Administrative disarray or lost opportunities?

Julie Butler and *Tom Le Santo* want to encourage people to claim tax credits

The greatest publicity for the tax credit system has been the government errors, the overpayments, and the confusion – but take away this veil and there is a strong, helpful system to enjoy. The current tax credits system was introduced on 6 April 2003 and replaced the old one under which tax relief was obtained through PAYE. This put pressure on payroll departments and breached confidentiality concerns. The transition was far from smooth, and claimants have struggled to get to grips ever since, leading to huge overpayments, and leaving HMRC with the arduous task of having to recover the overpayments or write them off as irrecoverable. However, is this adverse publicity deterring genuine claimants?

The system is split into two parts: Working Tax Credit (WTC) and Child Tax Credit (CTC). WTC is aimed at topping up the income of those on low wages, and CTC is aimed at topping up the income of claimants with children, whether the parents work or not.

WTC – the maximum available

WTC is available to those who:

- work 16 hours a week and have at least one child; or
- work 16 hours a week and have a disability; or
- satisfy the 50-plus condition; or
- are aged 25 and over and work at least 30 hours a week.

If a claimant satisfies any of these conditions, then they qualify for WTC. To calculate the entitlement, the claimant must look at the different elements of WTC to see which ones apply to their circumstances:

Basic element (£1,730) – Everybody who is eligible to receive WTC qualifies for the basic element.
Second adult element (£1,700) – This element is paid to any couple where at least one of them meets the qualifying criteria for WTC.
Lone parent element (£1,700) – Payable to single parents.
30 hours element (£705) – This is payable if a person or partner works at least 30 hours a week.
Disability element (£2,310) – This is paid where the claimant or partner works for at least 16 hours a week and the claimant has a physical or mental disability that puts him/her at a disadvantage in getting a job ('disability test') and satisfies the 'disability benefit test'.
Severe disability element (£980) – This is paid where a person or partner get DLA highest-rate care or higher-rate Attendance Allowance. Two of these elements can be paid where both partners qualify.
50-plus element (£1,185 or £1,770) – Payable for a limited period of 12 months for those aged 50-plus who have started work within the preceding three months (after 6.4.03). Prior to this s/he had been receiving either IS, JSA, ICB, PC, national insurance credits or SDA for at least six months.
Childcare element (80% of up to £175pw or up to £300pw) – This element can be included if at least one parent is working or on Statutory, Paternity or Adoption leave and is responsible for a child (but does not have to be the parent). HMRC pays it directly to the main carer, along with the CTC. However, if an individual has childcare costs that are eligible for the childcare costs element, s/he can choose to receive childcare vouchers, paid by the employer. This element will only be paid if the parent is paying for 'relevant' childcare, which is provided by an approved childcare provider.

CTC – the maximum

To qualify for CTC the claimant must be responsible for at least one child who is either under the age of 16 or is in full-time education and under the age of 20. The elements are:

Family element (£545) – Payable to all who qualify for CTC.
Family element 'baby addition' (£545) – An extra amount paid on top of the family element

if a person has a child or children aged under one.

Child element (£1,845) – This is paid in respect of each child.

Disability element (child) (£2,440) – Payable for each child who gets DLA or is registered blind, or stopped being registered blind in the last 28 weeks.

Severe disability element (child) (£980) – This is paid for each child who gets DLA highest-rate care component.

Calculating what's due – the reduction or taper

Each element carries a set level of tax credit with it, and so when the claimant has decided which elements they are entitled to they simply add together all the entitlements to arrive at their maximum entitlement to WTC and CTC.

The claimant must then review their annual household income to determine whether the entitlement should be reduced. If there is entitlement to WTC then the first level that the entitlement begins to be tapered away is if annual income exceeds £5,220. If the claimant is only entitled to CTC then the level is £14,495. The taper rate in both cases is 37% up to the level of £50,000 and then 6.67% for any income in excess of that.

Therefore if the claimant is entitled to WTC and CTC totalling £6,000 and their annual income was £20,000, the entitlement would be reduced by £5,468 (£20,000 - £5,220 x 37%) leaving them with £532.

The family element does not get tapered away until the claimants' income exceeds £50,000, and so they are still entitled to receive an element of CTC if the claimant has a child and their annual income is up to £58,175, or £66,350 if they qualify for the baby addition as well.

