

Deduction of income tax from savings income: implementation of the Personal Savings Allowance

**HM Revenue & Customs (HMRC) consultation document
Response from the Low Incomes Tax Reform Group (LITRG)**

1 Executive Summary

- 1.1 We welcome the opportunity to respond to the HMRC consultation document on the implementation of the Personal Savings Allowance (PSA). Our particular concern is the unrepresented low-income individual: we seek to ensure that it is as simple as possible for them to negotiate the tax system.
- 1.2 We welcome the introduction of the PSA, which will take effect from 6 April 2016. Alongside this, we welcome the cessation of the Tax Deduction Scheme for Interest (TDSI) in relation to interest paid by banks and building societies on deposits of individuals, partnerships and trusts, which will also take effect on that date. Not only do these changes mean that the majority of savers will no longer pay income tax on their bank or building society interest, but in addition, they will neither have to register a form R85 nor complete a form R40 in order to receive gross interest or claim a refund of overpaid tax on savings income respectively. Cessation of TDSI tax deduction arrangements will automatically give the correct result in the majority of cases, which is welcome for unrepresented taxpayers, but also for HMRC, for whom it reduces administration. There is though a sting in the tail for some taxpayers who make gift aid contributions and not having the benefit of the tax credit. These people will now be liable to an unexpected tax liability.¹

¹ See the LITRG news articles: <http://www.litrg.org.uk/News/2015/150304-PR-Gift-Aid-sting-in-tail> and <http://www.litrg.org.uk/News/2015/150318-PR-Budget-tax-free-savings-income>.

- 1.3 Nevertheless, we sound a note of caution over possible increased complexity for some low-income taxpayers. As the consultation notes (paragraph 1.6), despite the introduction of the PSA, and the retention of the 0% starting rate for savings band, some individuals (including those on low incomes) will receive savings income on which they have to pay tax. There is currently low awareness (among PAYE higher rate taxpayers) of the need to notify HMRC about savings income; the changes being made will lead to basic rate taxpayers, as well as higher rate and additional rate taxpayers, being in a position where they may have a responsibility to notify HMRC about savings income. HMRC need to carry out work to raise awareness of taxpayer duties in relation to tax.
- 1.4 Excellent communications will be essential to ensure taxpayers understand the changes, otherwise HMRC, banks and building societies are likely to find themselves inundated with queries from individuals concerning their savings income. In particular, there is likely to be confusion among individuals who hold both taxable sources of savings income and ISAs. There could also be difficulties for individuals whose savings income suddenly increases, for example if they take advantage of the new pensions flexibility rules and place significant sums in savings accounts that generate taxable interest.
- 1.5 Whichever option(s) is chosen, it is essential that clear guidance (including tools such as calculators) is produced for individuals, so that they can understand:
- whether they are eligible for the PSA, whether £1,000 or £500;
 - what type of income is eligible for the PSA;
 - how much of their savings income falls within the PSA and how much is liable to tax;
 - how much tax they have already paid on their savings income and how to calculate any additional tax liability;
 - how to pay more tax if necessary; and
 - how to claim a tax refund if appropriate.

In addition, it is essential that the guidance and tools provide clear explanations of how the PSA interacts with the Dividend Allowance, the various tax bands and the starting rate for savings. It is important that guidance and educational information is not available exclusively via digital channels, since many affected individuals will be digitally excluded.

2 About Us

- 2.1 The LITRG is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low-income workers, pensioners, migrants, students, disabled people and carers.

- 2.2 LITRG works extensively with HMRC and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.
- 2.3 The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

