

# **The Child and Working Tax Credits**

## **The Modernisation of Britain's Tax and Benefit System**

### **Number Ten**

April 2002



HM TREASURY



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# **The Child and Working Tax Credits**

April 2002

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# INTRODUCTION AND SUMMARY

## INTRODUCTION

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**1.1** Budget 2000 confirmed the Government's intention to reform the way in which families with children and those in work on low incomes are supported through the tax and benefit system. The reforms will create two new tax credits:

- the Child Tax Credit which will be a single, seamless system of support for families with children, paid directly to the main carer in a family; and
- the Working Tax Credit, paid through the wage packet to working people without children as well as families with children.

**1.2** These new credits will tackle child poverty and help to make work pay. They are designed to tailor support to families' specific circumstances, and to respond to their changing needs, providing most support when their need is greatest, for example, when they have very young children.

**1.3** A consultation document on the new tax credits<sup>1</sup> was published in July 2001. The proposals for the structure of the credits in the Tax Credits Bill, introduced in Parliament in November last year, reflected views received in response to that consultation exercise. This document elaborates on the proposals in the Bill, presenting the Government's thinking on how the new system will work, reflecting further discussions with various organisations with an interest in tax and benefit reform and its potential impact on the families most affected by it. It also details the rates and thresholds for the new tax credits, as announced by the Chancellor in his Budget statement.

## SUMMARY

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**1.4** Chapter 2 describes, in broad terms, how the new tax credits will work and how awards will be calculated. The chapter also describes some of the main advantages of the new tax credits compared with the existing systems of support for children and for working people.

**1.5** Chapter 3 sets out how the new tax credits will support families with children, recognising the responsibilities of parenthood, and how they will help tackle child poverty by providing the greatest support to those most in need and by making work pay.

**1.6** Chapter 4 describes how the new tax credits will respond to changes in families' circumstances and incomes. This feature of both the Working Tax Credit and the Child Tax Credit is a radical change from the way in which current support systems work and a major step forward in channelling support to families at times when they need it most.

**1.7** Annex A provides more detail on the mechanics of the tax credits and on how awards will be calculated. It also describes the criteria for eligibility.

**1.8** Annex B provides more detail on the transitional arrangements for the move to the new tax credits and their consequential effects on social security benefits.

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<sup>1</sup> *New Tax Credits: Supporting Families, Making Work Pay and Tackling Poverty*, Inland Revenue (2001).



## SUMMARY

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**2.1** Over the course of the last Parliament, the Government put in place a series of reforms to the tax and benefit system with the aims of:

- supporting families with children, recognising the responsibilities that come with parenthood;
- tackling child poverty by offering the greatest help to those most in need, such as low income families; and
- helping to make sure that work pays more than welfare and that people have incentives to move up the earnings ladder.

**2.2** The new tax credits are the next stage in this process of reform. They will separate support for adults in a family from support for the children, and for the first time integrate all income-related support for children, to provide a clearer focus on the two aims of:

- supporting families and tackling poverty through the Child Tax Credit; and
- making work pay through the Working Tax Credit.

**2.3** The Child Tax Credit will create a single, seamless system of support for families with children, payable irrespective of the work status of the adults in the household. This means that the Child Tax Credit will form a stable and secure income bridge as families move off welfare and into work. It will also provide a common framework of assessment, so that all families are part of the same inclusive system and poorer families do not feel stigmatised. The Child Tax Credit will, alongside Child Benefit, provide child support of:

- £54.25 a week for the first child for the 25 per cent of families with an income of less than £13,000 a year; and
- £26.50 a week for the first child for the 85 per cent of families with an income of less than £50,000 a year.

**2.4** The Working Tax Credit will tackle poor work incentives and persistent poverty among working people. For families with children, the Working Tax Credit will broadly replicate the support for adults provided through the Working Families' Tax Credit (WFTC) and will be available for those with incomes up to a maximum of around £14,000. It will also extend support to low income working people without children aged 25 or over working 30 hours or more a week. On its introduction, the Working Tax Credit will guarantee minimum incomes of:

- £237 a week for a family with one child and one earner working full-time on the National Minimum Wage; and
- £183 a week for a single earner couple without children or a disability, aged 25 or over and working full-time on the National Minimum Wage.



## THE ROLE OF TAX CREDITS

**2.5** Tax credits are the way in which the tax system recognises the needs and circumstances of specific households, providing tailored support to reflect, for example, the number of children in a family and the total income available. In effect, tax credits help to smooth out people's income over their lifetimes.

**2.6** Like the WFTC and the Disabled Person's Tax Credit (DPTC), the new tax credits are "payable" so that households benefit even when they have no income tax and National Insurance Contributions to pay. This means that tax credit payments may be more or less than, or equal to, the household's tax bill, so that, at any one time, some families will be making a net withdrawal from the Exchequer while others will be making a net contribution to it.

**2.7** As a family's circumstances change over time, so its position with respect to the Exchequer may change. The Child Tax Credit, for example, is designed to respond to changing family responsibilities.

**2.8** When a family's first child is born, they will be able to claim the Child Tax Credit and the tax credit the family receives will effectively offset part, or even all of their income tax and national insurance bill. Depending on their circumstances, the tax credit may exceed what they pay in income tax and National Insurance Contributions so that they will, in effect, be making a net withdrawal from the Exchequer. Similarly, when their children grow up and leave home, tax credits respond and the household is likely to become a net contributor once again.

**2.9** In addition, while incomes tend to rise over a person's lifetime, there are some working people who experience long periods on low incomes. Others may see their incomes fall as they reach the end of their working lives. These people may receive the Working Tax Credit which will reduce the amount they pay to the Exchequer. They may even receive a net payment.

### A modern income test

**2.10** The income tax system provides a light touch and non-stigmatising way of measuring income. An individual's income tax bill is almost exclusively determined by their income for the tax year. However, the tax system has traditionally been poor at recognising families' circumstances. For almost a generation, there was no proper recognition of children in the tax system, and it failed to help families balance their work and caring commitments.

**2.11** At the same time, the debate about the most appropriate way to support families with children through the benefit system tended to polarise between those who argued that support should be provided universally and those who favoured a tightly targeted means test. The advent of the new tax credits offers the opportunity to introduce a new approach based on the principle of progressive universalism. This means supporting all families with children, but offering the greatest help to those who need it most through a light touch income test.

**2.12** The old means testing approach, which looked at a family's circumstances at a specific point, compelled families to run down any savings before they could receive significant support from the state. A tightly targeted means test only helped the very poorest, leaving many low to middle income families without appropriate financial support.

**2.13** Instead, the new tax credits build on the definition of income used in the tax system. This extends the approach currently taken with middle and high income families to all families. Aligning the income test for new tax credits with the income tax system means that income is looked at across the tax year as a whole. It also involves moving away from a system which excluded families with modest savings to one which, instead, takes into account the income from that capital, thus moving from a “means test” to an “income test”. In addition, in recognition of the costs of parenthood borne by both middle and low income families, the Child Tax Credit will be available for those with annual incomes up to £58,000.

**Based on  
joint income**

**2.14** To direct more support to those most in need, entitlement must be based on the family’s circumstances, and assessed against the resources available to the family. For couples, tax credits take account of the income of both partners as the natural measure of the resources the family has to meet its needs. Therefore the new tax credits do not discriminate between one- and two-earner couples.

**2.15** In line with the majority of responses to the July consultation document, the Child Tax Credit will be paid direct to the main carer, usually the mother. This will allow, for the first time, all income-related payments for children to be paid to the main carer, in line with Child Benefit.

**2.16** This will provide the main carer with a regular and secure stream of income paid direct either weekly or four-weekly according to preference. The childcare tax credit element of Working Tax Credit will also be paid direct to the main carer, rather than with wages, thus easing cash flow constraints on using paid childcare and addressing a number of other issues arising from experience with the current childcare tax credit component of the WFTC.

## **THE STRUCTURE OF THE NEW TAX CREDITS**

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**2.17** The new tax credits are designed to provide the greatest support to those who need it most. An individual or family’s award for new tax credits is therefore based on two factors:

- their current circumstances: for the Child Tax Credit, the number of children they have; and for the Working Tax Credit, whether (and for how many hours) they are working, and the amount of any eligible childcare costs; and
- their income before income tax and National Insurance Contributions (joint income for a couple) for the tax year.

**2.18** Between them, these factors determine the tax credit amount a family is entitled to receive each year.

**2.19** Like the existing WFTC and DPTC, the Working Tax Credit and the Child Tax Credit are made up of a number of elements which allow entitlement to be tailored to individual circumstances. For example, the Child Tax Credit contains a “family element” which is available to any family with a qualifying child or young person and it contains separate “child elements” for each child. The individual elements provide extra support for families with a disabled or severely disabled child, and there will be a higher family element paid in the year following a child’s birth. This structure enables the Child Tax Credit to be tailored to meet the individual circumstances of families.

**2.20** The Working Tax Credit is constructed in a similar way. Like the WFTC, it includes a childcare tax credit to help families for whom the cost of childcare can be a barrier to work. Families will be eligible for the childcare tax credit where a lone parent or both partners in a couple work for at least 16 hours a week. It will be worth up to 70 per cent of eligible childcare costs of up to £200 a week (£135 a week for one child). The new tax credits will provide help with childcare costs further up the income distribution. For example, a family with two children, maximum childcare costs and an income of £35,000 a year can still receive up to £50 a week in support for childcare.

**2.21** The table below gives the main rates and other features of the Child and Working Tax Credits and further detail is provided in Annex A. As announced in Budget 2002, from April 2004, the child element of the Child Tax Credit will rise at least in line with earnings for the rest of the Parliament.

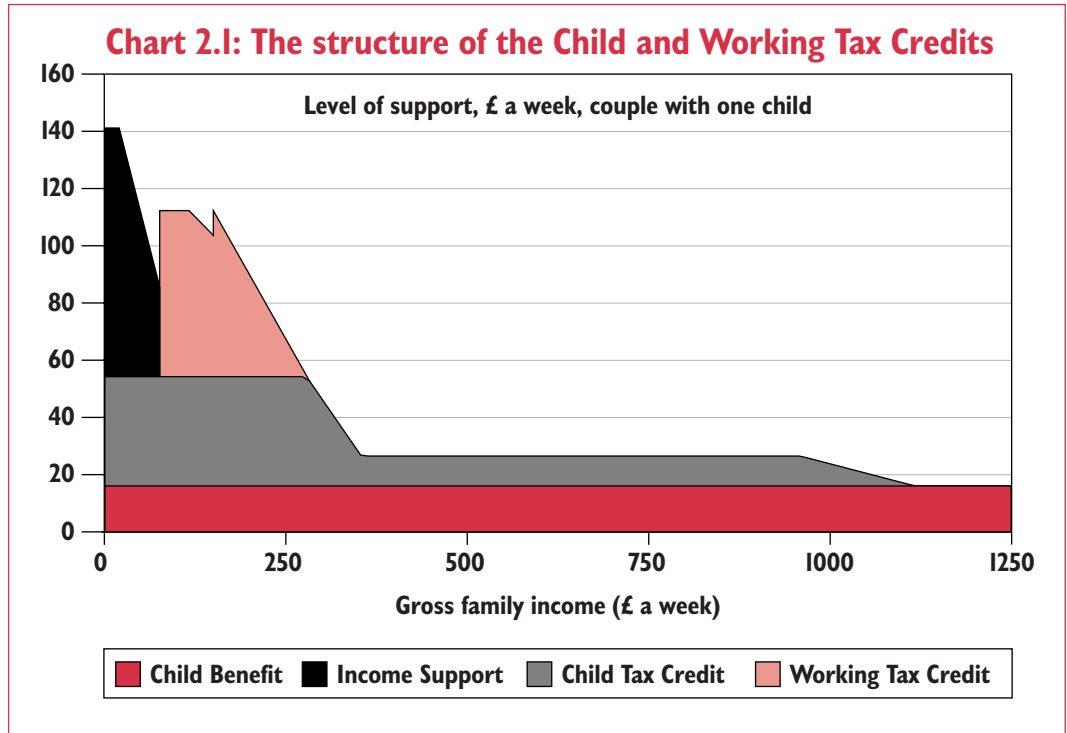
**Table 2.1: The principal elements of the Child and Working Tax Credits**

	2003-04 weekly amounts (£)
<b>Working Tax Credit</b>	
Adult element	29.20
30 hours element	11.90
Additional element for couples and lone parents	28.80
<b>Child Tax Credit</b>	
Family element	10.45
Child element	27.75
Threshold below which maximum tax credits are payable	97.00
Withdrawal rate (per cent)	37
Threshold above which the family element is withdrawn	£50,000 a year

**2.22** To calculate the maximum award to which a family is entitled, the different elements relevant to that family are added up. Individuals and couples with an income below the threshold of £5,060 a year will receive that maximum amount.