Capturing income as capital

The claimants report annual income on the tax credits claim form, and this will include the claimants' earnings from employment or self-employment and 'other income'. This may be made up of bank interest, dividends or rental income or any other income that the claimant may receive from investments. The calculation is all lumped together and the first £300 is disregarded for tax credit purposes, so if their total other income is £1,000 they only need to enter £700 on the form.

As tax credits are based on annual income, there are no limits on the amount of capital the claimant may receive each year. Therefore for example if in one year a family with children had an annual household income of £45,000 and made a capital gain of £200,000, they would still qualify for at least the family element of CTC. Therefore if the claimant can control the level of their annual income and create wealth of a capital nature, they could still benefit from making a claim for tax credits.

In addition, people who derive a lot of their yearly income from investment bonds could also benefit from tax credits, as there will be no income to report if they restrict themselves to the 5% withdrawal limit – only chargeable events would need to be included in their tax credit calculation.

The renewal process – the increase or decrease

In the first year of claim, the entitlement the claimant receives is based on their income for the previous tax year. In the period of April to July of the next tax year, HMRC will send them a renewal form. The claimant must use this form to report their actual income for the tax year that has just passed to enable HMRC to calculate the tax credits that they should have been entitled to receive for the year. If their income has changed significantly in comparison to the previous tax year, they may then have to pay some tax credits back to HMRC or they may be entitled to further receipts.

For example, if they made their first claim in the 2006/2007 tax year, the entitlement would be calculated based on the income for 2005/2006, and they would receive payments during the 2005/2006 tax year based on this calculation. At some point between April and July 2007 the claimant would receive their renewal form and enter on it the actual income that they received during the 2006/2007 tax year. The form then needs to be submitted to HMRC by 31 July, at which point they would still be receiving tax credits based on income for 2005/2006. If it turns out that income has increased significantly then the claimant will have been overpaid tax credits by HMRC, which will want to recover the excess payment. It is possibly the fear of repaying excess tax credits that prevents potential claimants from taking the bold step of making the claim.

If at the point of renewal the claimant does not know their actual income for the previous year, they can estimate it and then notify HMRC of the actual amount by 31 January of the following year.

Change of circumstances

There are many changes of circumstances that may take place during any one tax year, such as a separation, reduction or increase in hours worked or the birth of a new child. It is important to notify HMRC of any change that will affect the claimants' level of entitlement to WTC or CTC as soon as possible after the event has occurred. If the claimant does not notify, then they could arrive at a position of overpaying tax credits or even being underpaid credits that they are entitled to.

The income disregard

With regard to changes in the level of income, with effect from 6 April 2006 HMRC increased the general income disregard from £2,500 to £25,000. This means that if the claimant's tax credit entitlement has been based on the previous year's income and the income for the current year does not exceed the previous year's income by more than £25,000, your current year's entitlement will not be amended and the increase will not be taken into account. This measure was brought in to try and minimise the number of claimants who were unwittingly receiving overpayments of tax credits during the year and then finding that HMRC want to claw them all back at the end of the year. This has been very well received by current and potential claimants and their advisers.

Consider claiming the entitlement

As mentioned earlier, with all the publicity surrounding the complications and confusion that the new tax credit system has brought with it, many people are simply too scared to make a claim for tax credits for fear that they will spend the money in good faith only to be chased for repayment by HMRC. There are also many potential claimants who do not realise how welcoming the income limits are. However, with the increase in the level of the income disregard and the fact that in most cases HMRC will collect any overpayments by reducing future entitlements, with a little care it should be straightforward to process a claim each year. Are tax advisers overlooking client care if they fail to bring it to their clients' attention?

The tax adviser's client base – so many are eligible

Many clients achieve low profits or even trading losses in start-up years and difficult years of trading and they could therefore be eligible to claim tax credits. Many clients sacrifice income to help build up their business, and then the business is sold utilising the (soon to disappear) 10% rate of capital gains tax. As mentioned earlier the capital gains do not count in the calculation of entitlement. A large number of clients will be eligible and can be helped. The forms are complicated but similar in format to self-assessment tax returns, and the work can be incorporated into standard client care and client service procedures.

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