3 Introduction

- 3.1 It is our understanding that with effect from 6 April 2016, an individual whose total taxable income is less than the higher rate threshold will be eligible for a PSA of £1,000.² An individual whose total taxable income is between the higher and additional rate thresholds will be eligible for a PSA of £500.³ The draft legislation has not been published in relation to the PSA, so the exact operation is not entirely clear at this stage – it would be helpful to LITRG and voluntary sector advisers to receive clarification on this issue as soon as possible, since it is necessary to ensure voluntary advisers are able to assist low-income unrepresented taxpayers. LITRG and the tax charities⁴ are already receiving queries from unrepresented taxpayers about how the PSA and the Dividend Allowance⁵ will affect them.
- 3.2 The consultation document appears to be primarily concerned with whether or not to continue with tax deduction at source from non-TDSI interest payments. We note that another key issue however is whether or not tax is deducted from other types of income that fall within the PSA. In particular, the PSA applies to types of savings income other than TDSI interest that may be relevant to low-income taxpayers, such as income from purchased life annuities and gains from certain life insurance contracts. Complications are likely to arise where a low-income taxpayer receives an additional (probably a one-off) income payment that falls within the PSA, but which has had tax deducted at source or is treated as being net

² The Personal Allowance for 2016/17 is anticipated to be £11,000, with a basic rate band of £32,000. This should mean that an individual with up to £43,000 of taxable income can benefit from the PSA of £1,000.

³ This should mean that taxpayers with less than £150,001 of total taxable income can receive up to £200-worth of tax relief in relation to savings income.

⁴ The two tax charities are: Tax Help for Older People (a service from the charity Tax Volunteers (<http://www.taxvol.org.uk/>) and TaxAid (<http://taxaid.org.uk/>).

⁵ The Government announced at the Summer Budget 2015 that there will be a £5,000 Dividend Allowance from 6 April 2016. A factsheet including basic examples was published in August 2015: <https://www.gov.uk/government/publications/dividend-allowance-factsheet>

of basic rate income tax (life insurance gains). In such situations, it will be more difficult to assess whether or not there is a tax liability for the tax year. In light of this, we propose another option at section 7 of this response below.

4 Q1. Other than the issues identified in this consultation, are there other key issues that need to be considered in relation to the interaction of the PSA and rules on deduction of income tax from interest and other savings income?

- 4.1 Our response focuses on issues of concern for low-income unrepresented taxpayers. When considering key issues in relation to the interaction of the PSA and rules on deduction of income tax, we think it is useful to identify the groups that are likely to receive each type of income. For example, if a particular type of income is likely to be received by PAYE and self assessment taxpayers of all levels of income, it is worth taking action to try to ensure the correct treatment automatically for the majority, as for example, with the cessation of the TDSI tax deduction arrangements for bank and building society interest. If another type of income is likely to be received for the most part by higher and additional rate taxpayers, it might be more reasonable to err on the side of safeguarding revenue for the Exchequer, since these taxpayers are more able to afford representation and may already submit a self assessment tax return through which they can claim a tax repayment if appropriate.
- 4.2 Based on a recent research and analysis paper, it would appear that there is low awareness among higher rate and additional rate taxpayers of the responsibility to declare taxable savings income to HMRC.⁶ Unrepresented low-income taxpayers are perhaps even less likely to be aware of this responsibility, if they end up with a tax liability on their savings income despite the PSA. It is therefore important that education of taxpayers is improved. Otherwise, not only is there a risk to public finances, but for low-income individuals, no deduction at source plus a final tax liability could lead to severe cash flow difficulties when payment is demanded, particularly if coding out through PAYE is not possible.⁷ Such situations could perhaps be managed by suitable Time To Pay agreements or similar.
- 4.3 There is potential for confusion among individuals who hold both taxable sources of savings income and ISAs. The cessation of deduction of income tax at source from savings interest could result in the belief that this interest is not taxable (like ISA interest), even though it is and there could be a tax liability to the extent it is not covered by the PSA and the starting rate for savings. There could also be difficulties for individuals whose savings income

⁶ Chapter 1 Key Findings, “Awareness and Understanding of Taxation of Savings Interest” – Research Report 370 (May 2015): <https://www.gov.uk/government/publications/awareness-and-understanding-of-taxation-of-savings-interest>

⁷ This could include pensioners whose income consists of state retirement pension (taxable but not subject to PAYE) and savings income – the total of which exceeds the starting rate for savings band plus the PSA.

suddenly increases, for example if they take advantage of the new pensions flexibility rules and place significant sums in savings accounts that generate taxable interest.

