New Tax Credits

Supporting families, making work pay and tackling poverty

A Consultative Document

July 2001

Inland Revenue

Code of practice on written consultation: consultation criteria

1 Timing of consultation should be built into the planning process for a policy (including legislation) or service from the start, so that it has the best prospect of improving the proposals concerned, and so that sufficient time is left for it at each stage.

2 It should be clear who is being consulted, about what questions, in what timescale and for what purpose.

3 A consultation document should be as simple and concise as possible. It should include a summary, in two pages at most, of the main questions it seeks views on. It should make it as easy as possible for readers to respond, make contact or complain.

4 Documents should be made widely available, with the fullest use of electronic means (though not to the exclusion of others), and effectively drawn to the attention of all interested groups and individuals.

5 Sufficient time should be allowed for considered responses from all groups with an interest. Twelve weeks should be the standard minimum period for a consultation.

6 Responses should be carefully and open-mindedly analysed, and the results made widely available, with an account of the views expressed, and the reasons for decisions finally taken.

7 Departments should monitor and evaluate consultations, designating a consultation co-ordinator who will ensure the lessons are disseminated.

We confirm that these consultation criteria have and will continue to be followed.

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New Tax Credits: Timing and Contacts

In his 2000 Budget, the Chancellor announced his intention to introduce a new integrated child credit for families with children and an employment tax credit for low-income working households. The intention is that these new payable tax credits will be available from 2003. They will replace the support currently available through the Children's Tax Credit (which from April 2002 will include the new Baby Tax Credit for children under one), Working Families' Tax Credit, Disabled Person's Tax Credit and the child elements of Income Support and income-based Jobseeker's Allowance. Legislation to bring this about will need to be prepared for autumn 2001. This consultation document sets out how we envisage these new payable tax credits working and seeks views on some of the more detailed issues.

To enable the Revenue to prepare for this new legislation, we would welcome feedback on the proposals set out. Please write to:

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Comments should reach the team by 12 October 2001. Your response may be made public unless you say you want it kept confidential. If you have any questions about this consultation, please also contact Sandra Bevan.

If you have any complaint about any element of the consultation process leading from the issue of this document, please contact Paul Heggs, Inland Revenue, New Wing, Somerset House, Strand, LONDON, WC2R 1LB. Or you can contact him by telephone (020 7438 6302), fax (020 7438 6472) or by email at paul.heggs@ir.gsi.gov.uk

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Inland Revenue Visitors Information Centre
Ground Floor, South West Wing, Bush House, Strand, London, WC2B 4RD

Or can be accessed on the Internet at: www.inlandrevenue.gov.uk/consult_new

Foreword

This Government is committed to the objectives of supporting families, making work pay and tackling poverty. In 1997, we inherited a position in which one in three children lived in poverty and one in five children lived in work-less households. The reforms we made during the last Parliament – the introduction of the National Minimum Wage, the Working Families' Tax Credit and the Disabled Person's Tax Credit, increases in Child Benefit and income-related benefits, and changes to income tax and National Insurance – provided an excellent start in tackling these problems. As a result of our measures, more than one million children have been lifted out of poverty and we have helped to ensure that work pays for those families.

In the next stage of tax and benefit reform, the introduction of new tax credits, we want to build on the foundations laid in the last Parliament and take the next steps towards our goals.

The new tax credit for children, building on the foundations of universal Child Benefit, will, for the first time, create a seamless system of income-related support for families with children providing:

- a portable and secure income bridge spanning welfare and work
- payment of all support for children to the main carer, in line with Child Benefit
- a more transparent and streamlined system of support, bringing all income-related child payments into a single tax credit
- a common framework for assessment and payment, so that all families are part of the same system.

The new tax credit for work, the employment tax credit, extends the principle of in-work support to those without children, so that we can ensure work pays and tackle in-work poverty for a wider range of households.

This consultation paper from the Inland Revenue reflects discussions with interested parties on how the new tax credits system should work. In the design of the new system, our key objectives are to target resources on those who most need help and to provide flexibility for the system to respond to changing needs while, at the same time, minimising complexity for claimants. We look forward to receiving views from a broad spectrum of interest groups and individuals. Responses to this consultation will help us refine and shape our proposals before we introduce legislation in the autumn.

Dawn Primarolo

Paymaster General

Executive Summary

New Tax Credits: supporting families, making work pay and tackling poverty

The Chancellor announced in the 2000 Budget his intention to introduce two new payable tax credits – one for families with children and one for low-income working households. The credit for families with children will draw together in one payable tax credit all the existing income-related strands of support for families with children – the child elements in Income Support, income-based Jobseeker's Allowance, Working Families' Tax Credit and Disabled Person's Tax Credit, as well as the Children's Tax Credit – to create a secure means of support which spans both welfare and work. It will be paid in addition to Child Benefit. The employment tax credit will provide more financial help to workers in low-income households, whether or not they have children. It will build upon the elements of adult support in Working Families' Tax Credit and Disabled Person's Tax Credit and the New Deal 50+ Employment Credit and will also provide working families with assistance to meet the costs of childcare.

