

Draft guidance - Savings and Investment Manual

SAIM2260 The Financial Services Compensation Scheme (FSCS) and Interest

Although this guidance refers commonly to banks, the legislation introduced by FA09 does not just apply to financial products offered by banks but to any financial products meeting the criteria - see SAIM2270. However because the FSCS has made most of its payments in respect of bank deposits the guidance refers mainly to bank deposits.

When a bank (or another financial institution) is declared by the FSCS to be in default, customers of the bank are invited by the FSCS to make a claim under the compensation scheme. If the claim is accepted by the FSCS as valid and the bank deposit paid interest then it is common for the FSCS to include in the compensation payment interest on the financial product up until the date that the bank was declared to be in default or if appropriate, up to the date of maturity of a fixed term deposit.

The FSCS calculates the compensation payable just as if the bank had not defaulted and so uses the bank's records to determine whether the payment is net or gross. See the examples in SAIM2265.

The terms of the compensation scheme mean that any interest element included in the compensation calculation is not interest for common law purposes but is just part of the total amount of compensation paid by the FSCS. However, the bank customers receiving the compensation may have had the amount of compensation they receive calculated as if tax had been deducted from the 'interest' amount paid by the FSCS up to the date of the bank default. So they will assume that they have received interest subject to deduction of tax from the FSCS in exactly the same way as if the interest had been paid by the bank.

To ensure that FSCS claimants who receive compensation including an interest element paid by the FSCS are treated for tax purposes in the same way as if they had received the interest from the bank FA09, introduced two new pieces of legislation. These are S380A ITTOIA 2005 and S979A ITA07. These sections ensure that for Income Tax purposes interest paid by the FSCS to the date of the bank default is treated as if it were interest chargeable to Income Tax (S380A ITTOIA05). If the FSCS has computed the compensation on the basis that the claimant is a taxpayer (for example, the claimant receives a net amount) then the legislation treats the amount deducted by the FSCS as if it were tax deducted from that interest and so the claimant may make repayment claims or be charged to higher rate tax as necessary (S979A ITA07). See SAIM2265 Example 1.

SAIM2265 - Examples of FSCS Compensation Calculations

Example 1

Ms C has a savings account with Bank D which pays interest on the 30 June each year. In June 2008 Ms C receives £600 interest after deduction of tax at 20% (£750 interest gross). Bank D is declared in default on the 31 October 2008 and the FSCS accepts that Ms C has a valid claim. Ms C's balance with Bank D consists of her principal of £20,000 plus the net interest paid by the bank in June of £600. In addition the FSCS includes in the total compensation it pays to Ms C an amount equal to the net interest that Ms C would have received from the 1 July to the 31 October. This is £200 net (which would be £250 gross) and so the total compensation received by Ms C is £20,800.

In this example Ms C is chargeable to Income Tax on the gross interest she has received from the bank and FSCS (£750 and £250 respectively). However if she is a non-taxpayer she can make a repayment claim of £200 to HMRC for the tax deducted by both the bank and FSCS. If she is a basic rate taxpayer there is no further tax to pay and if a higher rate taxpayer then she will be chargeable to higher rate tax but can set against this the £200 tax deducted by the bank and FSCS.

Example 2

Mr E has a fixed term deposit with Bank D of £80,000 which he placed with the bank on the 20 October 2008. The interest rate is fixed at 5% a year and the deposit is due to mature on the 19 October 2011. The FSCS accepts that Mr E has a valid claim for compensation but gives him the option of continuing his deposit until maturity and receiving his compensation on the 19 October 2011 rather than on the date that the bank went into default. A condition of this option is that the interest is payable on maturity. The FSCS will pay compensation on maturity equal to his £80,000 deposit plus the 5% interest that the bank would have paid. On the maturity date Mr E, who is a higher rate taxpayer, receives compensation of:

Deposit		£80,000
Interest to 19 October 2009	Gross £4,000 less 20% 'tax'	£3,200
Interest to 19 October 2010	Gross £4,160 less 20% 'tax'	£3,328
Interest to 19 October 2011	Gross £4,326 less 20% 'tax'	£3,461
Total Compensation	Paid on 14 November 2011	£89,989

The gross interest element of £12,486 is chargeable to Income Tax as interest arising the year 2011-12. The £2,497 'tax deducted' from the gross interest will be treated in the same way as tax deducted from bank or building society interest. The amount actually received by Mr E that represents interest net of tax is £9,989.

SAIM2270 - Financial products and payments included in Section 380A ITTOIA 2005

Section 380A ITTOIA 05 does not apply to all compensation paid by the FSCS. The definition of payment representing interest is given in S380A (2) and from this definition we can establish a number of criteria. These are that:

- interest would have been paid to the recipient but for the financial institution being declared in default
- the compensation is being paid by the FSCS because of the default
- the payment representing interest is calculated in the same way as the interest would have been had it been paid to the recipient

So the return on the financial product would have originally have been paid in whole or in part in the form of interest. For example, the financial product could be an interest bearing bank account or bond. The payment representing interest paid by the FSCS must be calculated in the same way as the interest on the original financial instrument.

As long as the payments are made under the FSCS it does not matter that the funds the FSCS are using to make the payment are not from its own resources or from the FSCS levy. If the FSCS makes payments on behalf of a third party, for example another regulatory authority, or on behalf of the Treasury, as long as the payments are made under the FSCS then they will be within S380A.

SAIM2275 - Tax certificates from financial institutions that have been declared in default and from the FSCS

Even if a financial institution has been declared in default by the FSCS, the financial institution should provide its customers with tax certificates for any interest it pays just as it did prior to the default. If the customer receives a tax return or makes a repayment claim then the interest paid by the financial institution should be declared in the appropriate part of the form. For example, if the financial institution is a bank then the interest should be included as bank interest on the depositor's tax return or repayment claim.

The interest paid by the FSCS should similarly be included in the tax return or repayment claim along with interest received from the defaulting financial institution. The FSCS is required to issue certificates of tax deducted if the person receiving the compensation makes a written request under S979A (5) ITA07. Unlike banks the FSCS does not have the facility to automatically generate such certificates itself. To avoid delay to tax returns and claims if the person has alternative evidence that tax has been deducted by the FSCS, such as a screen print of an internet banking account or correspondence from the FSCS that explains the computation of the compensation, then these may be accepted as evidence to support a tax return or claim.