- 4.4 We note that HMRC are in the process of developing and introducing digital tax accounts. Unrepresented taxpayers with various savings accounts may assume that a figure for savings income in their digital tax account is correct and complete. It will be essential to educate taxpayers to check the information contained in their digital tax account for accuracy, and also provide them with a right of appeal if the information shown is incorrect.
- 4.5 Currently, banks and building societies must provide a statement showing the gross interest, the amount of tax deducted and the actual net interest paid, should the recipient request it.⁸ Presumably with the cessation of the TDSI scheme, this particular obligation will no longer apply. Nevertheless, we think it is important that banks and building societies should be obliged to provide individuals with annual statements of interest. Those individuals with more than one source of interest will need to have access to this information to be able to determine readily whether or not their PSA income exceeds the PSA, and as a result whether or not they have a reporting requirement and tax liability.

5 Q2. Which of the issues identified in this consultation do you consider most important, and why? Comments on implications for particular kinds of non-TDSI income, or particular categories of payer or recipient are welcome. Please provide quantitative evidence where available.

- 5.1 We agree with the key aims set out at paragraph 1.5 of the consultation document. There is a need to balance them and it should be noted that a tension might arise between them.
- 5.2 At paragraph 3.10, the consultation notes the importance of taxpayers being aware of and understanding their tax position and associated responsibilities. We think this is the most important issue: whichever option is adopted, taxpayer education and communications are essential. Education needs to include helping taxpayers to understand the tax status of their savings income and in particular, that their savings income might be taxable even if it has not been taxed at source. Taxpayer education also needs to reinforce messages about tax obligations, including the need to notify HMRC about taxable income not subject to deduction at source. It would not be reasonable to expect low-income, unrepresented taxpayers to notify HMRC about taxable sources of untaxed savings income unless and until taxpayer education is addressed satisfactorily.
- 5.3 In addition, at paragraph 3.10 the consultation notes the potential complexity if some savings income is effectively exempt from tax due to the PSA, but some savings income remains liable to tax. This will be a difficult message to communicate. It will not just affect those within self assessment, or higher rate and additional rate taxpayers. This issue is likely

⁸ s. 975 ITA 2007.

to affect some basic rate taxpayers who are unrepresented and not accustomed to dealing with HMRC, for example pensioners living disproportionately off savings income.

- 5.4 We also have a concern that some low-income individuals with relatively high levels of savings income might face increased tax compliance burdens. For example, they might be forced into self assessment, if their sources of PAYE income are not great enough to allow coding out of any tax liability arising on savings income.⁹
- 5.5 At paragraph 3.18, the consultation notes that “A larger proportion of these returns [gains from insurance policies] are taxable at higher and additional income tax rates, than is the case with bank and building society interest”. We observe that individuals who normally pay tax at the basic rate may move into the higher rate band due to the receipt of insurance policy gains in any particular tax year. In addition, as the consultation document notes, non-taxpayers do not currently receive a repayment of the basic rate tax deemed to have been paid on such gains. It would be helpful to receive clarification of whether this treatment will continue and indeed whether it will apply to such gains that fall within the PSA.
- 5.6 We note that certain types of payments made by banks and building societies are classed as annual payments, rather than interest. Such payments are not covered by TDSI. We agree with the consultation (paragraph 3.29) that it will be confusing for customers to have an account for which tax is deducted from annual payments and no tax is deducted from interest. Not only is this likely to cause confusion (unless dealt with by one of the suggested options), but it will be extremely difficult for HMRC, the banks and building societies to explain this to affected customers. Confusion is likely to increase customer contact with HMRC and institutions.
- 6 **Q3. Chapter 4 sets out options for change. Which of these options do you think is likely to provide the best balance between:**
- **making it as easy as possible for recipients to pay the right tax;**
 - **risks to the Exchequer if the right tax is not paid;**
 - **administrative burdens and costs for payers of interest and other amounts; and**
 - **costs to HMRC of operating and policing the tax system?**

Please explain the reasons for your view.

Q4. Of the options set out in Chapter 4, which is your preferred option or combination of options? Please explain why.

⁹ We note that the ‘making tax easier’ initiative might result in an easier way to pay the tax in due course: <https://www.gov.uk/government/publications/making-tax-easier>.