**2.23** Those who receive Income Support or income-based Jobseeker’s Allowance will automatically receive the maximum amount of Child Tax Credit. This means that these families will not have to undergo both the income test for new tax credits and the means test for out of work benefits.

**2.24** Those with an income above the threshold will receive less than the maximum – the award being gradually reduced at the rate of 37p for every pound of gross income over the threshold. For those in this situation, the reduction on account of income is first applied to the rest of Working Tax Credit, then to the childcare tax credit and finally to the Child Tax Credit. The family element of the Child Tax Credit is retained until income exceeds the second threshold of £50,000 a year (£958.90 a week), at which point the family element starts to be tapered away. This feature of the structure of the new tax credits is shown in the chart below.



**2.25** The example below shows how a new tax credit award would be calculated. More detail on how awards are calculated is also provided in Annex A.

**Example 2.1** – Derek and Amy have two children. Derek works full-time and earns £200 a week, while Amy divides her time between caring for the children and working part-time earning £100 a week and incurring £60 of eligible childcare costs. Their joint income for the year is therefore £300 a week, £15,600 a year.

A family in the same non-financial circumstances earning less than £97 a week would receive the following.

	Weekly value
Working Tax Credit	£69.90
Childcare tax credit (70% of £60 costs)	£42.00
Child Tax Credit	£65.95
<b>Maximum amount</b>	<b>£177.85</b>

As Derek and Amy have an income of £300 a week, £203 above the threshold, their tax credit is reduced by 37p for every pound over the threshold. This means a total deduction of £75.11, giving a total award of £102.74.

Their income is too high to receive Working Tax Credit, Amy will receive £102.74 a week in tax credits, of which £65.95 is Child Tax Credit and £36.79 is childcare tax credit, and she will also receive 28.50 a week in Child Benefit.

Their award is worth around £23 a week more than the family currently receives through the Children's Tax Credit and Working Families' Tax Credit.

**Calculating a tax credit award** **2.26** A family's tax credit award will be based on their current circumstances – such as the number of children. However, to establish a tax credit award based on facts to which the family have easy access, awards will initially be calculated by reference to the family's income for the previous tax year. So, for example, a tax credit award for the tax year 2004–05 will use income for the tax year 2003–04 to calculate the initial level of the award.

**2.27** Tax credits are, however, designed to provide support to those most in need, at the time when they need it most. This means that the tax credit system should be able to respond quickly to changes in circumstance and income. Chapter 4 describes in more detail how tax credits will adjust, both in-year and at the end of the year.

## AN IMPROVED SYSTEM FOR ALL

**2.28** As a result of the need to make urgent progress towards the Government's goals, the measures introduced in the previous Parliament largely worked within the constraints imposed by the prevailing systems of support. The new tax credits represent a significant advance in the way in which the Government supports families with children and provides in work support for low income households.

**Better than WFTC and DPTC** **2.29** The new tax credits mean a substantial improvement for those currently receiving Working Families' Tax Credit (WFTC) and Disabled Person's Tax Credit (DPTC). The main advantages are :

- **greater generosity** – a single earner couple working full-time at the National Minimum Wage (around £7,650 a year) with two children will receive around £400 a year more from the new tax credits compared to WFTC and the existing Children's Tax Credit;
- **less form-filling** – families will have one renewal each year, rather than two. The renewal process will also be streamlined, with parts of the renewal form already completed by the Inland Revenue using existing information;
- **simpler administration** – because the measure of income will be that for a tax year and the definition of income will be much closer to tax definitions, claimants will be able to use end of year statements from the tax system, such as their P60, to provide the information needed in their claim;
- **a fairer system** – awards are based on family income for the whole of the tax year (joint income for couples), rather than just a short interval around the time an application is made as in WFTC. This gives a fairer picture of the family's financial position as a whole, and also means that there is less scope for people to "play the system" at the time of claim to maximise their award at the expense of everyone else;
- **a more responsive system** – new tax credits can adapt to a family's changing needs and circumstances during the tax year. Families will be able to apply for an in-year reassessment of their tax credit award if their needs or circumstances change. In addition, if families start using a qualifying childcare provider they will not need to wait until the end of their award to get help with childcare costs;
- **better incentives for dual earner couples** – both WFTC and DPTC are assessed against income net of income tax and National Insurance Contributions. Under the new tax credits, assessment will be against gross income and so couples where both partners work will be able to keep more of what they earn. For example, where the first earner in a couple with two children is on half average earnings (£14,100) and the non-working partner moves into part-time work at typical entry wages, under the new tax credits the gain to work will have risen by £14 a week, an increase of over a third;

- **better incentives to save** – families will no longer be unfairly penalised for having savings. The system will treat the income from savings just like any other income. For example, a single earner couple with two children earning £18,000 with £6,000 of savings (generating £300 of interest a year) would gain over £14 a week from the new tax credits, mainly as a result of the abolition of the capital rules;
- **support for children will be paid to the main carer** – the Child Tax Credit and the childcare tax credit will be paid by the Inland Revenue direct to the parent or other person who takes most responsibility for looking after the children, with a choice between weekly and four-weekly payment. This will provide a secure and regular stream of income; and
- **a streamlined system of payment through the wage packet** – building on the experience of WFTC and DPTC, payment through the wage packet will be simpler to operate for the Working Tax Credit. In total, the new tax credits are expected to reduce the burdens on business by around £11m a year.

**2.30** There will be additional advantages for those currently receiving Disabled Person's Tax Credit. The new tax credits integrate support for disabled workers into a single system of in-work support which applies to all workers, with a focus on being in work rather than, as now, on having a disability. As many respondents to the consultation suggested, this is more inclusive than the current, separate arrangements.

**Better than  
IS/JSA**

**2.31** Recipients of Income Support or income-based Jobseeker's Allowance will automatically receive the full amount of Child Tax Credit, without the need to undergo a further income test. For this group the main improvements are:

- **greater generosity** – compared to the child allowances in Income Support and Jobseeker's Allowance, for example, most families with two children on Income Support will gain over £9 a week from the Child Tax Credit;
- **more security on the move into work** – families continue to receive Child Tax Credit when they return to work without the need to re-apply. The Child Tax Credit will be paid at the maximum rate for all families until income reaches £13,000 a year, delivering a secure stream of income for families moving off welfare and into work; and
- **a reduction in stigma** – as the Child Tax Credit will be paid to both working and workless families.

**Better than  
Children's Tax  
Credit**

**2.32** Compared to the Children's Tax Credit, the new tax credits will offer a number of advantages:

- **payment to the main carer** – as mentioned above, the Child Tax Credit will be paid by the Inland Revenue to the parent or person mainly responsible for looking after the children, with a choice between weekly and four-weekly payment. This will provide a secure and regular stream of income;
- **a fairer system** – awards will be based on the income of the family, so single earner couples will be treated the same as dual earner couples on the same level of income. For example, under the Child Tax Credit a single earner family on £40,000 will receive £545 a year, the same as a couple where both earn £20,000 a year, and £320 a year more than they would have received from the Children's Tax Credit; and

- **continuing support** – all families receiving Child Tax Credit will be part of one system of support. This means that, if a family sees their income fall, they will be able to access additional support from the same system. Payment of the full family element of Child Tax Credit for all families with income less than £50,000 a year will also provide a continuing stream of support to the main carer as income rises.

## **FAMILIES CURRENTLY EXCLUDED FROM INCOME-RELATED SUPPORT**

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### **Better for newly eligible groups**

**2.33** By creating a single, seamless system of support for families with children, the Child Tax Credit will extend support to around 100,000 families currently excluded from all income-related support for children. This includes groups such as students and student nurses. In addition, low income working people with savings over £8,000 will also be able to benefit from the Child and Working Tax Credits, whereas they are currently excluded from the WFTC.

**2.34** Extending support to these families will provide a significant boost to their income. Some families will benefit by the full amount of Child Tax Credit, which could mean an additional £38.20 a week for the first child and £27.75 a week for each subsequent child. The Child Tax Credit also means that for the first time, these families will be treated in the same way as other low income families who currently receive either the Working Families' Tax Credit, Income Support or Jobseeker's Allowance.

# 3

## TACKLING POVERTY AND MAKING WORK PAY

**3.1** This chapter illustrates how the levels of the Working and Child Tax Credits announced in Budget 2002 will enable the Government to meet the objectives of supporting families, making work pay and tackling poverty.

### SUPPORTING FAMILIES AND TACKLING POVERTY

**3.2** The introduction of the new tax credits will consolidate the progress made so far in supporting families, making work pay and tackling child poverty, providing an additional £2.7 billion to families with children and low-income working people without children. Around 5<sup>3</sup>/<sub>4</sub> million families will receive the Child Tax Credit. In total it will channel around £13 billion of support to families with children.

**3.3** Table 3.1 shows how the Child Tax Credit will work alongside Child Benefit to provide a maximum payment of £54.25 a week (£2,820 a year) for the first child, with a further £38.50 (£2,000 a year) for second and subsequent children. Around a quarter of all families with children will receive this maximum amount of Child Tax Credit and 85% of families will receive at least the full family element of £10.45 (£545 a year) in addition to Child Benefit.