Once the new system is in place, adults who are not in work will continue to be eligible for the adult element of Income Support or income-based Jobseeker's Allowance. Working households on low incomes will be eligible for the employment tax credit. Most families with children, whether or not the adults in the family are in work, will be eligible for the new tax credit for children.

Content of the document

This paper sets out the Government's proposals for the structure of the new tax credits, how they will interact and the rules and definitions governing eligibility. It invites views on a range of issues and on the proposals as a whole. Part 2 of the paper provides a partial Regulatory Impact Assessment on which views are also invited.

Chapter 1 puts the new tax credits in the context of the programme of reform aimed at relieving child poverty and encouraging people into work by making work pay. It explains the rationale for further reform, the role that tax credits can fulfil and shows how they will build upon measures introduced in the last Parliament.

Chapter 2 sets out the key features of the new credit for families with children and explains how the new credit will incorporate the various elements of support for children in the Working Families' Tax Credit, Disabled Person's Tax Credit, Income Support and income-based Jobseeker's Allowance and the Children's Tax Credit. It also raises a number of specific and general points for consultation.

Chapter 3 covers the key structural elements of the employment tax credit for workers in low-income households and raises a number of points for consultation around eligibility for the credit, including on the number of hours' work required and the qualifying conditions for households without children. It also covers the proposals for paying the employment tax credit through the wage packet.

Chapter 4 covers the childcare tax credit element of the employment tax credit and the proposals for making it more flexible in response to changes in childcare than its counterpart in the Working Families' Tax Credit.

Chapter 5 sets out the proposals for the treatment of income and capital under the new tax credits, including the case for measuring income before the deduction of income tax and National Insurance contributions.

Chapter 6 describes how the new system of tax credits might work. It discusses the proposals for the length of awards, the degree of flexibility to adjust awards to reflect changes in circumstances and the means by which tax credits are to be paid.

Chapter 7 covers the interaction between the new tax credits and different elements of the social security system.

Part 2 of the document contains the **partial Regulatory Impact Assessment**, which considers the impact of the policy by comparison with current systems of support. The **Equality Issues** of new tax credits are considered on pages 62 and 63.

A number of the changes proposed to existing systems of support have an impact on areas of responsibility devolved to the Northern Ireland Assembly. Currently, discussions are taking place with Northern Ireland Ministers to consider the impact of the proposed changes on Northern Ireland social security provision. However, for the purposes of this consultation, we have taken it as a working assumption that the tax credit system will apply across the United Kingdom.

For ease of reference, **Part 3** of the document contains a summary of the specific points on which we would welcome views.

1 New Tax Credits: an introduction

1 The Chancellor confirmed in Budget 2000[1] the Government's decision to proceed with the proposals set out in Budget 1999[2] to introduce from 2003 two new income tax credits:

- a new credit for families with children to bring together the different strands of support for children in the Working Families' Tax Credit, the Disabled Person's Tax Credit, Income Support, income-based Jobseeker's Allowance and the Children's Tax Credit and create a seamless system of financial support for children, building on the foundation of universal Child Benefit. This tax credit, provisionally called the integrated child credit, would be paid to the main carer in families in and out of work; and
- an employment tax credit for those in work, which would be payable through the wage packet and available to people without children as well as families with children.

2 Since Budget 2000, officials at the Treasury, Inland Revenue and Department for Work and Pensions[3] have been considering the options for the design of these new tax credits. In doing so, they have taken account of the experience of other countries who have introduced similar tax credits (see page 8). They have also discussed with many organisations the ways in which tax credits might work, including those with an interest in the design and delivery of social policy. And they have drawn upon the very helpful report on the proposal for an integrated child credit produced in March 2001 by the Social Security Select Committee, which took evidence from academics and specialists in the field.

3 Many of the discussions to date have necessarily been undertaken on a confidential basis but they have been invaluable in developing the proposals outlined in the pages that follow.

4 The aim of this consultation is to invite views on the proposals for the structure of the new tax credits. The rates, tapers and thresholds for the new tax credits will be set nearer to their implementation, as part of the Budget process. Some parts of the consultation document are relatively technical, and necessarily so because of the nature of some issues on which it seeks views. But we would be grateful for views on the proposals as a whole, as well as on the specific issues raised for consultation.

