Plevin and Lord Sumption observed:

> 'Any reasonable person in her position who was told that more than two thirds of the premium was going to intermediaries would be bound to question whether the insurance represented value for money, and whether it was a sensible transaction to enter into. The fact that she was left in ignorance in my opinion made the relationship unfair.'

This unfair relationship brought Mrs Plevin's contract within the scope of the Consumer Credit Act 1974, s 104A and allowed the court to re-open the credit agreement and order the refund of part of the premium.

Recent reporting in the national press has suggested that *Plevin* is a new development. It is not and we will return to this at the end of the article.

Alice and Daniel

Alice and Daniel have been married for many years. They have three school age children.

In 2005, Daniel was involved in a serious accident which left him unable to work. Alice also gave up work for several years to take care of him. Daniel qualified for a small pension, but they made ends meet by extending their mortgage and making full use of the credit limits on their joint store and credit cards.

The couple were sold PPI on these borrowings even though neither of them could ever have made a successful claim on the policies.

Alice later returned to education as a mature student. She has yet to repay her Plan 2 student loan.

In 2019/20, the couple received PPI compensation of which £24,000 is taxable interest. Tax has been deducted from this at the basic rate.

Alice is now working. Her taxable income is a salary of £48,000 and bank interest of £100.

Daniel's only taxable income is his pension of £5,000. He has claimed the benefit of the marriage allowance for the couple and transferred part of his personal allowance to Alice.

The couple received £2,500 in child benefit.

The tax liabilities of Daniel and Alice are as shown in the calculations below.

Daniel's calculations

Daniel	£
Pension	5,000
PPI interest (1/2 x £24,000)	12,000
Total	17,000
Less: Personal allowance	12,500
Taxable	4,500
Taxed at:	
Savings allowance (£1,000 @ 0%)	0
Starting rate for savings (£3,500 @ 0%)	0
Total liability	0
Tax deducted £12,000 at 20% =	£2,400
Repayment due	£2,400

Notes.

- Daniel can make full use of the starting rate for savings because his non-savings income is less than his personal allowance.
- He receives the full personal allowance. His marriage allowance election is no longer valid because of Alice's changed circumstances. If she had remained a basic rate taxpayer Daniel could have transferred £1,250 of his allowance to her. This would still have left all his PPI interest covered by the £5,000 band for the starting rate for savings. This has now been wasted as far as the couple are concerned.

Alice's calculations

The tax calculations for Alice are shown in the column alongside.

The total tax due for Alice, which will be payable on 31 January 2021 is £5,779 being: £4,690 + £1,089.

Let us hope Alice has not spent all her compensation.

Alice	£	£
Employment income		48,000
Savings income:		
Interest	100	
PPI interest (1/2 share)	12,000	12,100
		60,100
Less: Personal allowance		12,500
Taxable		47,600
Employment income	35,500 at 20%	7,100
Savings income	500 at 0%	0
	1,500 at 20%	300
	10,100 at 40%	4,040
Total tax due on income		11,440
Add: High income child benefit charge (HICBC)		2,500
Total due		13,940
Less: Tax deducted as follows		
PPI interest (£12,000 @ 20%)	2,400	
PAYE (Code 1375M operated)	6,850	9.250
Total tax payable		4,690
Student loan repayment		
Income		60,100
Less: threshold		25,725
Excess		34,375
Charged at 9% =		3,094
Less: Deducted by employer		2,005
Additional student loan repayment due		1,089

Notes.

- Alice's share of the interest tips her into the higher rate with some unfortunate consequences:
  - as a higher-rate taxpayer she can no longer have the benefit of the marriage allowance; and
  - her savings allowance is reduced to £500; £100 of this is already set against her bank interest.
- The higher rate threshold and the starting point for the HICBC are currently aligned. (There is no explicit link in the legislation, it is just that the numbers happen to be the same at the moment.) Because her income is more than £60,000 all of her child benefit is clawed back.
- Alice is entitled to none of the starting rate for savings because her non-savings income exceeds £17,500 – the total of her personal allowance (£12,500) plus the savings nil rate band (£5,000).
- The PPI interest has forced Alice into the self-assessment regime. She will have to make repayments on her student loan in respect of her savings income. This obligation arises only if a graduate is within self-assessment for some other reason. There would be no liability if all her income tax liabilities could have been taken care of within PAYE or by way of a simple assessment.