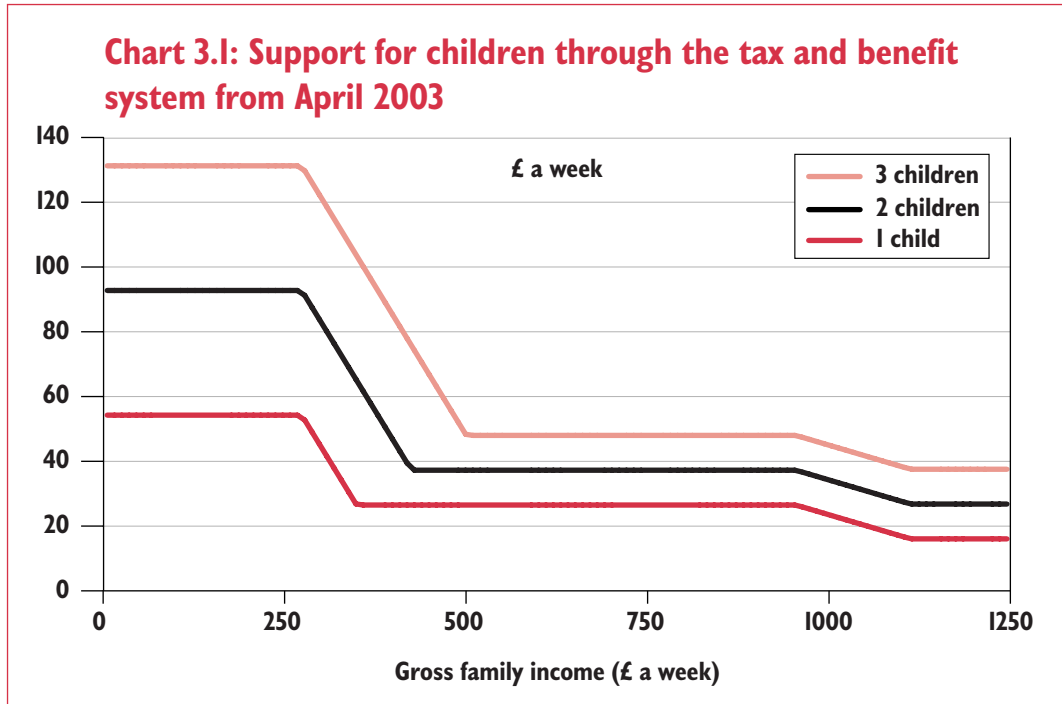
**Table 3.1: Maximum levels of support for families with children in 2003**

	2003–04 weekly amounts, £	
	First child	Subsequent children
Child Benefit	16.05	10.75
Child Tax Credit		
– family element	10.45	
– child element	27.75	27.75
Maximum support	54.25	38.50

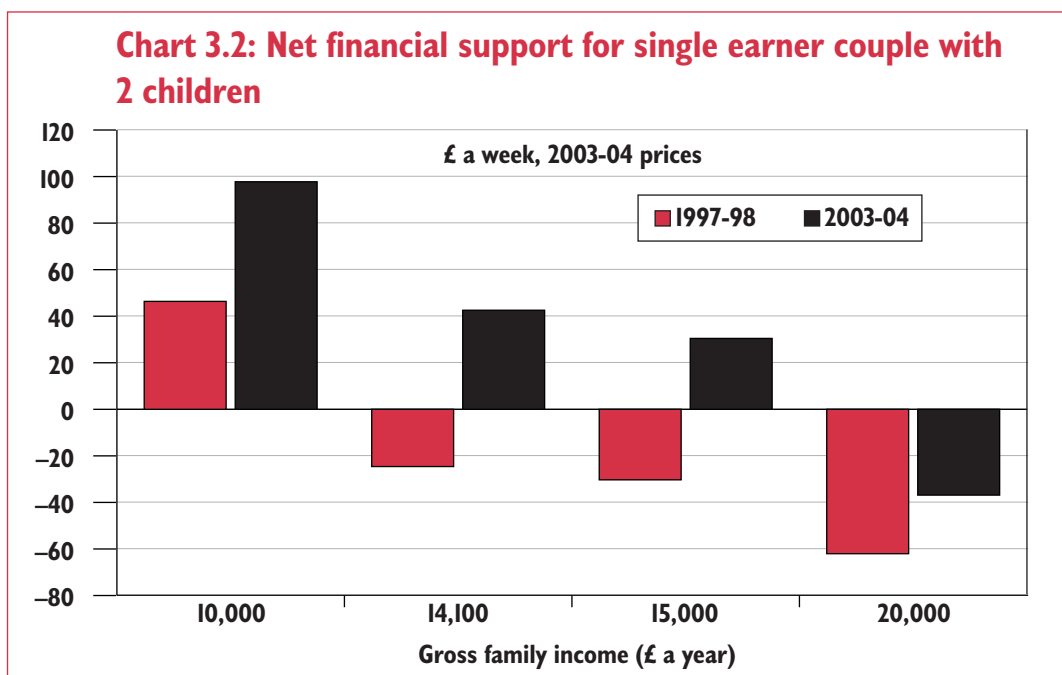
**3.4** Chart 3.1 shows the level of support that different families with children will receive from the Child Tax Credit and Child Benefit from April 2003. While all families receive some support, in line with the Government’s overall strategy, the greatest financial help is available to those families who need it most. Considering the total support available for the first child:

- all families are guaranteed at least £16.05 a week in financial support through Child Benefit;
- families with an income of less than £50,000 are guaranteed £26.50 a week; and
- families with an income of less than £13,000 a year are guaranteed £54.25 a week.

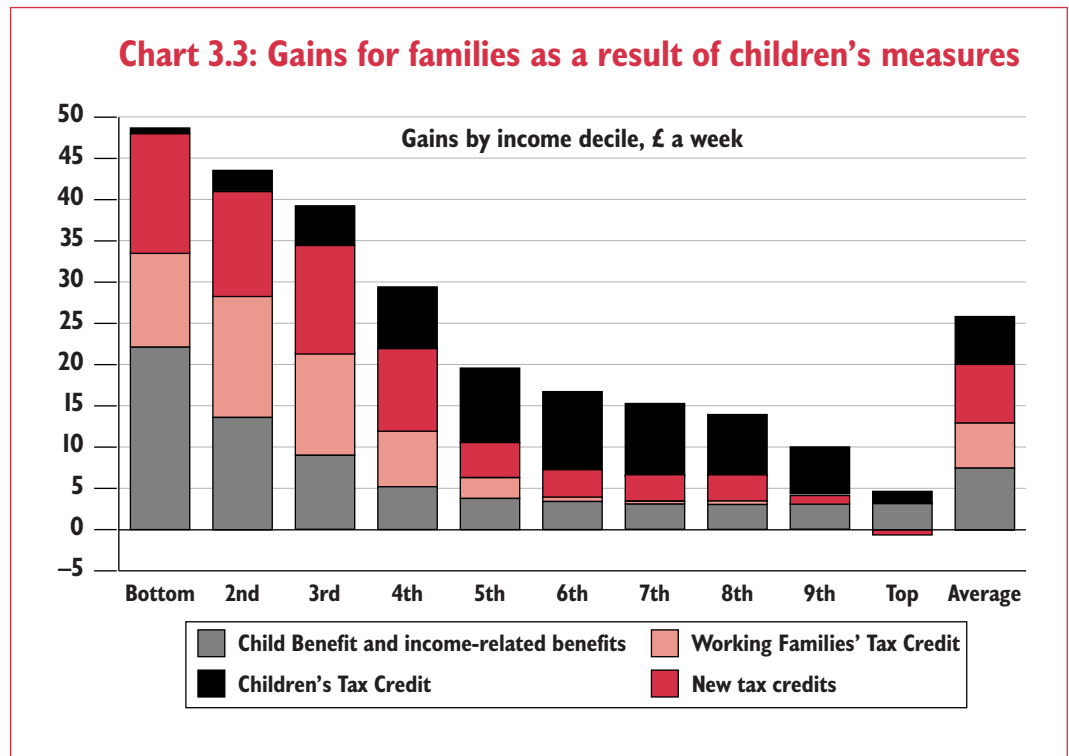




**3.5** Chart 3.2 below compares the position in 1997-98 with that when the new tax credits are introduced. It shows how the Government will increase support for families with children. Net financial support – that is the amount received in tax credits and benefits less the amount paid in income tax and National Insurance Contributions – will increase considerably. A family on half average earnings (£14,100) with two children will receive a net tax credit payment of over £40. Under the 1997-98 tax and benefit system, they would have made a net contribution of nearly £25. A family on £20,000 a year will pay around £35 a week in net tax, compared to making a net financial contribution of around £60 a week under the 1997-98 tax and benefit system.



**3.6** Chart 3.3 shows the effect by income decile of the children's measures introduced since 1997 on families with children. It shows that while all families have gained from the reforms, the greatest gains have been among those on the lowest incomes.



**Tackling poverty 3.7** The Government's long-term goal is to halve child poverty by 2010 and to abolish it within a generation. The new tax credits are central to the Government's strategy for achieving this.

**3.8** The Child Tax Credit will create a single credit payable to those in and out of work at the same rate. This alignment will benefit many workless families who currently receive less support for their children than low income working families. For example, this will mean that a family on Income Support with two children under 16 will receive an additional £9 a week compared to the current system.

**3.9** These increases in support build on the measures introduced in the last Parliament. They mean that the level of child support for a family on Income Support with two children under 11 will have increased by 85% in real terms since 1997.

**3.10** The Government assesses the impact of its tax and benefit policies on low income households compared with what would otherwise have happened if the Government had done no more than index 1997 policies to prices.<sup>1</sup> This enables the Government to estimate up front the full impact of Budget measures, aside from wider economic and demographic changes. The figures below comprise both:

- a reduction in the number of children in relative poverty; and
- the number of children who would otherwise have fallen into relative poverty as median income and earnings rise.

<sup>1</sup> The methodology is similar to that used in independent research. See, for example, Sutherland and Piachaud, *Journal of Social Policy*, Vol. 30, 2001.

**Table 3.2: Effects of personal tax and benefit reforms announced since 1997**

	50 per cent median	60 per cent median	70 per cent median
Number of children lifted above low income thresholds, compared with a 1997 indexed regime	2.2 million	1.5 million	0.8 million

*Note: Estimates are for the full year impact when all measures up to 2003-04 have been introduced. Incomes are measured after housing costs and include the self-employed. Thresholds are on a contemporary year basis.*

**3.11** These assessments are complemented by a target which will reflect all economic and demographic changes: the Public Service Agreement (PSA) target set in Spending Review 2000 to reduce the number of children in low-income households by a quarter by 2004 compared to 1998–99. This requires action to ensure that the benefits of reforms introduced during the last Parliament are sustained as the economy grows, as well as additional steps to raise low incomes. By 2000–01, the number of children in households below 60 per cent of contemporary median income had fallen by 0.3 million compared with 1998–99 and by 0.5 million compared with 1996–97, even though the 2000–01 figures do not reflect the full effect of all measures announced to date. Against an absolute line, there have been significant gains for low-income families, with the number of children below the 1996–97 60 per cent median line fixed in real terms falling by 1.4 million between 1996–97 and 2000–01.

**3.12** Poverty is of even greater concern, and has the greatest effect on families with children, where it is persistent. The Government believes that work is the best long-term route out of poverty. The new Child Tax Credit and Working Tax Credit will together ease the transition from welfare to work and help to ensure that work pays.

## IMPROVING WORK INCENTIVES

**3.13** The Working Tax Credit is designed to help improve work incentives, building on the measures taken in the last Parliament. In particular, the Government has sought to tackle two main problems:

- the unemployment trap, where those without work find that the difference between in- and out-of-work incomes is too small to provide an incentive to take a job; and
- the poverty trap, where those already in work may be discouraged from working longer hours or taking a better paid job because it may leave them little better off, after in work support is reduced and they have paid more income tax and National Insurance Contributions (NICs).