[1] Budget 2000 – Prudent for a Purpose: Working for a Stronger and Fairer Britain, HM Treasury March 2000.
[2] Budget 1999 – Building a Stronger Economic Future for Britain, HM Treasury March 1999.
[3] Formerly the Department of Social Security, and the Department for Education and Employment.

The development of tax credits in Canada, Australia and the USA

Canada – Child Tax Benefit

In the early 1990s, Canada embarked on a programme of integrating various benefits and tax credits for families. This began in 1993 with the integration of tax credits for families with children with a broad-based income-tested Family Allowance to create Child Tax Benefit. This was an income-tested tax credit paid by the Canadian tax authority to families on low and middle incomes and was complemented by a Working Income Supplement to low-income working families. In 1998, the Working Income Supplement was abolished and the Child Tax Benefit was expanded to include a more generous supplement to the poorest families, regardless of employment status. The rates of this tax credit have since been increased to extend the coverage of the credit up to families on relatively high incomes. By 2004, more than 90% of Canadian families will be able to benefit from the credit.

In addition to this broad-based federal tax credit, many provinces provide earnings supplement programmes for working low-income households.

Revenue and Treasury officials have looked closely at the Canadian experience and how they have tackled the issues associated with developing a targeted, yet broad-based system which is delivered by the tax authorities as a tax credit.

Australia – Family Tax Benefit

In 2000, the Australian Government implemented a radical reform of support for families, integrating twelve pre-existing systems of support into three new credits; Family Tax Benefit Part A (a broad-based payment for families with children very much along the lines of Canada's Child Tax Benefit), Family Tax Benefit Part B (a top-up to Part A for single income families with young children aged under five) and Children Care Benefit (a partial payment of childcare costs for families incurring such costs).

The Australian approach was to bring together the delivery of these programmes of support under the umbrella of a single delivery agency working for both the tax and welfare authorities. The policy issues faced in Australia were much the same as those faced in Canada. Interestingly, on certain key points (such as changes of circumstances and income), the Australian system takes a different approach and we have found it useful to compare the approaches of the two countries to see what examples of good practice can be drawn upon.

USA – Earned Income Tax Credit

The Earned Income Tax Credit is a direct payment to low-income workers which initially increases as income rises and then begins to be reduced as income rises further. In addition to this, there are various child-related allowances built into the income tax system. For those not working, there are limited programmes of safety net support which are a combination of cash payments and non-cash support such as food stamps.

Although the social and economic conditions in each of these countries differ to some extent from those in the UK, we have looked carefully at the systems operating in each country to see where lessons can be learned. We are continuing to study experiences in other countries and to work closely with officials and experts there.

The latest phase in the reform of taxes and benefits

5 In the last Parliament, the Government set in hand wide-ranging reform of the tax and benefits systems. The work on reform has been informed throughout by the report drawn up in 1998 by Martin Taylor's Task Force[4] on how the tax and benefit systems should be modernised. The introduction of the new tax credits marks the latest phase in the programme of reform and is intended to rationalise and streamline the existing systems of support for children and of in-work support for families and people with disabilities. It will build on the measures introduced in the last Parliament as part of the strategy for achieving the Government's twin goals of promoting employment opportunity for all and of tackling poverty, in particular, its commitment to abolish child poverty within a generation.

6 The full range of measures already introduced, and some of their initial effects, are detailed in *Tackling Poverty and Making Work Pay – Tax Credits for the 21st Century*[5]. But, for the purposes of this document, the relevant elements of this strategy are those directed at making work pay and supporting families with children, namely:

- the National Minimum Wage, introduced in April 1999 to guarantee a fair minimum level of pay – to be raised to £4.10 per hour from October 2001;
- the Working Families' Tax Credit and the Disabled Person's Tax Credit, which came in from October 1999, and the various improvements to them brought in by subsequent Budgets;
- the childcare tax credit within those tax credits which provides extra help with childcare costs for working families;
- the 10p starting rate of income tax and reforms to National Insurance designed to reduce tax and National Insurance for the low paid;
- the Children's Tax Credit, introduced in April 2001, to provide more support to families with children. A higher 'Baby Tax Credit' will be available from April 2002 for families with a child aged under one; and
- the further direct help to families with children – with increases, since April 1997, in real terms, of over 26% in universal Child Benefit and 80% in the maximum support available in Income Support for children under 11.

Why further reform?

7 To make rapid progress towards the goals of tackling poverty and making work pay, the measures introduced during the last Parliament, with a couple of exceptions, worked within the broad parameters of the existing tax and benefit systems. The proposals outlined here represent more fundamental reform which entails longer lead times. They build on the very substantial progress made in the last Parliament.

