Analysis and Research
Tax Credits and Social Policy
11/OCT/01

The structure of new tax credits (ICC + ETC)

Background

1. New income tax credits (NTC) – the integrated child credit (ICC) and employment tax credit (ETC) – are to be introduced in April 2003. They will replace existing support for low/middle-income families currently contained in Income Support (IS), income-based Jobseeker's Allowance (JSA), the Working Families' Tax Credit (WFTC), Disabled Person's Tax Credit (DPTC), Children's Tax Credit (CTC) and New Deal employment credits for those over 50. NTCs will wholly replace WFTC, DPTC, CTC and the New Deal credits. The adult support elements within IS and JSA will remain.
2. Entitlement to NTCs will be based on family's[1] circumstances and income, and will be awarded to families, not individuals[2]. ICC will provide support for children and families with children, and has no working condition or age limit. ETC will provide support for working families, again without age limit where there are children. For those families without children, entitlement to ETC depends on at least one adult being aged over 25 or a working disabled person.
3. The Inland Revenue (IR) will administer both credits though, under transitional arrangements for 2003/04, the DWP will administer ICC paid to families remaining on IS/JSA. IR will also take over the administration of Child Benefit from the DWP, but it will otherwise be largely unaffected by NTCs, and is outwith the scope of this note.
4. This note outlines the structure of NTCs, and examines those differences to the current regime most relevant to classification questions. A fuller description of ICC and ETC and their purpose and administration is contained in the recently issued Consultative Document[3]. A graph illustrating NTC support is contained in Annex A to this note, and an interactive ready reckoner of the impact of NTCs on individual families is in Annex B.

Outline NTC structure

5. ICC will be made up of a number of elements:
   - ✓ A family element for all qualifying families with children, broadly replicating CTC. This element will be higher for those families with a child under the age of one.
   - ✓ A child element for each child within the family, broadly replicating the current child support elements within IS/JSA, WFTC and DPTC.
   - ✓ An additional credit for each child with a disability within the family, based on existing support within IS/JSA, WFTC and DPTC.

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[1] Essentially using the standard `benefit unit' definition.
[2] This, with the remainder of the description of NTCs in this note, is based on policy decisions and assumptions as at August 2001, many of which remain mutable.
[3] *"New Tax Credits – Supporting families, making work pay and tackling poverty"* – Inland Revenue, July 2001

6. ETC will also be made up of a number of elements, most of which replace existing support for adults within WFTC and DPTC:
   - ✓ A basic element, payable at different rates for individuals and families.
   - ✓ An additional element for full-time work.
   - ✓ Additional amounts for workers with a disability.
   - ✓ Additional amounts for those qualifying aged over 50 returning to work (replacing the current New Deal credits).
   - ✓ Additional support for eligible childcare costs (replacing the current childcare tax credit with WFTC and DPTC).

7. For those families satisfying the eligibility criteria for NTCs, the level of their entitlement will be calculated as follows[4]:
   i. Each individual family's maximum entitlement to ICC and ETC is calculated
   ii. Those families in receipt of IS/JSA are passported through to payment of their maximum (ICC-only) entitlement.
   iii. Those families with gross (ie, pre-tax, tax credit and benefit) income less than £95 pw also receive the maximum credits.
   iv. For those families with income greater than £95 pw, their NTC award is tapered away (first ETC, then ICC once ETC is exhausted) at the rate of 37% of any gross income above this amount until they are left with just the family element of ICC. This level of entitlement is then fixed unless the family's gross income is more than £652.60 pw (the basic-rate income tax (IT) limit). For those families with higher incomes, the family element of ICC is tapered away (to nothing) at the rate of £1 for every £15 of income above this 2nd threshold.

7. Any ETC due will be paid to the worker in a family, via their employer (PVE) where they are employed. If both partners in a couple work at least 16 hours, they can choose which should get it. Any ICC due will be paid direct to the main carer, on a self-defined basis. Both will generally be awarded on an annual (tax year) basis, responsive to changes of circumstance and, within set parameters (discussed below), changes of income. Awards will be subject to a reconciliation process at the end of each tax year.