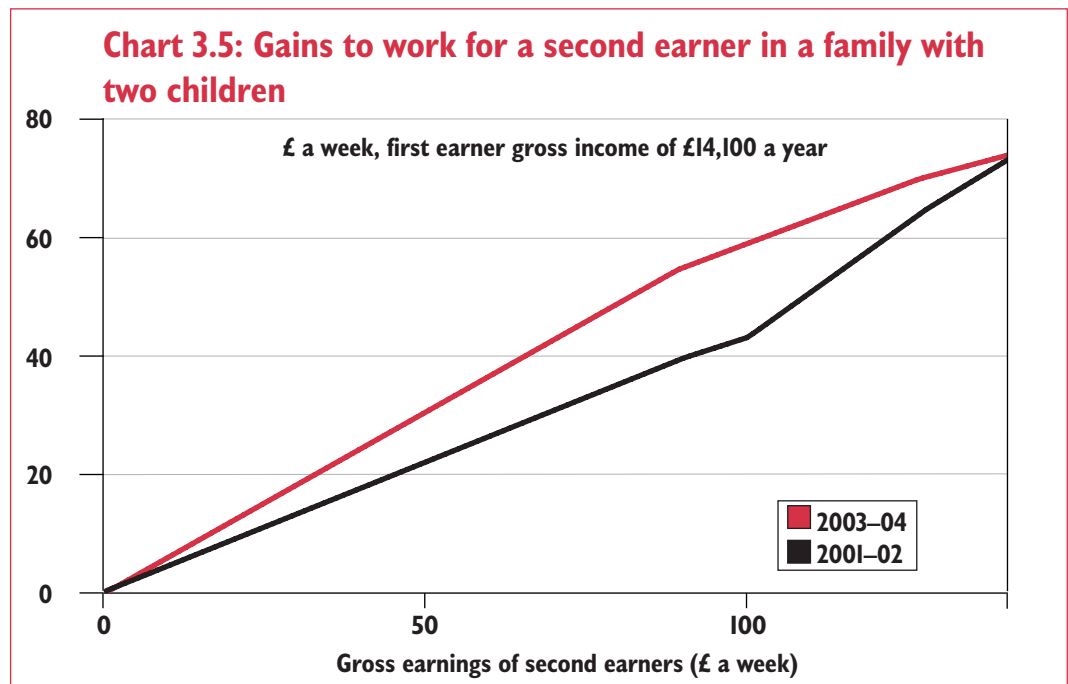
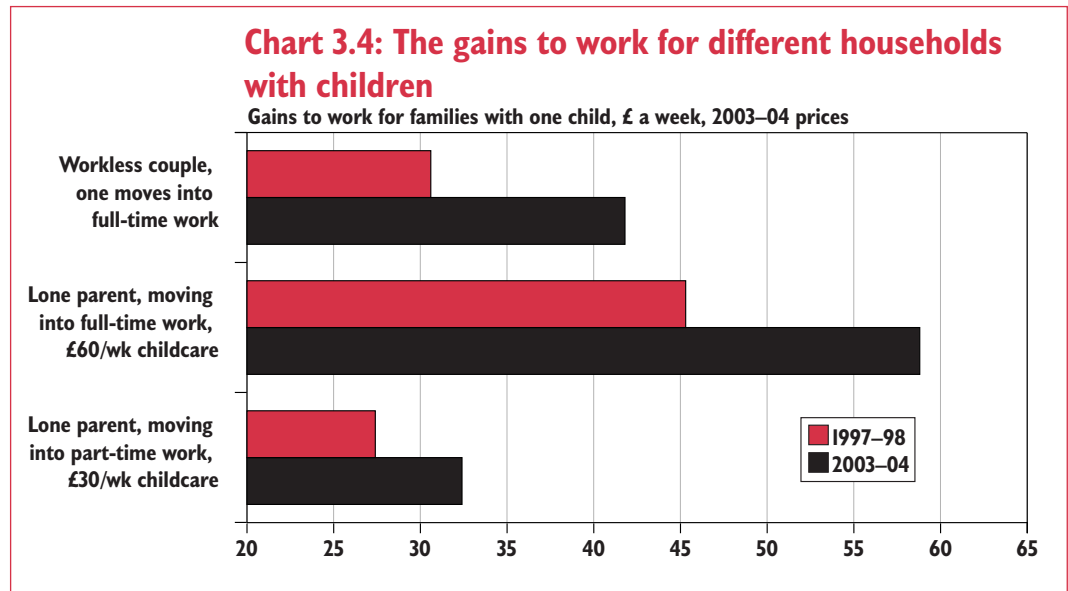
**3.14** As a result of the National Minimum Wage and the Government's package of tax and benefit reforms, the Government can now guarantee a minimum level of income for people moving into employment, with or without children. Extending the Working Tax Credit to those without children will increase their guaranteed minimum income in full time work. The guaranteed minimum incomes under the new tax credits are shown in the table below. For an eligible couple without children, the minimum income in full-time work under the Working Tax Credit is £183 a week, or £5.25 an hour.

**Table 3.3: Minimum income guarantees**

£ a week	April 2002	April 2003
Family 1 child, full-time work (35 hours)	227	237
Family 1 child, part-time work (16 hours)	167	179
Couple, no children, aged 25 or over, full-time work (35 hours)	130	183
Single person, no children, aged 25 or over, full time work (35 hours)	130	154

*Note: Assumes prevailing rate of National Minimum Wage and that family is eligible for Working Families' Tax Credit and Working Tax Credit/Child Tax Credit.*

**3.15** The reforms introduced over the course of the last Parliament were of particular help to families with children, who had previously faced some of the poorest work incentives. The new tax credits consolidate this progress and Chart 3.4 below shows how the gains to work have improved for different households at typical entry wages as a result of the measures since 1997, including the Working and Child Tax Credits.



**3.16** The new tax credits will also improve the financial rewards to work for the non-working partner in a single earner couple. This is, in part, a result of withdrawing new tax credits on the basis of gross rather than net income. Chart 3.5 shows how the gains to work for a second earner, where the first earner is on half average earnings (£14,100), will improve under the new tax credits. At typical entry wages, the gain to work for a second earner taking a part-time job will have increased by around £14 a week.

**3.17** The Government's reforms have also helped to ease the poverty trap. Many low income families, who used to face very high marginal deduction rates, now keep more of every extra pound they earn. Table 3.4 below shows the progress that has been made. Whereas in 1997, almost 750,000 families faced marginal deduction rates in excess of 70 per cent, this number has fallen by nearly half a million as a result of the measures introduced by this Government. The increases in the numbers facing marginal deduction rates of over 60 per cent is largely due to the extension of in work support to those without children through the Working Tax Credit. Currently this group is unable to access in work support from tax credits.

**Table 3.4: The effect of the Government's reforms on high marginal deduction rates**

Marginal deduction rate <sup>1</sup>	Before Budget 1998 <sup>2</sup>	2002-03 Tax and Benefits System <sup>3</sup>	After Introduction of New Tax Credits <sup>4</sup>
Over 100 per cent	5,000	0	0
Over 90 per cent	130,000	45,000	45,000
Over 80 per cent	300,000	210,000	200,000
Over 70 per cent	740,000	255,000	260,000
Over 60 per cent	760,000	940,000	1,450,000

<sup>1</sup> Cumulative figures for working households in receipt of income-related benefits or WFTC (new tax credits from 2003).

<sup>2</sup> Based on 1997-98 caseload and take-up estimates.

<sup>3</sup> Based on 1999-2000 caseload and take-up estimates.

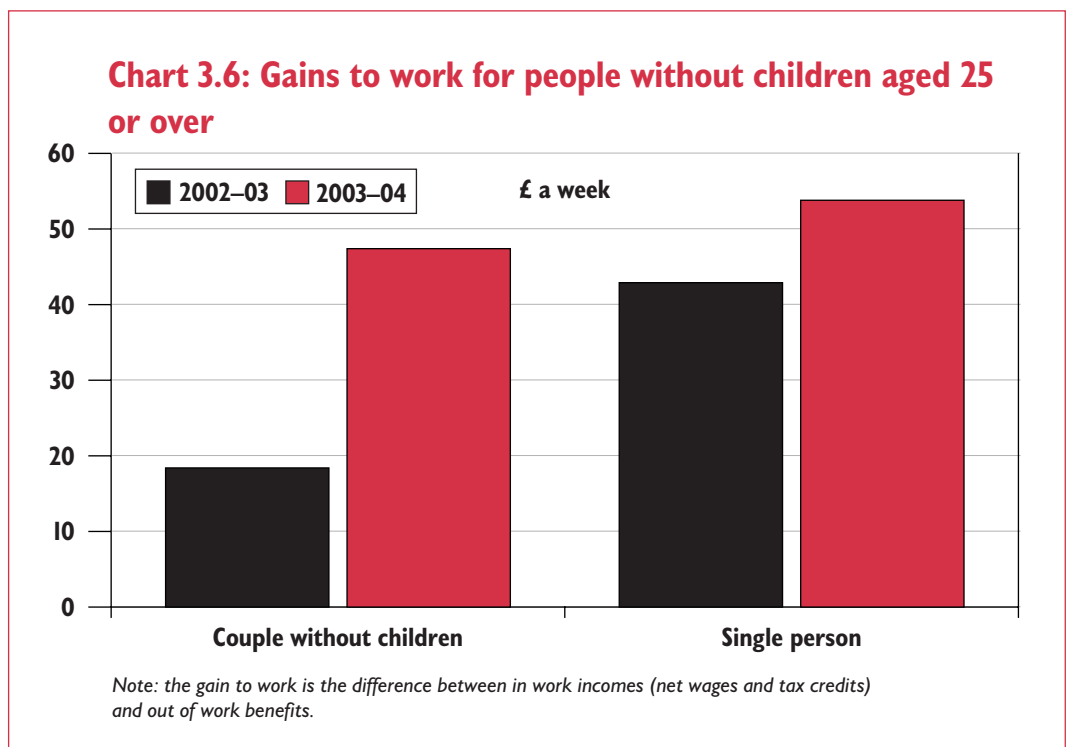
<sup>4</sup> After Budget 2002 including new tax credits, based on 1999-2000 caseload and take-up assumptions.

**3.18** This analysis does not take account of the way in which the new tax credits will respond to rises in income, described in Chapter 4. The new tax credits only respond to rises in annual income in the current year of more than £2,500, disregarding the first £2,500 of any rise. This means that recipients will not see their tax credits reduced as soon as their income rises, so reducing the effective marginal deduction in any one year.

**Support for workers without children** **3.19** As well as improving work incentives, the Working Tax Credit will help to tackle the problem of persistent low income among working people without children. Around one million people without children live in households in which someone works more than 16 hours a week but household income is below 60 per cent of the median. Around half of this group live in households where the main earner is 25 or over and works 30 hours or more a week.

**3.20** Making the Working Tax Credit available to those aged 25 or over without children will help improve work incentives for this group. Chart 3.6 shows how the gain to full-time work at typical entry wages will be improved by the Working Tax Credit. The gain to work for a single earner couple without children will increase to nearly £50 a week compared with under £20 a week before the introduction of the new tax credits.

**3.21** A single earner couple aged 25 or over, working full-time and earning £10,000 a year, would gain around £30 a week in 2003–04 compared to the current system. This represents an increase of nearly 20% in their income before housing costs.



## IMPROVING THE CHOICES FOR WORKING FAMILIES

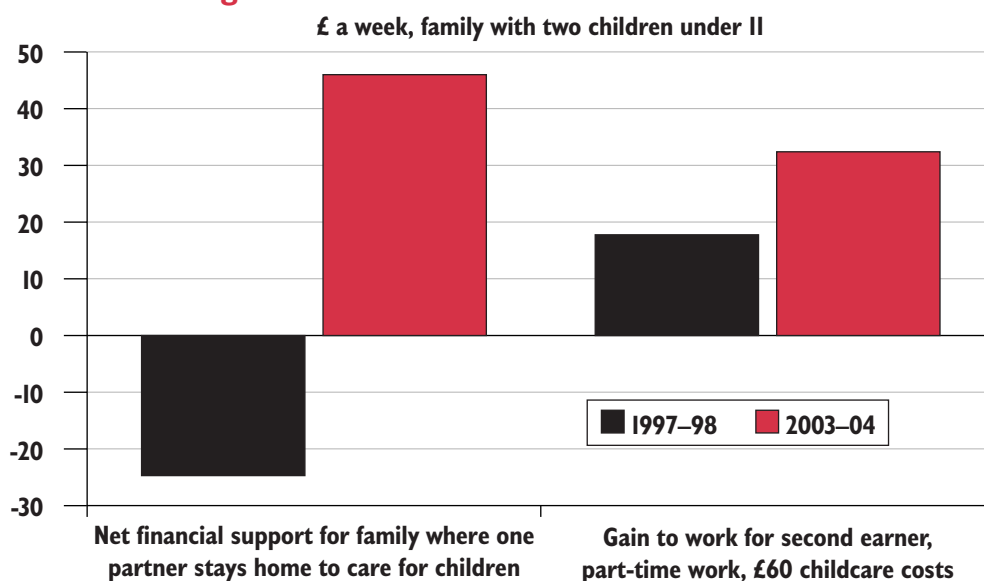
**3.21** All too often in the past, the tax and benefit systems did not properly support parents' choices over how to balance work and caring for children. In some cases, both parents needed to work because in-work support was insufficient for one parent to remain at home to care for the children. In others, the rapid withdrawal of support and the lack of help with childcare costs meant that for many non-working partners, taking a job offered no material financial benefit.