An old problem

The peak period for the selling and mis-selling of PPI was during the years 1990 to 2010. During this time, PPI was sold in respect of almost all forms of borrowing including home catalogue shopping, high street store cards, unsecured overdrafts and car loans: the forms of credit most likely to be used by individuals with the least financial security and sophistication. These same individuals are now expected to navigate their way through a system where often both the tax authority and the payer of the redress can be less than helpful.

A wide variety of financial institutions have been obliged to pay compensation on mis-sold PPI. For the sake of brevity and clarity we will just refer to them as 'banks' from now on.

The amounts involved can be far from trivial. Even a small initial premium applied to a loan will have compounded to a substantial sum. The individual customer is entitled not just to repayment of their premium but also to the interest charged on that premium (and the interest on that interest and so on) if, as was often the case, it was added to the borrowings.

For those of us who lived through the early 1990s, it can be difficult now to remember back to the time when Liverpool were the champions of English football as winners of the old First Division; when John Major replaced Margaret Thatcher as prime minister; when mortgage interest relief was still available; and when the official rate for beneficial loans was 16.5% (currently 2.25%). For many readers, this will be before they were even born. Interest rates were substantially higher than they are now. The combination of high rates and the passage of decades means that the amount of interest charged on mis-sold PPI can form a significant part of the total redress paid.

It can also lead to confusion. As mentioned, the PPI settlement offer made by the bank to the customer will include not only a refund of interest paid (not taxable), but also compensation in the form of interest (taxable). We have found that both clients and HMRC have had difficulty extracting the correct details from the documentation. Often, the item most clearly labelled 'interest' is the non-taxable element, while the taxable savings income may be described as 'compensation' or 'payment for loss of interest'. See the example of ***Michal***.

The rate of compensation that was recommended by the Financial Ombudsman Service is based on the rate set out in the Judgements Act 1838, s 17(1). The current rate is 8%, but was 15% before 1 April 1993. The taxable element in the compensation package can usually, but not always, be identified by a reference to the '8%'.

Michal

Michal has received the following settlement offer from his bank.

From XYZ bank plc
Our offer has been calculated as:

	£	£
Refund of PPI commission		1,100
Interest on refunded commission		1,500
Statutory compensation	1,200	
Less: Income tax deduction	240	960
Total refund you are owed		3,560

Readers familiar with income tax will recognise that £240 represents the basic rate tax (20%) on £1,200 and that the mis-named 'statutory compensation' is the amount of the taxable savings income.

However, for those who have had no previous dealings with the tax system, the only interest figure visible is the £1,500 for 'interest on refunded commission'. This actually represents the extra interest charged over the years because the premium was added to the original borrowing. It is not the compensatory, taxable, interest. But a naïve claimant will take this as the starting point for the amount to be entered in a return or a claim form. They will then manipulate this figure (for example split it between taxed and untaxed interest) to arrive at the entries to balance on the HMRC forms.

We find another problem on checking Michal's bank statement: the actual redress he has received is £3,600. The delays between the offer being made and accepted, and then the final payment being sent means that the bank has paid additional 'statutory compensation'.

But Michal is unlikely to receive any updated statement. The bank is not obliged to issue any certificate of the taxable amount and tax deducted unless Michal makes a request in writing. (ITA 2007, s 975). If he telephones the bank, we have found that he may well be fobbed off and advised that he has already been sent everything. There will be no offer of a certificate to provide a definitive statement of the amounts to be reported to HMRC.

To work out the true taxable amount then we need to calculate the difference between the accepted offer and the amount received: £3,600 – £3,560 = £40. This represents the additional net interest of £40 which comprises the additional gross interest of £50 (£40 x 100/80) less tax deducted of £10. Add these to the amounts included in the offer letter.

If Michal is not within self assessment he can make a repayment claim on form R40 (tinyurl.com/hot8uw7). He would complete the following boxes in respect of his PPI claim.

- *Box 3.1* Net interest paid by banks, building societies etc, purchased life annuities and PPI payments – after tax taken off – £1,000
- *Box 3.2* Tax taken off – £250
- *Box 3.3* Gross amount – the amount before tax taken off – £1,250

If Michal is safely in the middle of the basic rate band, making an incorrect claim based on the offer letter will have no effect on the tax payable or repayable. He will secure a repayment of £200 based on the full benefit of the savings allowance of £1,000. Any missing interest will be taxable at basic rate, but will already have been taxed at that rate.