- 6.1 We agree with the need to balance the considerations set out in question 3. We set out our thoughts on the different options below and our preference for option 3.
- 6.2 **Option 1** – Retain the current rules for deduction of tax from non-TDSI interest – the consultation notes the potential for confusion among recipients of non-TDSI interest, who also receive bank or building society interest. The key question in that regard is whether there is a simple message that can be communicated to the general public – it would appear that this is not the case with this option. For non-taxpayers in receipt of non-TDSI interest, with tax deducted at source, it would be essential to make them aware of the ability to claim tax back and also make it easy to do so. Given they will be receiving TDSI interest gross, there is a possibility that some individuals would deem it too much of a burden to claim the tax back from their non-TDSI interest, meaning that they lose out.
- 6.3 **Option 2** – Remove the obligation to deduct income tax from all non-TDSI interest – this option would clearly present a risk to the Exchequer. Recent research suggests that higher rate taxpayers are often not aware of the need to notify HMRC of savings income; indeed, even when they are aware, some are not inclined to fulfil their duty.¹⁰ Under this option, basic rate taxpayers on low incomes would also be obliged to notify HMRC of any tax liability. This means that this option could only be pursued if HMRC are able to raise awareness among taxpayers about their obligations and also follow up with those who do not comply. For individuals, the message would be the same as for TDSI interest however, so in that respect, taxpayer education would be more straightforward than under option 1.
- 6.4 **Option 3** – Remove the obligation to deduct income tax from non-TDSI interest paid to individuals only – this would have the advantageous result of a more accurate outcome for many recipients of non-TDSI interest, meaning less of a burden for taxpayers and HMRC. It would be more complex for payers of interest, but would create less opportunity for confusion among taxpayers. For individuals, the message would be the same as for TDSI interest, so in that respect, taxpayer education would be more straightforward. For these reasons, this is our preferred option.
- 6.5 **Option 4** – Remove the obligation to deduct income tax from non-TDSI interest below a specified amount – this seems unnecessarily complex; in particular, it would be difficult to provide guidance, for example in terms of communicating the relationship between the specified amount and the PSA. It must be remembered that many individuals, even those on low incomes, have several sources of interest, meaning that it is unlikely to achieve the correct outcome for many recipients of non-TDSI interest. In addition, for those with more than one source of interest, this would make it more complicated to assess whether or not

¹⁰ Paragraphs 2.9, 2.15 ff. Chapter 2 Executive Summary, “Awareness and Understanding of Taxation of Savings Interest” – Research Report 370 (May 2015):
<https://www.gov.uk/government/publications/awareness-and-understanding-of-taxation-of-savings-interest>

they need to notify HMRC and whether or not they have a tax liability or need to claim a tax repayment.

- 6.6 **Option 5** – Allow individuals to elect to receive interest with or without deduction of tax – this seems unnecessarily complex for payers and recipients of interest. It would be necessary to improve awareness and understanding significantly in order for individuals to be capable of making an informed decision. Given current levels of awareness, this does not appear realistic. In terms of operating a system similar to the form R85, we would draw your attention to our 2013 report *Banks, building societies, HMRC and their non-taxpaying customers – A plea for better service*.¹¹ There would inevitably be confusion, as on the one hand, HMRC would be telling individuals they no longer need to complete form R85, but that, where they receive non-TDSI interest, they can complete form X, if they wish to receive gross income. This would be in addition to the necessary guidance and communications about the PSA. It would not necessarily remove the need for action following the year end.
- 6.7 **Option 6** – Modify the obligation to deduct income tax from non-TDSI income, as part of wider changes to deduction of tax obligations in Part 15 ITA 2007 – this also introduces the possibility of changes to deduction obligations in Part 15 ITA 2007, for example in respect of yearly interest. This option appears likely to affect institutions in particular; we make no comment.

7 Q5. Are there other options that should be considered? If so, please say what they are and why they should be considered.