**3.22** The Government's reforms have eased the burden on parents seeking to balance work and family. More generous levels of support have made it easier for one parent in a couple to remain at home to care for their children, or for lone parents to find a better balance between work and caring for their children. Reforms to the structure of support, including the impact of the new tax credits, have also improved the financial returns to work faced by parents seeking to re-enter employment after a period of caring for their children. Improved support for families with childcare costs is key in allowing families to achieve an improved work-life balance. This complements the Government's reforms to maternity provision to give parents more choices about how to balance work and family life.

**3.23** Chart 3.7 shows the effects of the Government's tax and benefit reforms on a family with two children under 11, in which the main earner has an income of half average earnings (£14,100) and the other parent stays at home to care for the children:

- under the 1997–98 system of tax and benefits, the family paid £25 a week more in income tax and National Insurance Contributions than it received in benefits. In 2003–04, a family making the same choice would receive a net tax credit payment of around £40 a week; and at the same time
- where the non-working partner is considering moving into employment, the gains to work will have increased by 80 per cent.

**Chart 3.7: Support for families' choices over balancing work and caring**



Note: net financial support equals tax credits (Family Credit in 1997-98) plus Child Benefit less income tax and National Insurance Contributions.

# 4

## NEW TAX CREDITS – A RESPONSIVE SYSTEM

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**4.1** The new tax credits will provide continuity of support for those who are not experiencing significant changes in circumstances or income, with the ability to adjust quickly for those who are facing major changes. This chapter explains how the new system will achieve this without imposing unnecessary burdens on those claiming tax credits or cutting across their incentives to work.

**4.2** The current, payable tax credits are relatively unresponsive to changing needs. The Working Families' Tax Credit (WFTC) is paid as a six-month fixed award, determined according to family circumstances and a snapshot of income at the point of claim. Although WFTC awards can now be revisited if a family has a new child, the general rule is that, once an award has been made, it remains fixed for six months regardless of what happens to the family.

### A RESPONSIVE TAX CREDIT

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**4.3** Tax credit awards will initially be set on the basis of current circumstances and the previous tax year's income. If circumstances do not change and there are no significant changes in income, the award will run at that level until the end of the tax year. So, once the system is up and running, awards will be able to run for 12 months at a time unless there is some reason for an adjustment.

**4.4** After the end of the tax year, claimants will be sent a renewal form for the next tax year. The renewal form will already include much of the information already held, so as to reduce the amount of form filling. People will be asked to confirm their income and circumstances for the year just finished. This will allow the Inland Revenue to finalise the award for that year by cross-checking actual income and picking up any changes that had not been notified during the year. These renewal details will also provide the basis for the following year's tax credit award.

**4.5** In practice, it will take people a short while to get the necessary information together – for example, they may need to wait for their P60 from their employer. So during that period, their tax credit award will run on at the existing rate to ensure continuity of support. When the award for the next tax year has been calculated, any adjustments on account of the credit already paid out can be made as part of that calculation. This will avoid having to interrupt payments during the renewal process and give people time to return their renewal form.

#### Changes in awards

**4.6** There are three categories of change which could affect a tax credit award:

- changes in the adults heading a household, for example, if a couple breaks up or when people begin living together as a couple;
- changes in the circumstances which determine the tax credits and elements for which claimants are eligible, such as the arrival of a new child or the use of qualifying childcare; and
- changes in income between the current and previous year.



**Household composition** **4.7** Tax credit awards are made to a household based on the income of the adults heading it. A change in the adults heading a household therefore brings a tax credit award to an end. It is important that, in these circumstances, people inform the Inland Revenue promptly so that they can make a fresh claim based on their new situation, and avoid the old award continuing to be paid when it is no longer valid. That is why this is one of the few changes that people will formally have to notify to the Inland Revenue. In the case of WFTC, where claims have to be made every six months, notifying such changes is part of the process of renewing a claim. For new tax credits which can run for up to a year, people will need to inform the Inland Revenue within three months of the change in the composition of the household.

**Changing circumstances** **4.8** The only other area where there will be a formal requirement to tell the Inland Revenue about changes in year, is when the use of qualifying childcare ceases or the cost of it is significantly reduced compared with the amount on which the award is based. This will allow support with childcare costs, which could form a major part of a Working Tax Credit award, to be adjusted promptly, helping to meet a concern expressed about the existing childcare tax credit, which does not respond when a child is withdrawn from, or placed in, qualifying childcare.

**4.9** While awards for tax credits can run for up to a year, tax credits can respond promptly, if the Inland Revenue are notified, to events such as the birth of a child, or, as just discussed, changes in childcare arrangements.

**4.10** Chapter 2 explained how the maximum available amount of tax credit is calculated by adding together the appropriate tax credit elements for which people are eligible. The actual award a family receives is calculated by reducing their maximum amount at a rate of 37p for every pound of their income above the threshold, set in Budget 2002 at £5,060 a year.

**4.11** As circumstances change during the year, so will the elements that people are entitled to claim. Provided the Inland Revenue is told about changes increasing entitlement within three months, tax credit awards will be revised from the date of the change. (Changes reducing entitlement always take effect from the date of the change.) Apart from the changes mentioned above there will be no formal requirement to notify the Revenue within this time. That is because there will be many awards – in particular to people receiving just the family element of the Child Tax Credit – for which changes would not affect the amount of credit payable. In any case, where a change would result in an increased amount to be paid out, it is very likely that this will provide enough incentive to tell the Revenue and get the extra support paid promptly.

**4.12** To illustrate how this might work, take a family starting the tax year with one child. Their maximum award would include the family element and one child element. If the family has a new baby during the year, a new child element would be added from that point, as would the higher family element for those with a child under one, assuming the change was notified within three months. Their award would be recalculated and for the rest of the year, they would receive tax credits on the basis of two children. The example below shows how an award might be affected when a child is born.

**Example 4.1 – Simon and Anita begin the tax year with one child. Simon works full-time earning £250 a week (£13,000 a year) and Anita stays at home to care for their child.**

**Their initial award is based on having one child. A family with the same non-financial circumstances with an income less than £97 a week would be entitled to £108.10. Simon and Anita, with an income of £250 a week, have an award of £51.49 a week.**

**Three months into the award, Simon and Anita have another child. A family with these non-financial circumstances with an income less than £97 a week would be entitled to £146.30, which includes the higher family element for those with a child under one. With the same income of £250 a week, this gives Simon and Anita an award of £89.69 a week for the remaining nine months of the year.**

**This is around £10 a week more than they would receive under the current Children’s Tax Credit and Working Families’ Tax Credit. In addition, while families currently have to make a completely new claim for Working Families’ Tax Credit when they have a new child, under the new system, they will be able to inform the Inland Revenue by telephone, reducing the amount of form filling.**

**4.13** Similarly, changes reducing the maximum amount of tax credit will take effect at the date of the change to avoid creating an incentive to delay notification. Again, such changes may not reduce the amount of tax credit payable, so a formal requirement to notify them to the Revenue would be unduly onerous. But the Inland Revenue will encourage people to notify changes promptly to avoid the risk of having tax credit overpaid, which would need to be paid back.

## CHANGING INCOME

**4.14** The Tax Credits Bill, which is currently before Parliament, provides for a number of different approaches to dealing with rises and falls in income between one year and the next. In its response to representations about the proposals in the consultative document issued last July, the Government noted that it wanted to reflect further on the various possible approaches and to have further discussions with interested parties. After careful consideration of the available evidence, the Government has decided to follow the approach outlined below. The operation of the new system will be carefully monitored, and the Government will look to learn any lessons for future development.

**4.15** In arriving at a decision on the extent to which the new tax credits system should respond to changes in income and circumstances, the Government looked carefully at similar systems in other countries, in particular in Canada, which has a relatively simple and unresponsive system, and Australia, which has a very responsive system. It has held detailed discussions with officials, academics and researchers in those countries.

### **International experience**

Since its last major reform in 1998, when the Canada Child Tax Benefit was introduced, Canada has had a system of support for all children which does not depend on the employment status of their parents. The amount of Child Tax Benefit a family is due is based on the taxable income of the household in the previous tax year which, in Canada, is the calendar year. Since almost all Canadians complete a tax return, this is the income reported on their return each April.

Child Tax Benefit awards are calculated each July, on the basis of that household income and are set until July the following year. Families can apply for a reassessment in-year if there is a change in household composition, or in the number of children in the home. But awards do not vary directly with in-year changes in household income. Canadian families whose income falls substantially therefore have to wait until the next annual assessment before they can get any extra support – unless they qualify for support through the provincial social assistance system which provides some degree of safety net support for families who see a dramatic fall in income during the year.

By contrast, the Australian system of support for children consists of two main credits: Family Tax Benefit Part A (a broad based payment for families with children) and Family Tax Benefit Part B (a top-up to Part A for single-income families with children under 5). Just as in Canada, most Australian families complete an annual tax return, with the Australian tax year running from July to July. But, unlike Canada, if they wish to claim Family Tax Benefit, they are required both to report their income for the previous tax year and to forecast their income for the current year.

The statement of household income for the year just ended is used to reconcile their Family Tax Benefit award for that year and the forecast for the current year is used to calculate the award for the coming tax year. Like the Canadian system, the Family Tax Benefit responds to changes in circumstances – but it also responds to in-year changes in forecasts of family income. Forecast and actual family income are finally reconciled when the next tax return is made and any underpayments top up tax benefits already paid for the tax year just ended, while overpayments must be repaid.

The two systems represent different trade-offs between competing objectives:

- providing certainty and administrative simplicity; and
- ensuring fairness, targeting support to needs and providing enough flexibility for families to choose to seek support when they need it.

Neither the Canadian nor the Australian system provides a model which the UK could replicate precisely. The Canadian model is difficult to translate to the UK: the levels at which it provides support are relatively low, so targeting support to those who need it most is less relevant and it relies on provincial support systems to provide a safety net for falls in income. The Australian model is more generous and more closely targeted to family needs, but its first year of operation has demonstrated the risks, inherent in its approach to responsiveness, of a significant number of end-of-year debts.

**4.16** As the following section explains, the Government has drawn on both the Canadian and the Australian experiences to design a system which steers a course between the two, reflecting a balance between the objectives outlined in Chapter 2.

**4.17** In summary, the new system will respond to changes in annual income between one year and the next by providing for awards to be revised – either during the tax year or at the end of it – to reflect:

- all falls in annual income; and
- rises in annual income of more than £2,500 a year, disregarding the first £2,500 of any rise.

**Falls in income 4.18** Basing initial tax credit awards on the previous year's income provides tax credit recipients with a known starting point and a degree of assurance about their award. But basing entitlement to tax credits solely on last year's income, as is done in Canada, would, whilst offering security, make it impossible to provide timely extra support to people whose incomes were falling. This is particularly important in the absence of an additional safety net like Canadian provincial social security.

**4.19** As discussed in Chapter 2, families with children receiving Income Support or Jobseeker's Allowance will automatically be entitled to the maximum amount of Child Tax Credit for which they are eligible. Families who become entitled to out-of-work benefits will move onto the maximum amount of Child Tax Credit at that point. This provides a safety net for those families who become workless or fall onto benefits within the tax year.

**4.20** But the challenge is to provide a modern system that is able to respond with extra support for those who see a fall in their income, but who do not qualify for Income Support or Jobseeker's Allowance because they remain in work. Such falls in income could arise, for example, when regular overtime payments are lost, where there is a reduction in working hours or where one partner in a dual earner couple stops working.