However, the missing interest will matter if the savings income (including PPI) for the year is less than £1,000, or the starting rate for savings is available, or if Michal's income is chargeable at higher rates.

The amounts in this example may be trivial, but there are compensation claims substantially larger than this and potentially long delays between the taxpayer receiving their last communication from the payer and the date the compensation is actually paid.

Although this interest is only calculated on a simple basis, it does mean that a £1,000 premium paid in April 1990 on a mis-sold policy would have accrued taxable interest of £1,800 if it had been refunded in March 2020.

Sources of confusion

The confusing words used by banks have baffled not only taxpayers, but HMRC as well. Even if a client has sent all their documents to HMRC, the officer reviewing the claim may have extracted the wrong figures and issued an assessment with a demand for payment rather than the substantial refund properly due.

Other issues that have been a challenge for unrepresented taxpayers include:

- a failure to appreciate that the interest is all taxable in the year it is received, even though it may have accrued over half a lifetime;
- banks suggesting the customer visits their 'local tax office';
- not recognising that their compensation counts as 'savings income' in tax speak – there was certainly no element of saving or investment in their eyes; and
- the heading of the boxes on HMRC's R40 repayment claim form gives the impression that banks and building societies will deduct tax from standard interest payments. But the notes to the form say that they do not. This is doubly confusing when the PPI compensation is from a bank or building society and the taxpayer also has interest from savings accounts.

Current issues

Almost four million new complaints were received in the six months that straddled the August 2019 deadline. The volume of last-minute applications and the effects of the Covid-19 restrictions means that many claims are still working their way through the system.

In the calendar year 2019, financial institutions reported to the FCA that they had upheld over two and a quarter million complaints about mis-sold PPI (tinyurl.com/y2ot7yw9). The total redress paid in the year was some £4bn with an average payout of just under £2,000. We did ask the FCA through a freedom of information request how much of that was taxable interest, but have been told that this level of detail is not contained in the reports made to them. It is clear, though, that the number of individuals who may require help to get the tax right on their payments is substantial; the tax in aggregate is significant; and the issue is flowing through to the current tax year.

We may also start to see new Plevin claims. Following the determination of the appeal in the *Plevin* case, the FCA determined that a commission rate of 50% should be the 'tipping point' at which a commission payment should be presumed to be unfair if it was not fully disclosed to the borrower and any commission above this should be refunded. However, this was only a rule of thumb and was the basis on which the Financial Ombudsman Service might be expected to intervene in any complaint made to them.

Claims for Plevin mis-selling were included within the overall PPI deadline of August 2019. But this only represents the date from which the Ombudsman would cease to adjudicate on new claims. It does not remove an individual's ability to assert their rights under the Consumer Credit Act. It is simply that these will need to be taken to court if a bank does not accept the customer's assertions that any undisclosed commission was excessive.

Some recent judgments (for example, *Doran v Paragon Personal Finance Ltd* [2018], unreported) have rejected the FCA's methodology and have awarded the full refund of commission, not just the excess above 50%.

> "The volume of last-minute applications and the Covid-19 restrictions means that many claims are still working their way through the system."

Planning point

The receipt of payment protection insurance compensation can cause unexpected tax implications, but ensure that affected clients have provided the complete information and check that the correct taxable interest has been taken into account.

Conclusion

A number of claims firms appear to be seeking clients actively and we may expect to have to deal with the tax issues from PPI mis-selling for a few years yet.

Although its formal deadline has passed, the FCA still holds out the possibility for late claims to be made if there are exceptional circumstances such as serious illness that has led to the application being made late. Details are in the link in the 'Find out more' box should any *Taxation* readers have a client to whom this may apply.

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On Taxation.co.uk

- HMRC *Savings and Investment Manual*, SAIM2105 to 2145: tinyurl.com/y3mbsxhv
- Low Incomes Tax Reform Group – *How do I claim back tax on a payment protection insurance (PPI) pay-out?*: tinyurl.com/tl3emc9
- Financial Conduct Authority: PPI FAQs – including exceptional circumstances: tinyurl.com/yxsuydgo