

Peer-to-peer lending – tax issues (Lecture P1263 – 9.52 minutes)

Introduction

People with a bit of spare cash have had a tricky time in recent years knowing where to put it in order to achieve some sort of noticeable return. With interest rates being as low as they are, letting savings relax contentedly in a building society account is probably costing money since rates of inflation are above the derisory rates which are on offer.

So it's hardly surprising that we have seen the rise in popularity of "peer-to-peer" lending which offers investors headline-grabbing returns.

But things are rarely as rosy as they seem. A peer-to-peer ("P2P") investment is not like putting your money into a building society. A more fitting analogy is that you are lending money to a guy in a pub who you've never met. In fact, your pub is the Rose & Crown while your borrower frequents the Red Lion and the only thing you have in common is that he wishes to borrow some money and you have some money sitting in a savings account earning pennies.

The borrower and the lender are duly introduced by a P2P lending platform (such as Funding Circle, Zopa and numerous others) and a deal is agreed.

The P2P platform therefore acts as a financial dating site or online money matchmaker putting together individuals or companies with borrowing requirements with investors looking for a reasonable return. The P2P platform takes a fee. The borrower gets a better deal than he would by approaching a bank. The lender can charge an interest rate of considerably more than is being currently achieved from his savings account. Unless you are the banking middleman who has been made redundant in this arrangement, it's a win-win.

The pub analogy is, of course, both flippant and inaccurate as the transaction is one of providing financial services and is therefore regulated by the Financial Conduct Authority (FCA). So it's not the Wild West. And once the investor has deposited his funds, the P2P platforms will select borrowers using investor-provided criteria, will carry out the required risk analyses and credit checks, will obtain security and complete all legal formalities.

The P2P platform may also spread the investor risk by lending the invested funds by way of a number of small sub loans (usually £25,000 or less) to a number of different borrowers (so each borrower will typically borrow a small amount from many different lenders to make up the full loan they need). This "eggs and baskets" approach spreads the risk and softens the blow in the event of default or non-recovery.

The FCA also protects investors by restricting their investment in P2P products to no more than 10% of their investable assets. [Albeit this is self-certified so not exactly watertight.]

That said, P2P lending is investment rather than saving. The contract for the debt is between borrower and lender (not lender and P2P platform) and while P2P has worked well for many investors, there always remains the possibility of the investment not being repaid if individuals or companies don't pay back their loans.

There is no "safety-net" in the form of a savings safety guarantee and the Financial Services Compensation Scheme (which protects the first £85,000 of savings per financial institution if that

institution fails) does not apply to P2P lending. The investor could therefore lose every penny of his investment if the loans go bad. Caveat emptor.

On the plus side, if the P2P platform itself went bust, the loan remains in place and can still be enforced.

On balance, P2P lending is relatively safe (especially when investments are spread), provides relatively good liquidity and offers relatively good interest rates. It's an investment opportunity for risk-averse people who are wary of investing.

The tax side

Once a P2P investment has been made, the online platform will try and find a match. No interest will be paid by the P2P platform while the invested funds remain unmatched.

Once the matches are in place, the P2P platform will collect the repayments of interest and capital from each borrower and pass them to the lenders (after deducting a facilitator's fee). Interest will therefore flow from the borrower, via the P2P platform, out to the lender. Since 2017, the interest is paid without deduction of tax at source by the P2P platform. This is savings income and, like all savings income, is taxable at the point of receipt.

The taxable amount is the amount paid to the investor by the P2P platform and is therefore net of any fees which the platform deducts. The investor will typically receive a statement showing the interest and the fee deducted and should enter the amount received on his self-assessment return. Any repayments of the principal investment are not taxable or disclosable.

The savings allowance (£1,000 for basic rate taxpayers, £500 for higher rate taxpayers) will apply to P2P income as will be £5,000 starting rate band (if applicable).

There are "Innovative Finance ISAs" on the market which allows P2P loans to be held within an ISA wrapper. Interest from P2P loans can therefore be converted into tax free income (the usual £20,000 per tax year ISA cap will apply). "Contact your IFA for further information".

Irrecoverable loans

The COVID crisis has impacted on the P2P lending sector. As borrowers find it increasingly difficult to make the required loan repayments to the platform, many investors are having trouble accessing their cash. These are not normal times.

The P2P platforms will normally provide an option (via a secondary market) whereby an investor can sell his loan to a fellow investor. The sales price will depend on the probability of full recovery and the interest rate attaching to that loan.

However, this is only an option if there are fellow investors who want to take another debt on board and that is a big "if" in the current climate.

The P2P platform will do all it can to recover the full debt, but if a loan becomes wholly or partly irrecoverable, the investor will lose money.