**4.21** A system which could not respond to falls in income in the current year would not be able to provide additional support to this group at the time they need it. It would be far less responsive than the current WFTC regime where families must wait a maximum of six months before their tax credit entitlement can be reassessed. Such an approach would mean that recipients experiencing a fall in income would have to wait until their award was renewed before receiving any additional help. For example, a family whose income fell from £15,000 to £10,000 very early in the tax year would not receive the additional £35 a week in support for up to 12 months.

**4.22** In the worst cases, a family might be better off leaving work altogether as the value of out of work benefits would be greater than their wages and tax credits. As an example, take a family with two children where there is one full-time earner on £15,000 a year and one part-time earner on £5,000 a year. With an entirely unresponsive system, if the full-time earner lost their job, the family would be around £40 a week better off if the part-time earner gave up work.

**4.23** The Government has therefore decided that the new system should allow tax credit recipients who experience a fall in income to inform the Inland Revenue that they expect their income for the current tax year to be less than last year's so that they can receive a higher award based on their estimate of income in the current year. This will give recipients the opportunity to get increased tax credit payments when they most need them, in line with the Government's objectives of supporting people in work and tackling poverty. It is also in line with the views of the large majority of organisations responding to last summer's consultation.

**4.24** However, since the initial award will always be based on the previous year's income, it will avoid the problem experienced in Australia of asking everyone to forecast their income for the current year in order for their award to be determined.

**4.25** Not all falls in income will affect a family's tax credits. To help claimants to decide whether and when to apply for a reassessment of their tax credit award the Inland Revenue will provide guidance. This will be in the notice sent to recipients, which will set out their tax credit award and advise on the level of change in their annual income that would mean a change in the amount of their award. Guidance and advice will also be available through the Inland Revenue's telephone helplines.

**4.26** Claimants might prefer to wait, and allow any fall in income to be picked up at the end of the year when their award is finalised. They would not lose any tax credit by doing so. At the end of the tax year, any fall in current year income compared to previous year income that had not been notified to the Inland Revenue within the year would be picked up in the reconciliation process. Recipients would then be paid any additional tax credit to which they were entitled in a lump sum. The Government expects that many of those who see relatively small falls in income may choose not to ask for a reassessment of their award in advance of the end of year reconciliation.

**4.27** The example below shows how the new tax credits would respond to a fall in income.

**Example 4.2 – Sarah and Mark have two children. Last year, Mark earned £10,000 and Sarah earned £8,000, together an average of £346.15 a week. A family with the same non-financial circumstances and an income below £97 a week would be entitled to £135.85 a week. Taking into account Sarah and Mark's income gives them a tax credit award of £43.66 a week.**

**This year Sarah reduces her hours to spend more time with the children. She earns £4,000 a year while Mark continues to earn £10,000 a year. As they expect their income this year to be below last year's income, they contact the Inland Revenue to have their award reassessed.**

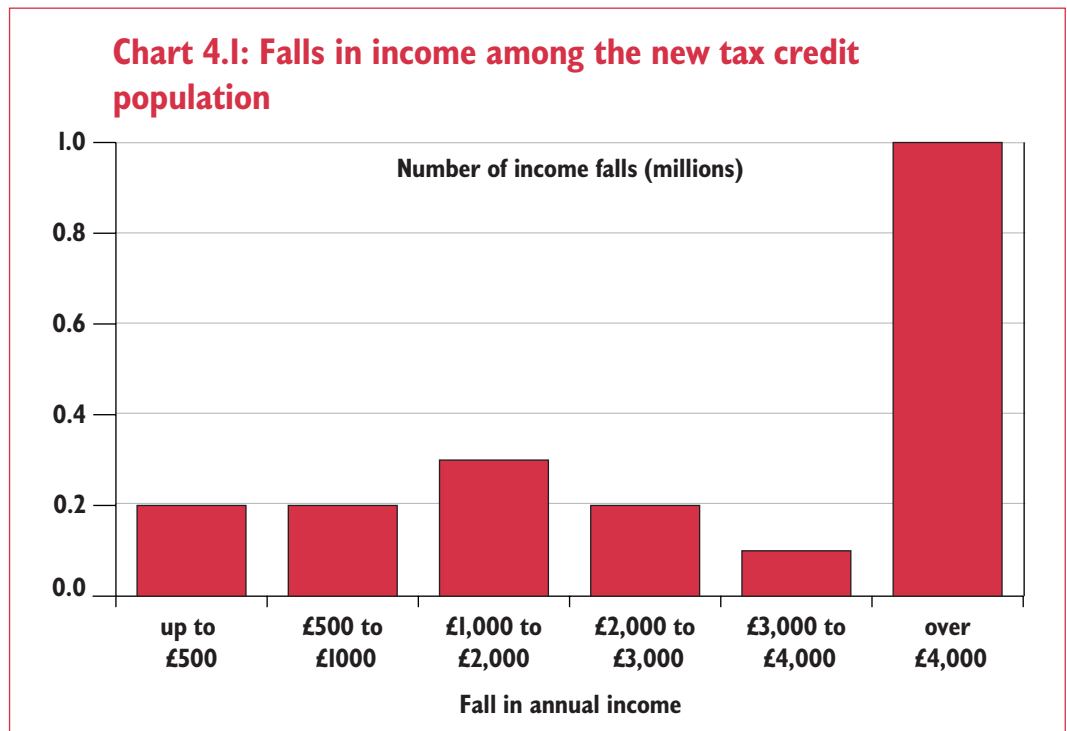
**The family's non-financial circumstances have not changed, but the income measure needs to change to reflect their forecast income of £14,000 a year. Using this new income measure, Mark and Sarah's award is recalculated and their award is adjusted so they now receive £72.12 a week.**

**4.28** This example shows how tax credits can adjust quickly to support families who may have seen a drop in income. In the example above, tax credits respond by providing over £28 a week in additional support. Under the Working Families' Tax Credit, families had to wait up to six months before having their award adjusted for a fall in income. This would mean the family receiving up to £700 less in support.

**4.29** The Government also considered whether to respond to all falls in income or only falls over a certain value. Responding only to large falls would reduce the targeting and timeliness of extra support and reproduce many of the disadvantages of an unresponsive system. For example, not responding to falls in annual income of less than £2,500 could deny families up to £925 in additional support and would counter the Government's objectives of making work pay, supporting children and tackling poverty.

**4.30** In addition, the data on the pattern of falls in income suggest that there are relatively few households who see only small falls in income. Where household income does fall, the reduction tends to be significant - often in absolute terms, but almost always relative to household income. Chart 4.1 shows the number of falls in income not associated with change in household composition or the household moving into or out of work. It suggests that around half of households likely to benefit from the new tax credits who see falls in income from one year to the next might be expected to see falls in income in excess of £4,000.

**4.31** Setting a small threshold below which falls in income would be ignored (leaving tax credit entitlement on the previous year basis) would, in practice, mean that relatively few recipients were excluded from having their award re-assessed. So the potential saving, both in administrative costs and tax credits expenditure, would be insignificant. It would, however, have potentially significant effects for those excluded. The Government has therefore decided that claimants whose income falls in the current year should have their tax credits based on their actual lower, current year income, regardless of the amount of the reduction.



**Rises in income** **4.32** Tax credit awards must also respond to rises in income in the current year. Not doing so would result in poor targeting of resources and would be prohibitively expensive.

**4.33** The Government is aware, however, that taking into account all income rises could lead to significant numbers of recipients having overpayments, as the majority of them could expect to experience a rise in income from one year to the next. It would also create uncertainty for recipients. The early experience of operating the Australian Family Tax Benefit system would suggest that these concerns are well founded. A number of organisations have urged the Government to introduce some kind of threshold for income rises.

**4.34** In striking a balance, the Government has decided to set a threshold for income rises in the current year, compared with the last, so that any rises in income below this threshold are ignored. On the basis of the evidence (discussed below), the Government has decided to set the threshold for rises at £2,500. If income in the current year rises by less than this threshold, the award will continue to be based on the previous year's income. If, however, income in the current year is more than £2,500 higher than last year's, the award will be based on the actual current year income, less £2,500. The rationale for choosing a "disregard" rather than a pure threshold for rises, and for setting the disregard at £2,500, is also outlined below.

**4.35** Just as with falls in income, recipients will not be compelled to inform the Inland Revenue if their income rises. The Inland Revenue will provide recipients with guidance on the level of change in annual income that would mean a change in their tax credit award, advising those whose increase in income is above this level to contact them to have their tax credit award reassessed during the year. This will help to avoid overpayment of tax credits. However, recipients could, if they chose, wait until the end of the year for a reconciliation. An example of how the new tax credits will respond to rises in income is shown below.

**Example 4.3 – Joe is a lone parent who works full-time and has one child. In the previous tax year, he earned £8,000, an average of £153.84 a week. A family with the same non-financial circumstances earning less than £97 a week would be entitled to £108.10 a week. After taking Joe’s income into account, he is entitled to a tax credit award of £87.07 a week.**

**At the start of this tax year, Joe finds a better paid job and expects to earn £11,500 in total. As his rise in income of £3,500 is above the £2,500 threshold, he contacts the Inland Revenue to have her award reassessed.**

**Joe’s non-financial circumstances have not changed, but the actual amount he is entitled to needs to change to reflect his forecast of income. As the first £2,500 of any rise in income is disregarded, his award is recalculated as if his income had risen by £1,000, i.e. as if he had an income of £9,000 for the year. Using this new income measure, Joe’s award is recalculated and his award is adjusted so he receives £79.95 a week.**

**Families will only receive the benefit of the disregard in the year of the rise. In the following year, assuming no further changes in income, Joe’s tax credit would initially be based on the actual income for the year just finished, i.e. £11,500.**

**4.36** Setting a £2,500 threshold and disregarding rises in income up to this threshold means that recipients will not see their tax credits reduced as soon as their income rises. This will provide certainty for those who see rises in income of less than £2,500. It will also mean that people offered the opportunity to earn extra money, whether through overtime or through moving into work, will have the security of knowing that they will see the full benefit of the first slice of their additional income. Because the first £2,500 of any rise in income is disregarded, even those who see a larger rise in income will still benefit as they have the first £2,500 of any rise disregarded.

**Why a disregard for rises?**

**4.37** Before deciding to set a disregard for income rises, the Government also examined and rejected an alternative “cliff-edge” approach. Under such a regime income rises below the threshold would be ignored, but if income rose by more than the threshold, the whole increase would be taken into account, thus creating a “cliff-edge”. For example, if the threshold were set at £2,500, a family whose income rose by £2,499 would receive the full benefit of the rise in income as the increase in income would be insufficient to affect their tax credit award. However, if the same family’s income rose by £2,501, the full amount of the rise could be reflected in a reduced tax credit award.

**4.38** Under a “cliff edge” regime, once the threshold was triggered, the tax credit award would be reassessed taking into account the total rise in income. So a family whose income rose by £2,501 a year would receive up to £925 a year less in tax credit than if its income had risen by £2,499. In effect, the extra £2 of earned income would cost the family up to £925 in tax credits.

**4.39** The disregard approach, by ignoring the first £2,500 rise in income, removes this cliff edge and the uncertainty and complexity it would involve for recipients. It also means that income rises are treated the same for everyone.