8. Generally, definitions for NTC purposes are much the same as for the existing regimes, using tax and WFTC definitions as the default option in areas of ambiguity. However, there are some differences, noted in a separate section, below.

NTC costs

9. The gross, non-indexed full year NTC Exchequer costs, after taking into account expected take-up, are currently estimated to be around £13bn pa. The net costs, indexed against the FSBR baseline of the costs of the current regime, are estimated to be £2.1bn pa. Both estimates assume steady-state conditions, and are at current prices. These estimates are discussed in more detail in separate notes produced by TCASP. Similarly the breakdown of NTC costs by amounts that may be set off against tax and repayable amounts will be the subject of another TCASP note.

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[4] At 2001/02 prices

National accounts classification of the current regime

10. Currently, the IS/JSA and [New Deal credit] costs that will be replaced by NTCs are classified as Annually Managed Expenditure (AME). CTC is classified as a negative tax (as a tax allowance). Discussions with the ONS on the correct classification of WFTC/DPTC are continuing, but on the OECD's equivalent definition, these tax credits are defined as negative tax to the extent to which they may be offset against individuals' IT liability. Any remaining amounts are classified as Government expenditure.

Differences between NTCs and the current regime

11. NTCs are more generous than the current regime in a number of respects. Current rates of support are levelled up to WFTC/DPTC equivalents, and the definition of children extended (against the CTC definition) to include dependants aged 16-19 still in full-time education. ETC is payable to families with no children, unlike WFTC. Entitlement to the family element does not offset entitlement to other credits, unlike CTC. Specific differences, more relevant to classification issues are set out in the paragraphs set out below. For the purposes of this note New Deal credit classification issues are ignored, as the relevant client population and NTC costs are relatively very small.

12. *Administration.* One of the main policy drivers behind NTCs is the aim of creating a single, seamless system of support for low and middle-income families, administered by IR as part of the tax system[5]. This integrated system pulls together a common framework of assessment and payment, in contrast to the current, more fragmented regime.

13. *Payable credits.* NTC entitlement is payable in full. However, where ETC is received through PVE by someone who pays tax and NICs, the effect is that ETC reduces the tax/NICs to be deducted from pay or that that person receives in their pay packet the excess of ETC over the tax/NICs due from him/her. But this how it works out in practice, rather than any statutory arrangement, and this effective netting off does not happen with ICC or where ETC is paid direct. Under the current regime, IS/JSA (obviously) and WFTC/DPTC are also payable. However, CTC is only due to the extent to which it may be offset against families' IT liability.

14. *Income brought to account.* For NTCs, entitlement will be based on the income of both partners in a couple. Currently, IS/JSA and WFTC/DPTC take into account joint income, while CTC takes into account, for higher-rate tax paying families, the income of the highest earner only.

15. For both IS/JSA and WFTC/DPTC, entitlement is based on net income, after tax and NICs. CTC is based, where relevant, on pre-tax income. NTC entitlement will also be based on pre-tax income, like (at the risk of tautology) tax itself. More generally, NTCs will broadly use normal tax rules for the definition of income to be brought to account.

16. *Capital rules.* Entitlement to NTCs will not be subject to capital limits or bring to account nominal tariff income on capital and savings, but rather bring actual income from capital to account, subject to a disregard. IS/JSA and WFTC/DPTC are both subject to capital limits and use tariff income. CTC uses normal tax rules.

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[5] *cf* the Inland Revenue's Consultative Document (above)

17. *Assessment and award periods*[6]. As noted above, NTCs will generally be awarded for up to 12 months, running until the end of each tax year (subject to continuing entitlement) in which they are claimed. The only exception to this will be periods in receipt of IS/JSA, when the family will be passported through to payment of the maximum ICC award, on a weekly basis. In both cases, NTC entitlement will be reviewed at the end of each tax year, and any arrears and overpayments followed up. CTC is awarded for a full tax year, but IS/JSA is awarded on a weekly basis and WFTC/DPTC for (fixed) six-month periods.