Tax relief on irrecoverable loans

As a debt is not a chargeable asset for CGT, there is no question of taxpayers being able to treat the irrecoverable loan as a loss on a capital asset which is available for relief against capital gains.

There are provisions in the CGT legislation (S.253 TCGA 1992) for a loan to a trader which has become irrecoverable to be treated as a capital loss for CGT, but this requires the defaulting borrower to have used the money for trading purposes which isn't always the case.

Thankfully income tax relief is available for P2P loans which have become wholly or partly irrecoverable. The relief has applied since 6 April 2015, but COVID is now shining a light on its usefulness.

If a P2P loan is not repaid (or not fully repaid), the lender can set the loss suffered on the loan against the interest they receive on other P2P loans in the same tax year. This relief is automatic and does not need to be formally claimed. The lender will then be taxed on the interest received less the bad debt relief.

Conditions for bad debt relief

Relief for bad debts on P2P loans can only be set against interest on other P2P loans. It cannot be used against "general" interest or against any other form of income. It cannot be transferred (for example, to a spouse).

Bad debt relief is given against interest from the same P2P platform in priority to income from a different platform. But this is procedural, and it all comes out in the wash.

If the bad debt exceeds the P2P interest for the tax year, the excess is carried forward against future P2P income. There is no carry back option.

Carry forward relief is only available against interest received from loans made through P2P platforms in the 4 years following the tax year in which the debt became irrecoverable. Therefore, if carried forward, relief for the outstanding amount of the irrecoverable loan must be used against P2P interest received in the earliest year first, up to a maximum of 4 years. This means that for an irrecoverable loan in 2016/17, any unused relief will have lapsed on 6 April 2021.

The bad debt must have arisen from a loan made via a P2P lending platform that is authorised by the FCA. This includes platform operators based elsewhere in the EEA who have been granted equivalent permissions under the law of that jurisdiction.

Relief is only available if:

- 1) The lender is subject to UK Income Tax on their P2P income;
- 2) The loan is made on commercial terms, at market rates and conditions and on an arm's length basis; and
- 3) The loan is not part of a scheme or arrangement to obtain a tax advantage.

Condition 1) will still be met if the lender has no tax to pay, for instance because the amount of interest paid is covered by the lender's personal allowance or falls within the 0% starting rate band or is taxed at 0% under the savings allowance. This condition will not however be met if the loan is held within an ISA (as the lender would not then be subject to income tax on the income).

If the loss arises in the hands of a company, relief for the loss should be available under the loan relationships rules.

Relief can be claimed at the point at which there is no reasonable prospect of the P2P loan being repaid. Whether a loan has become irrecoverable should be judged on a case-by-case basis. As the loan will be managed by a P2P platform, the platform would usually be in a position to determine when a loan has become irrecoverable (as they have a relationship with the borrower). The platform would then inform the lender that the loan had become irrecoverable.

Loans that a lender has acquired by way of assignment (for example by purchase from another investor via the P2P platform) are treated in the same way as loans that are made as an original lender and are therefore eligible for bad debt relief.

The amount of relief available is the P2P loan still outstanding from the borrower at the time it became irrecoverable (being the loan less capital repayments already received).

If a lender has received relief for a bad debt on a P2P loan that is repaid at a later date (for example if the borrower manages to pay late, or if there is some recovery of assets by the P2P platform), the amount recovered is treated as P2P income of the lender in the year of receipt. In essence, amounts recovered once bad debt relief has been claimed will come back into the income tax computation as taxable income.

Where an irrecoverable P2P loan would have been eligible for CGT as a capital loss under the S.253 TCGA 1992 "loans to traders" rules, it will no longer be eligible for that relief (because S.2(3) TCGA 1992 specifically gives priority to income tax reliefs).

Compliance procedures

P2P interest should be entered on the "Additional Information" pages (form [SA101](#)) as "Other UK income, Interest from gilt-edged and other UK securities, deeply discounted securities and accrued income profits". The interest will be "Box 3" income.

The P2P interest figure to be reported is interest received less any bad debt relief from all platforms. There is therefore no separate box for the bad debt relief as the relief is automatic and simply reduces the taxable amount.

Any excess relief for P2P bad debts available to carry forward does not need to be included on the tax return, but the lender should keep records of any carry forward relief in order to make a correct and complete claim in a tax return for a future period.

Lenders who do not submit a tax return can simply report their P2P income separately for the tax year by contacting their local tax office and providing the annual tax statement from the P2P lending platform. The reportable figure is the interest less any bad debts suffered via the same platform.

Any claims to set relief for P2P bad debts from one platform against P2P interest received through another platform, or to carry relief forward against P2P interest received in future years, must be made through a tax return.

Contributed by Steve Sanders