# Tax Credits and Debt Problems

Protections for debtors are being undermined by the fact that the Inland Revenue can use its own processes to recover debts directly from tax credit entitlement

## The Citizens Advice Bureau service

The Citizens Advice Bureau (CAB) service in Scotland offers assistance across the whole range of issues which affect clients. This puts us in a unique position to comment on the interaction between policy initiatives originating from the Westminster Government and those which come from the Scottish Executive. One such area is the interface between Westminster's policy on overpaid tax credits and the Scottish Executive's policy on helping people with debt problems.

## Definitions

- **Tax credits** – The Inland Revenue pays tax credits to people who are in low-paid employment and people who have children. Entitlement to tax credits is calculated on a yearly basis, which means that a change in circumstances during the year can cause over- or under-payments. Where there has been an overpayment, the Inland Revenue is empowered to recover this automatically from future tax credit payments, regardless of whether the overpayment was the fault of the person concerned. This can cause severe hardship.

- **Debt recovery** – The Scottish Executive is responsible for legislating on how creditors can use the courts to recover money from debtors in Scotland. There are a number of policy initiatives which protect debtors from harsh action. However, these are being undermined by the fact that the Inland Revenue can use its own processes to recover debts directly from tax credit entitlement.

*" A North of Scotland CAB reports of a couple with three children, who were paid working and child tax credits. In October 2004, the couple received their award notice for the financial year 2004/05. This highlighted an overpayment of £2,800 despite the fact that they had notified changes of circumstances timeously. In order to recover the overpayment, all tax credit payments would stop from November 2004 to April 2005, despite on-going entitlement.*

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## Tax credits and debt problems – the main issues

- Debtors need financial stability if they are to deal with their debt problems. It allows them to find their financial footing and assess which is the most appropriate solution to their debt situation. Where a repayment plan has been negotiated with creditors, continuing financial stability is an important factor in enabling debtors to stick to the agreed repayments. Unilateral action by one creditor to access an unfair proportion of the debtor's income destroys stability and can ruin months or years of careful financial planning.
- Inland Revenue action to recover tax credit overpayments has the effect of destroying financial stability by reducing – sometimes drastically and at short notice – current income. The process also gives the Inland Revenue unfair preference over other creditors.
- Recovery of tax credits can upset the operation of protected trust deeds. A protected trust deed is a form of debtor protection in Scotland. It enables debtors with sufficient income to enter into an arrangement with an insolvency practitioner to pay off their debts over a three-year period. However, where income drops during the life of the trust deed because of recovery of a tax credit overpayment, a trustee has to consider other ways of realising assets for the benefit of creditors. Sequestration (bankruptcy) is one option.
- Recovery of tax credits may also result in sequestration outside a protected trust deed situation, where a drop in income from tax credits simply makes it impossible for a debtor to continue to service their debts.
- The Scottish Executive has recently introduced a scheme to protect debtors from court action where they are making reasonable repayments to their creditors – known as the debt arrangement scheme. Where recovery of a tax credits overpayment causes a change in the income of a debtor participating in such a scheme, a money adviser is required to make a formal application for the repayment plan to be altered. Where a debtor's income is no longer deemed sufficient, it is possible they may have to drop out of the scheme – ending the protection they have enjoyed from action by other creditors.

## CAS proposals for change

Citizens Advice Scotland believes that current mechanisms for the recovery of tax credits are exacerbating difficulties for those with multiple debt problems. We call on the Inland Revenue to:

- Exercise its discretion not to recover overpayments when to do so would prevent a debtor continuing to participate in one of the schemes described above
- Work with the Scottish Executive to ensure that tax credits claimants with debt problems are supported to deal with their situation and signposted to money advice

## Case evidence

*An East of Scotland CAB reports of a client with three children in a multiple debt situation. She had been referred to an insolvency practitioner to discuss entering into a 'protected trust deed'. On the basis of her income, it was agreed to proceed. She was then informed by the Inland Revenue that she had been overpaid tax credits, and her current award would be cut. The income available to pay her creditors was therefore reduced, and the insolvency practitioner had to look again at the trust deed arrangement. The bureau advised her that the insolvency practitioner may be able to negotiate reduced payments: however, sequestration may be her only option.*

*A West of Scotland CAB reports of a young family with debt problems. The client had been overpaid tax credits the previous financial year and, as a result, was currently in receipt of minimal payments. The bureau notes that she could no longer afford to service her debts, and one of her creditors may force her into bankruptcy.*