18. Individual families' NTC entitlement will initially be based on their income during the previous tax year. Should their income change during the course of the current tax year, their entitlement will be re-calculated (where appropriate – it may not always change), subject to a disregard of the first £2,000 of any increase. Subject to the IS/JSA exception, income will continue to be brought to account on an annual basis (reconciled at the end of the tax year), even where it has changed – like tax. CTC is based on current, annual income, but IS/JSA is based on weekly income and WFYC/DPTC is based on a snapshot of applicant's income at the start of each six-month award.

19. NTC entitlement also responds to families' other relevant changes of circumstances, at the time they occur and from that point on. CTC is awarded for the whole of each tax year in which families have qualifying children. IS/JSA responds to changes contemporaneously, but WFTC/DPTC awards are generally fixed for the whole of their six-month span – the exception being maternity periods.

20. *Payment*. Currently, IS/JSA are usually paid direct to the applicant. For WFTC/DPTC, families may nominate the recipient, but in practice, it is usually paid as PVE to the main earner. CTC is offset against families' IT, usually that of the main earner, but it may be split on request. Generally, ETC will be paid through PVE, where they are an employee, but directly to the self-employed. However, a decision has yet to be made on whether the childcare element of ETC will be paid with ETC or ICC, though the assumption is ICC so that it is paid to the main carer. Neither WFTC/DPTC nor ETC are paid via PAYE coding.

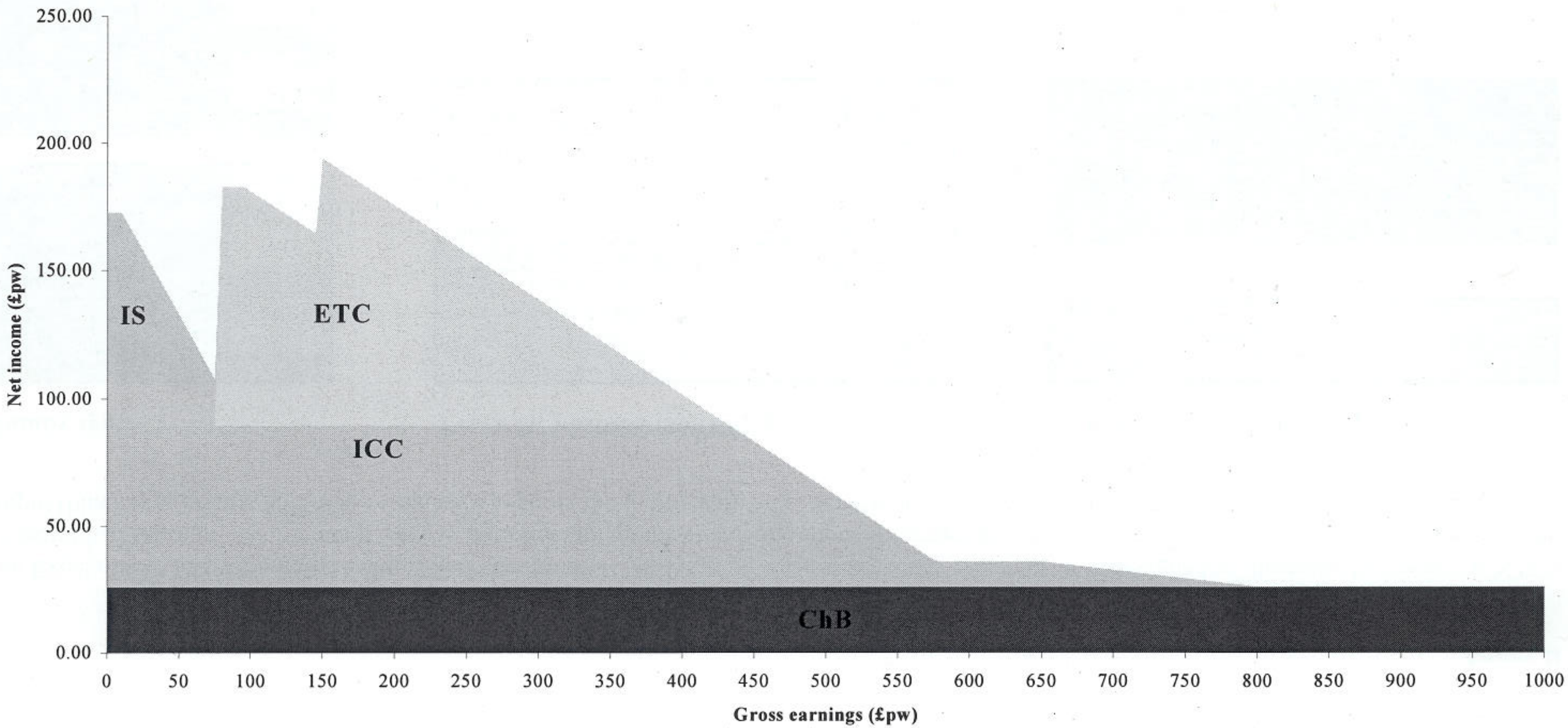
[6] This subject is covered extensively in Chapter 6 of the Consultative Document