- 7.1 Based on the points we make at section 3 above, we think it would be worth considering an option whereby no tax is deducted from any income that falls within the PSA. This would have the advantage of being simple for taxpayers to understand. The educational message required for all taxpayers would also be straightforward – if their total savings income exceeds the PSA, they will have a tax liability.
- 7.2 We acknowledge that there is a downside in that this approach would require those individuals with savings income that exceeds the PSA to notify HMRC. It may also result in some low-income taxpayers having to complete one-off self assessment tax returns for those years when they have a tax liability.¹² This may however be preferable to deduction at source, which would mean that many taxpayers would have to submit a repayment claim. As we note elsewhere, we have a concern that continued deduction of tax at source will leave

¹¹ http://www.litrg.org.uk/reports/2013/R85_report_Jan2013

¹² We refer you to footnote number 8 above.

many low-income taxpayers worse off, as they will not claim the repayment of tax to which they are entitled.¹³

- 7.3 In order to pursue this idea, it would probably be necessary to carry out further work to assess how many individuals this is likely to affect. Consideration should also be given to how tax liabilities on PSA income could be dealt with – whether through self assessment or some other, simpler process. If deduction at source is to continue, we would expect more work to be done on improving the repayment claim processes – both in terms of making them simpler to negotiate and raising awareness.

8 Q6. Chapter 5 considers potential impacts on payers and recipients of savings income, and on government. Do you have any comments on the assessment of impacts, either generally or in relation to the specific options set out?

- 8.1 The recently published research and analysis paper shows a lack of awareness among higher and additional rate taxpayers of the obligation to notify HMRC about savings income.¹⁴ This demonstrates the importance of improving taxpayer education and ensuring guidance is clear. In addition, it would appear that some taxpayers are aware of the obligation, but choose not to comply. This suggests that there is also a need for increased visibility of compliance activity to ensure taxpayers understand that it is better to notify HMRC voluntarily than to wait for HMRC to catch up with them.
- 8.2 At paragraph 5.7, the consultation notes that retention of the current non-TDSI deduction arrangements will leave most taxpayers in the same position as they are currently. We note, however, that it means that those taxpayers on the lowest incomes (non-taxpayers and those whose non-TDSI interest is within the PSA) will continue to suffer deduction of tax at source. They will have to claim the tax back. While this maintains the *status quo*, we note that there are many refunds that go unclaimed, either due to lack of awareness, or because unrepresented individuals find the refund process too daunting to negotiate. Therefore, if non-TDSI deduction arrangements continue, it is essential that refund processes are made simpler and that more attention is drawn to them.¹⁵

¹³ This is borne out by the successive ‘Taxback’ campaigns run by HMRC in 1991, 2000, 2004 and 2009.

¹⁴ Paragraphs 2.9, 2.15 ff. Chapter 2 Executive Summary, “Awareness and Understanding of Taxation of Savings Interest” – Research Report 370 (May 2015):
<https://www.gov.uk/government/publications/awareness-and-understanding-of-taxation-of-savings-interest>

¹⁵ There is guidance on how to claim a tax refund on GOV.UK: <https://www.gov.uk/claim-tax-refund>. This refers to at least seven processes or forms which can be used to claim a refund, depending on the particular situation. This is confusing, particularly for the unrepresented taxpayer.

- 8.3 At paragraph 5.8, the consultation considers the impact of ending deduction at source from non-TDSI interest. In terms of the obligation to notify, this would not be a change for higher and additional rate taxpayers. There would, however, be a greater risk to the public finances, particularly in view of the lack of awareness of tax responsibilities and inclination among some taxpayers to ignore their obligations. For low-income individuals, no deduction at source could be problematic – if they are unaware of the need to notify HMRC, when they realise or face compliance, they might be unable to pay any liability or face severe hardship. Basic rate taxpayers have had no previous obligation to declare, so this would be a new responsibility. For both groups (higher/additional rate taxpayers and basic rate taxpayers) it would be essential to ensure strong communications, run awareness-raising campaigns and provide clear guidance.
- 8.4 In order to safeguard the public finances, we would not be surprised to see heightened compliance activity from HMRC. It is essential that compliance activity takes account of a taxpayer's situation and knowledge when considering the question of whether a taxpayer has taken reasonable care. For example, basic rate taxpayers will be facing a new obligation from 6 April 2016; for existing higher and additional rate taxpayers, the obligation to notify will not be new.

LITRG
10 September 2015