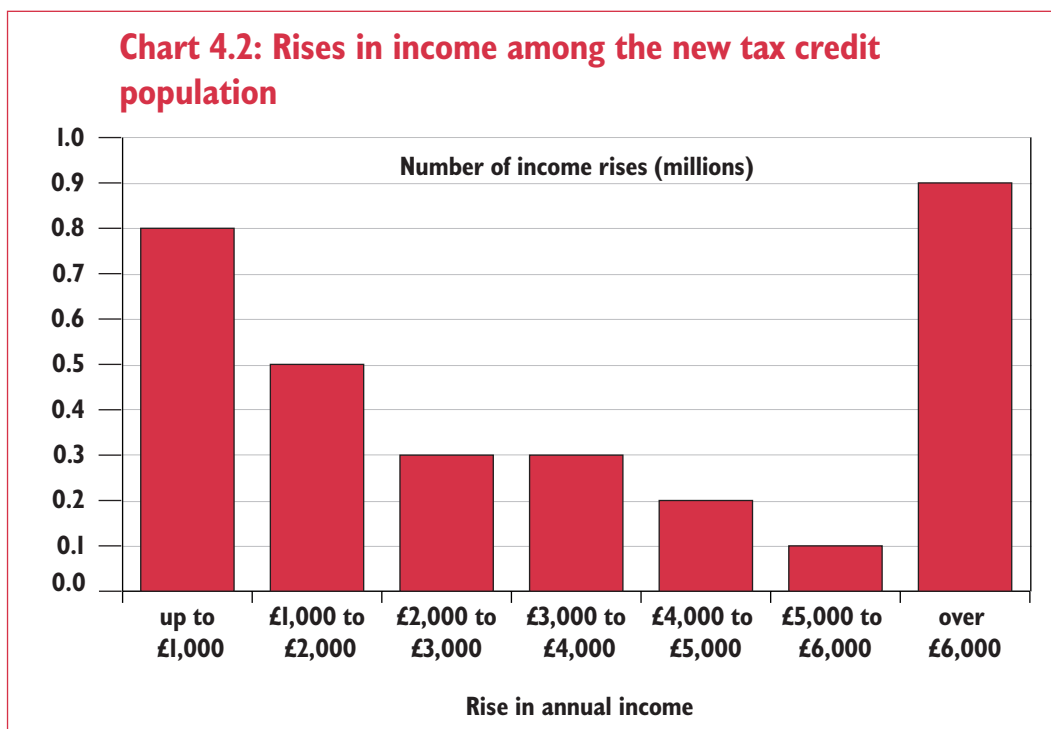
**Why a £2,500 disregard?**

**4.40** A disregard for rises reduces the number of claimants who may need to have their awards reassessed purely because of income changes. Increasing the size of the disregard would further reduce the numbers of those who might need to have their awards reassessed. But a larger disregard increases the cost of the new tax credits and reduces the effective targeting of resources.

**4.41** The Government has therefore looked carefully at the available evidence on the changes in income which households experience from one year to the next. In particular, it has looked separately at income changes not related to a change in household composition or movements between being a working or workless household. Changes in household composition or the household becoming workless are contingencies already covered by other provisions in the new tax credits and Income Support and Jobseeker’s Allowance respectively.

**4.42** Analysis of the British Household Panel Survey (BHPS) suggests that around 60 per cent of households in the new tax credits population could be expected to see a rise in income between one year and the next. The chart below shows the distribution of income rises for the new tax credit population drawn from the BHPS. It shows that households tend to experience either relatively small increases in income of £1,000 or £2,000 a year or else much larger increases. This is perhaps not surprising as an increase of £1,000 would be roughly equivalent to average earnings growth for a family on £24,000. Among households experiencing a rise in income this year compared to last, around 40 per cent see increases of below £2,000. Setting the new tax credits disregard at £2,500, therefore, takes account of that evidence and goes beyond to provide a further small margin for rises and allows for the arrangements in the first year of new tax credits (see below), in the interests of minimising the chances of overpaid tax credit.





**4.43** Many of the recipients of tax credits who see a rise in income of more than £2,500 will not have their awards adjusted as a result. For many who are receiving just the family element of the Child Tax Credit, only very large changes in income are likely to affect the amounts of tax credit to be paid to them. The Government estimates that in steady state, around 750,000 individuals and couples a year will move onto a current year basis of entitlement and see their awards change as a result of a rise in income. These are the people who would be advised to ask for an adjusted award during the year to reduce the risk of overpayments. This compares to around 1 million cases with falling incomes leading to a changed award, who would also have the option of asking for an adjusted award during the year.

**4.44** The table below breaks down the number of families that are estimated to see a fall in their tax credit award following a rise in their household income by their position in the new tax credit population. It suggests that the vast majority of families whose awards will be reassessed will be people on either maximum tax credits or the first income taper, those formerly entitled to WFTC. Such recipients will generally have some experience of regular contact with the Inland Revenue, and currently have to make two claims each year. These families are also at income levels where the £2,500 disregard represents quite a significant proportion of their income. They will also benefit from the £2,500 disregard for income rises.

**Table 4.1: Rises in income that lead to a fall in tax credit award**

Position in tax credit population at start of the year	Number of families seeing entitlement falls by more than £1 a week
Maximum tax credits	100,000
First income taper	500,000
Family element only or second taper	100,000
Total (rounded)	750,000

**Special arrangements for 2003–04** **4.45** The Government plans to begin issuing claim forms for new tax credits later this year. This will allow plenty of time for people to complete their forms and return them to the Inland Revenue to be processed before April 2003. This means, however, that information about incomes in 2002–03 will not be available when people are completing their claim forms. Instead, for awards beginning in April 2003, claimants will be asked about their income information for the tax year 2001–02, and initial tax credit awards will be based upon this information.

**4.46** For 2003–04, responding to changes in income will therefore be based on a comparison between income in the current year compared, not to income in the previous year (2002–03), but to the year before (2001–02). This arrangement will only be used for the first year of tax credits (2003–04). Subsequent years will use the previous year's income as the basis for initial tax credit awards. For example, awards in 2004–05 will initially be based on income information for 2003–04, and awards will respond to changes in 2004–05 income compared to 2003–04.

**4.47** Using income information for 2001–02 will increase the number of awards that may need to be reassessed due to rises in income. The Government expects around 1 million awards to be reassessed as a result of rises in this first year, compared to around 750,000 in subsequent years.

## DEALING WITH UNDER AND OVERPAYMENTS

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**4.48** As discussed above, recipients who do not notify the Inland Revenue of changes in circumstances or income could find they had been underpaid or overpaid tax credits. In addition, allowing tax credits to respond to changes in income during the year means that, for some, their award will be based on a forecast of their income for the year. At the end of year reconciliation, their entitlement for the year just gone will be finalised based on their actual income. Where forecast income and actual income for the year differ, there is the potential for an under or overpayment to arise. But, as the earlier part of this chapter explained, the new system has been designed to minimise the scope for substantial overpayments.

**4.49** While we are reasonably confident of our estimates of the number of families whose awards might need to be reassessed, it is more difficult to predict how many of those families will opt for in-year reassessment and how many will choose to leave it to the end of year reconciliation. The new system will therefore need to cater for the possibility of potential underpayments or overpayments of tax credits.

**4.50** If recipients have, for whatever reason, been underpaid tax credits, the Inland Revenue will make a single payment covering any outstanding tax credits owed. Where they are overpaid tax credits, there are a number of mechanisms open to the Inland Revenue to recover the excess. Unlike in the Australian system, the preferred method for dealing with overpayments will not be to issue a one-off demand.

**4.51** Families with children will remain eligible for new tax credits until their income (joint income in the case of couples) exceeds £58,000. This means that the vast majority will continue to receive tax credits from one year to the next. This makes it possible to recover many overpayments by adjusting subsequent awards of tax credits. Alternatively, overpayments could be recovered by making changes to individuals' PAYE codes. Only if neither of these methods is appropriate will the Inland Revenue ask for a direct payment.

**4.52** The Inland Revenue's approach to dealing with overpayments will be set out in a code of practice, which will be published in draft for wider consultation later this year.



# A

## THE STRUCTURE OF NEW TAX CREDITS

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**A.1** This Annex provides more detail on the eligibility rules for new tax credits and how much the different elements of the credits are worth. It also shows how income information is used to calculate entitlement

### THE CHILD TAX CREDIT

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**A.2** The Child Tax Credit will provide a single seamless system of support for families with children. It will bring together support for children currently provided through the Working Families' Tax Credit, Disabled Person's Tax Credit, the Children's Tax Credit, Income Support and income-based Jobseeker's Allowance.

**A.3** This new credit will not be conditional on being in work and will therefore span the in and out of work divide. This will create a stable source of income for families as they make the transition from welfare to work. In total, some £13 billion of support will be directed to families with children through this new credit and around 5<sup>3</sup>/<sub>4</sub> million families with children will benefit from it.

**A.4** As announced when the Tax Credits Bill was published on 29 November, the Child Tax Credit will provide support for children until 1st September following their 16th birthday, as a matter of course. Beyond that date, support will be available in respect of young people up to the age of 19 who continue in full-time non-advanced education.

**How much will it be worth?** **A.5** The Child Tax Credit will be paid in addition to Child Benefit, and will comprise a number of elements, recognising the circumstances of different families. From April 2003, the different elements will comprise:

- a **family element** paid to all eligible families, broadly replicating the Children's Tax Credit, in recognition of the responsibilities faced by families with children. A higher family element will be paid for the year following a child's birth;
- a **child element** for each child within the family, in the same way as in Working Families' Tax Credit, Disabled Person's Tax Credit, Income Support and income-based Jobseeker's Allowance; and
- **disabled child elements** for families caring for a child with a disability or a severe disability. These will use the same definition of disability as is used for the current tax credits.

**A.6** The main rates of Child Tax Credit are shown in Table A.1. Combined with Child Benefit, the Child Tax Credit provides maximum support of up to £54.25 a week for families with incomes of up to £13,000.

**Table A.1: The Child and Working Tax Credits**

	2003-04 £ a year	Weekly equivalents, £
<b>Working Tax Credit</b>		
Basic element	1,525.00	29.20
Couples and lone parent element	1,500.00	28.80
30 hour element	620.00	11.90
Disabled worker element	2,040.00	39.15
Enhanced disabled adult element	865.00	16.60
Childcare element		
– maximum eligible cost for 1 child	7,040.00	135.00
– maximum eligible cost for 2 or more children	10,430.00	200.00
– per cent of eligible costs covered	70	
<b>Child Tax Credit</b>		
Family element	545.00	10.45
Family element, baby addition	545.00	10.45
Child element	1,445.00	27.75
Disabled child element	2,155.00	41.30
Enhanced disabled child element	865.00	16.60
<b>Common features</b>		
First income threshold	5,060.00	97.00
First withdrawal rate (per cent)	37	
Second income threshold	50,000	958.90
Second withdrawal rate	1 in 15	
First threshold for those entitled to Child Tax Credit only	13,230	253.76

**Payment to  
the main  
carer**

**A.7** The current income-related systems of support for families with children are paid in a variety of ways. Either partner in a couple can choose to receive the Children's Tax Credit, unless at least one of them is a higher-rate tax payer when it must be claimed by the higher income partner. Working Families' Tax Credit, Disabled Person's Tax Credit, Income Support and Jobseeker's Allowance are single payments payable to the person who makes the claim. This means that the child elements of current systems of support may, or may not, be paid to the person who mainly cares for the children.

**A.8** The Child Tax Credit will be paid by the Inland Revenue direct to the main carer for the children in the family. This is in line with the approach taken with Child Benefit and means that for the first time all payments for children will be directed to the main carer.

## THE WORKING TAX CREDIT

**A.9** Through the Working Tax Credit, the Government will extend in-work support to those without children, building on the principles of the Working Families' Tax Credit and the Disabled Person's Tax Credit. For families with children or a worker with a disability, the Working Tax Credit will broadly replicate the adult support currently provided through the existing payable tax credits.

**Working hours** **A.10** Families with children and workers with a disability (who meet the qualifying benefit rules or who qualify through the Fast-Track) will be eligible for the Working Tax Credit provided they work at least 16 hours a week. This recognises the difficulties that those with children face in combining work with family responsibilities and the difficulties that workers with a disability may face. These groups will also be eligible for tax credits from the age of 16. This replicates the rules they currently face in Working Families' and Disabled Person's Tax Credit.