Annex A

Illustration of NTC structure

The chart below illustrates NTC support for working families with children at different income levels. It is based on a specimen family of two adults and two children, one adult working increasing hours @ £ 5 ph.

Net benefit & NTC entitlement vs gross earnings



Case study ready reckoner

The Excel object below contains a simplified version of TCASP's NTC case study ready reckoner. It is designed to illustrate the impact of NTCs on individual families. To operate it, simply double-click on the object and input specimen family circumstances in the fields shaded yellow. The output (black type) fields will then be updated to show the families income, benefit and tax credit entitlement on a pre- and post-NTC basis.

Family type

Number of adults	
Age of main earner	52
Age of partner	45
Number of children	
<1	
1-11	
11-15	1
16-18	1

Gross wages (£pa)	
Main earner	12,500
Second earner	5,000
Hours worked a week	
Main earner	35
Second earner	16
Childcare costs	
Weekly costs (£)	50
Return to work entitlement	
Main earner	Yes
Partner	

Accommodation type	
None	
Local authority	Yes
Private rented	
Other	

Pre-NTC position (2001/02 prices)

Gross taxable income	**£336.54**
Income Tax and NIC	£46.51
Children's Tax Credit	**£10.00**
50+ New Deal credit	**£60.00**
Net income before WFTC & benefits	**£360.03**
Child Benefit	£25.85
Income Support	£0.00
WFTC	**£11.28**
Housing Benefit and CTB	£0.00
Net income (before housing costs)	**£397.16**
Marginal deduction rate	*66.7%*

Post-NTC position (2001/02 prices)

Gross taxable income	**£336.54**
Income Tax and NIC	£46.51
Net income before NTCs & benefits	**£290.03**
Child Benefit	£25.85
Income Support	£0.00
ETC	**£35.58**
CCTC	**£35.00**
ICC	**£63.50**
Housing Benefit and CTB	£0.00
Net income (before housing costs)	**£449.96**
Marginal deduction rate	***63.0%***

Impact of NTCs (2001/02 prices)

GAINER	
Net change in income (pw)	£ 52.80
% change in net income	13.3%

Total adults	2
Total adults for ETC	2
Total children	2
Total children for NTCs	2
Qualifying children for childcare costs	1
Total wages	£ 17,500

Maximum NTC premia

ETC:	
Adult	£53.50
Working hours	£11.45
Return to work	£60.00
ETC overall	**£124.95**
CCTC	**£35.00**
ICC:	
Child	£53.50
Family	£10.00
ICC overall	**£63.50**
TOTAL NTCs	**£223.45**

Assumed housing costs based on uprated typical values used by DSS
CTC assumed to be claimed by main earner in first instance, or shared where main earner pays insufficient tax
The marginal deduction rate is calculated on the basis of any earnings being increased by £1 pw, to show work incentive effects
CCTC is identified separately above, for convenience. On current policy assumptions, however, it is to be part of ETC.