**A.11** To maintain incentives for families with children or a disability to move into full-time work, an additional "30 hour element" will be paid if the claimant (or one of the claimants) works at least 30 hours a week. As announced in November 2001, couples with children will be eligible for the 30 hour credit if jointly they work at least 30 hours a week, provided one of them works at least 16 hours. This will allow couples to share their family responsibilities more evenly.

**A.12** Workers with neither children nor a disability, aged 25 or over, will be entitled to the Working Tax Credit provided they work at least 30 hours a week. This is in recognition that people in this situation do not face the same barriers to full-time work and should be encouraged to work full-time because it is more likely to offer them the opportunity to improve their skills and progress up the earnings ladder. Eligibility for workers in this group will begin at the age of 25, as it is those aged 25 or over who are most likely to face poorer incentives to work or suffer persistent poverty in work.

**How much will it be worth?** **A.13** The Working Tax Credit will contain a number of elements to reflect differing circumstances:

- a **basic element** paid to all those eligible for the Working Tax Credit;
- **lone parent and couple elements**, which recognise the additional needs of these groups;
- a **30 hour element** to provide incentives to increase hours towards full-time work; and
- other elements to recognise particular aspects of disadvantage in the labour market, such as those for **disabled workers** and those for people **aged 50 or over** who are returning to work after a period out of the labour market.

**A.14** The full list of rates of the Working Tax Credit is shown in Table A.1 above.

## THE CHILDCARE TAX CREDIT ELEMENT OF WORKING TAX CREDIT

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**A.15** The introduction of the childcare tax credit in Working Families' Tax Credit and Disabled Person's Tax Credit marked a step change in the way in which support was provided to working people who incur childcare costs. Research has consistently shown that the costs of childcare can act as a barrier to work for families. In recognition of this, the Working Families' and Disabled Person's Tax Credits allow families to receive extra tax credits meeting up to 70 per cent of their eligible childcare costs, subject to cost limits of £135 a week for one child and £200 a week for families with two or more children in childcare. Over 150,000 families currently benefit from the childcare tax credit in the Working Families' Tax Credit. This is more than three times the number of families who benefited from the previous childcare disregard in Family Credit.

**How much will it be worth?** **A.16** The childcare tax credit element in the Working Tax Credit builds on this success. It will also maintain the firm link to work established under the Working Families' and Disabled Person's Tax Credits. Families will therefore be eligible for the childcare tax credit where a lone parent or both partners in a couple work for at least 16 hours a week. As with the current childcare tax credit, it will be worth up to 70 per cent of eligible childcare costs of up to £200 a week (£135 a week for one child).

**A.17** The childcare tax credit will be paid direct to the main carer, alongside the Child Tax Credit, weekly or four-weekly as the claimant chooses. This will help ease cash flow and budgetary problems for families with children that may arise when support for childcare is received alongside wages, which are often paid in arrears. It also enables support for childcare to be adjusted more quickly, in line with the responsive nature of the tax credits.

**A.18** Childcare regulation is a devolved matter. The childcare tax credit is generally available for approved childcare provided under various registration schemes. In England, childcare eligible for the childcare tax credit includes:

- registered childminders, nurseries, play schemes or out of school clubs;
- a childcare scheme run on Crown property, which does not need to be registered;
- certain schools or other establishments exempt from registration; and
- providers of care for children aged 8 and over, which is approved by specifically accredited organisations.

## CALCULATING ENTITLEMENT FOR NEW TAX CREDITS

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**A.19** An individual or couple's award for new tax credits is based on a combination of:

- their circumstances, for example, whether they are working, the number of children they have or if they have eligible childcare costs. This determines which tax credits, and the particular elements within the tax credits, they are eligible for; and
- their income, which determines whether they should get the tax credit in full or at a reduced rate to take account of their income.

**A.20** In practice, this means adding up each of the elements that an individual or couple is eligible for, to create a maximum available amount of tax credit. For example, a single earner couple working full-time with 1 child would be eligible for the following elements.

**Table A.2: Calculating the maximum amount**

	Weekly value (£)
<b>Working tax credit</b>	
– adult element	29.20
– addition for couples and lone parents	28.80
– 30 hours element	11.90
<b>Child tax credit</b>	
– family element	10.45
– child element	27.75
<b>Maximum amount</b>	<b>108.10</b>

**A.21** The tax credit award the individual or couple is entitled to is set by reference to the income available to them. Those with annual income below the threshold of £5,060 a year (£97 a week), receive the maximum award to which they are entitled. For those with income above the threshold, the maximum amount is reduced by 37p for every pound of income over the threshold.

**A.22** The reduction in the maximum possible tax credit on account of income first reduces the Working Tax Credit apart from the childcare element, then the childcare element and then the child elements of the Child Tax Credit. The family element of Child Tax Credit is retained until income exceeds the second threshold of £50,000 a year, at which point it begins to be tapered away at a rate of 1 in 15. This order of reduction means that tax credit payable through employers is withdrawn first, so that many families with children receive all their tax credits by direct payment.

**A.23** Families receiving Income Support and income-based Jobseeker's Allowance will automatically be entitled to full Child Tax Credit. Such families will therefore not need to undergo the income tests in both the benefits and tax credit systems.

**A.24** There will also be a group of families, such as those headed by student nurses and some students, who are entitled to the Child Tax Credit but not the Working Tax Credit, and who are not receiving Income Support or Jobseeker's Allowance. The Child Tax Credit will not begin to be withdrawn for these families until their income reaches £13,230. This ensures that all families with children on the same income will receive the same level of support per child, regardless of whether the family is working or not.





# B

## TRANSITIONAL ARRANGEMENTS

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**B.1** The introduction of the Child and Working Tax Credits marks a step-change in the way in which support is provided to families with children and low paid workers. This will involve around 6 million households moving on to the new system. The Government is aware of the need to minimise the disturbance caused to families and the risks that payments will be disrupted. This Annex describes the arrangements which will help to facilitate a smooth transition to the new system, and some of the consequential effects for social security benefits.

### ENSURING A SMOOTH TRANSITION FOR CURRENT TAX CREDIT RECIPIENTS

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**B.2** Later this year, the Inland Revenue will begin writing to all those currently receiving one of the existing tax credits inviting them either to apply for the new tax credits online, or to complete and return the paper form they will be receiving. Help will be provided both on-line and with the form and additional support will be available by phone or in person at local Inland Revenue offices. The Inland Revenue wants to ensure that all those eligible for the new credits claim as soon as possible so that they will start to receive payments in April 2003.

**B.3** People not currently receiving tax credits but who think they may be eligible can go on-line and check their eligibility. If they find they are entitled to tax credits, they will be able to make their application electronically – there and then. Otherwise, people will be able to ring up for a paper form, or pick one up from Inland Revenue Enquiry Centres. An extensive publicity campaign is planned to help ensure no-one misses out.

**WFTC and DPTC recipients** **B.4** The Government wants to ensure that people receiving one of the current tax credits, who will be eligible for one or both of the new credits, make a claim for the new credits in good time and do not experience any gaps in support. So a number of changes are being put in place this year.

**B.5** It is especially important that those who currently claim WFTC or DPTC are not faced with completing two different tax credit claim forms in quick succession, one to renew their WFTC or DPTC and one for Working Tax Credit and Child Tax Credit. To avoid people having to renew their tax credit awards for relatively short periods in the run-up to April 2003, and help ensure a smooth transition to the new tax credits, awards of WFTC and DPTC will be lengthened from this summer.

**B.6** From 4 June this year, all new awards of WFTC and DPTC will run until 7 April 2003 instead of the normal 26 weeks. This will mean that no-one will have to re-apply for WFTC or DPTC from December 2002 onwards for an award which would last for less than four months.

**B.7** To ensure that all WFTC and DPTC awards end on 7 April 2003, to coincide with the introduction of the new tax credits, awards starting on or after 15 October 2002 will be shortened and will run to 7 April 2003.

**Helping employers** **B.8** Paying WFTC and DPTC through the wage packet has been a key element in delivering on the promise to make work pay. The Government is committed to that principle, which is why the new Working Tax Credit will be paid to employees through the wage packet, providing a clear and targeted top-up to wages.

**B.9** But the Government also wants to ensure the transition to Working Tax Credit runs smoothly for employers. The system for paying Working Tax Credit through the wage packet will be based on on the WFTC system. There will, however, be some key simplifications to the system which taken together will save employers £11 million annually.

**B.10** To allow employers time to adjust to the new system and to smooth the transition to the Working Tax Credit for claimants, payments of WFTC and DPTC by employers will gradually be phased out from 27 August. All awards of WFTC and DPTC in place before 27 August will be paid as normal for the first 26 weeks, but the Inland Revenue will make the remaining payments up to 7 April 2003. Awards which begin on or after 27 August will be paid direct by the Inland Revenue throughout.

**B.11** Employers should not, therefore, have to make payments of WFTC or DPTC alongside the new Working Tax Credit. This will ensure that payment of the Working Tax Credit through the wage packet is introduced with minimum disruption to employers and employees.

## CHANGES TO SOCIAL SECURITY BENEFITS

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**B.12** Child Tax Credit will replace the child elements of Income Support, including the Minimum Income Guarantee (MIG), and income-based Jobseeker's Allowance and the support for children currently provided within certain other benefits. Child Dependency Increases paid in non-means tested benefits will be abolished for new claims to Retirement Benefit, Bereavement Benefit, Incapacity Benefit (including residual Severe Disablement Allowance) and Invalid Care Allowance. Existing recipients will have their entitlement transitionally protected.

**B.13** For families who receive income related benefits, continuity of payment will be of particular importance. The Government has therefore decided that there will be a transition period for people on these benefits, to minimise the risks in this area. Current plans are for:

- families on MIG with children to be migrated to Child Tax Credit by October 2003 to coincide with the planned introduction of Pension Credit; and
- families on Income Support or income-based Jobseeker's Allowance to be migrated to Child Tax Credit from April 2004.

**B.14** Families will not be disadvantaged by the transition period. The rates of the child elements within the income-related benefits will be adjusted so that families receive the same amount in respect of their children as they would if they were receiving Child Tax Credit. For the vast majority of families in this position, there will be no need for them to claim Child Tax Credit unless they move into work. If they are still on benefit when the migration begins, the Department for Work and Pensions will handle their cases automatically.

**B.15** In addition to the levelling of rates, a number of changes will be made to income related benefits in order to ensure that families who receive these benefits are not disadvantaged during the transition period. These include:

- a disregard to ensure that eligible families benefit from the Child Tax Credit element for children under the age of one;
- a run-on of child premia on the death of a child; and
- a disregard of Guardian's Allowance.

**B.16** During the transition period, any family falling onto IS/JSA with Child Tax Credit already in payment will be awarded IS/JSA child allowances and have the Child Tax Credit taken into account as income.

**B.17** Once steady state is reached, IS/JSA child allowances will be removed and Child Tax Credit and Child Benefit will no longer be taken into account as income in IS/JSA. Families who receive adult allowances in these benefits will automatically be passported to maximum Child Tax Credit.

**B.18** The interaction with Housing Benefit and Council Tax Benefit (HB/CTB) is particularly important. The Department for Work and Pensions and the Inland Revenue have been working closely with local authorities to ensure as smooth a fit as possible. The structure and rates of Child Tax Credit will be replicated in HB/CTB and both Child Tax Credit and Working Tax Credit will be taken into account as income, in line with the current treatment of WFTC/DPTC.

**Role in new  
tax credits for  
jobcentre plus**

**B.19** While responsibility for administering the Child and Working Tax Credits rests with Inland Revenue, the Department for Work and Pensions still has a pivotal role to play, both in terms of delivering a one-stop system of support for working age customers and in promoting the benefits of tax credits as part of the package for people moving into work. Staff will be supported in this role by new IT being delivered as part of the Department for Work and Pensions' wider modernisation programme.