[4] The Modernisation of Britain's Tax and Benefits Systems no 2 – Work Incentives: A report by Martin Taylor.
[5] March 2000, Number Six in the HM Treasury series *The Modernisation of Britain's Tax and Benefit System.*

8 The measures listed in paragraph 6 left in place the following arrangements:

- income-related support for children is provided through several instruments – Working Families' Tax Credit, Disabled Person's Tax Credit, the Children's Tax Credit and Income Support or income-based Jobseeker's Allowance. Child Benefit is a separate instrument, providing universal support for families with children;
- in-work support for families on low incomes is provided by the Working Families' Tax Credit, Disabled Person's Tax Credit, and the Employment Credit for those aged 50 or more, alongside various other employment grants;
- these various instruments are administered by different arms of Government – the Inland Revenue and the Department for Work and Pensions;
- both payable tax credits serve more than one objective – the Working Families' Tax Credit, for example, serves to improve work incentives by making work pay, as well as supporting families with children and tackling child poverty.

9 The primary aims of this next phase of reform are

- to separate the support for adults in a family from support for the children, so as to provide a clearer focus:
  - on making work pay for those in low-income households, including those without children, through the employment tax credit; and
  - on tackling child poverty and providing financial support for families with children, through the integrated child credit and Child Benefit;
- to provide a common framework for assessing entitlement to income tax credits, based more closely on the rules and definitions of income on which people's tax bills are based. As a principle, this follows naturally from the fact that tax credits form an integral part of the income tax system. But this approach also:
  - has the practical advantage of helping people to understand more clearly how their tax credit entitlements and tax liabilities are assessed and the extent of their household's net contribution to the Exchequer;
  - helps further to integrate the tax and benefits systems and to bridge the divide between work and welfare;
  - allows information gathered for income tax purposes to be used more effectively than at present in claiming tax credit entitlements; and
- to rationalise administration by making one department, the Inland Revenue, responsible for administering all aspects of the Government's financial support for children, as well as for income tax credits generally. The announcement on 25 June of the transfer of the Child Benefit Agency in Great Britain to the Inland Revenue will facilitate that rationalisation.

10 Achieving these objectives will make the system more accessible to users and easier for both claimants and commentators to understand – thus helping to promote higher take-up and to encourage a more informed debate about the level of support the Government should seek to provide through each tax credit. At the same time, the closer links with existing income tax systems will make it easier to cross-check the information on which tax credit awards are based, as a safeguard against abuse.

The role of tax credits

11 What individuals pay in income tax depends, broadly, on their income in the tax year. Their tax bill is based on the principles of independent taxation – that each person should be taxed on their own income and have their own tax allowance and rate bands. None of that will change on the introduction of new tax credits.

12 Tax credits provide a way for the tax system to recognise a family or household's circumstances and responsibilities in the tax year. Depending on the tax credit in question, they will be paid direct or through the wage packet to a member of the household. New tax credits are 'payable', so that families can benefit from them fully, whether or not the amount they are entitled to exceeds the tax and National Insurance contributions that the individual adults within the family would be due to pay. So, although tax credits are not always an immediate deduction from people's tax and National Insurance contributions, the effect is to reduce or wipe out the household's or family's tax and National Insurance bill or to provide them with a net payment. That is:

- where the amount of tax credit due to a family is less than the tax and National Insurance contributions they would be due to pay as individuals, the tax credit serves to reduce the overall contribution they have to make to the Exchequer; and
- where it is equal to or greater than their tax and National Insurance contributions as individuals, they have in practice no net contribution to make – instead, they may be making a net withdrawal.

13 As a family's circumstances change over time, they may find their net position in relation to the Exchequer changing. The likelihood of making net withdrawals from the Exchequer is greater, other things being equal, the lower the family's total income.

Entitlement based on family income

14 *Tackling Poverty and Making Work Pay* emphasised that a key objective of the new system was to target support to families on the basis of need. That means that entitlement to tax credits must take account of family, rather than individual, circumstances and that the amount of tax credit awarded should reflect both:

- the specific needs of the family – so that the credits should include additional payments that take into account the number of people in it and any special needs they have. For example, the new integrated child credit will make extra payments for a child with a disability; and
- the income available to meet those needs – that means that, in families headed by spouses or partners who both have incomes, we need to take account of them both.

15 This principle also leads to the conclusion that new tax credit awards should be made to the family or household rather than to an individual, although different types of payment may be made to different individuals within it. So, for example, although the <u>family</u> will apply for the integrated child credit, it will be paid to the <u>main carer within the family</u>. This contrasts with the current situation where

- out-of-work benefits like Income Support or income-based Jobseeker's Allowance are claimed by and paid to an individual applicant, on behalf of a household which may include the spouse or partner of the applicant and, where relevant, dependent children;
- in-work tax credits – Working Families' Tax Credit and Disabled Person's Tax Credit – are claimed by an individual applicant on behalf of the family;

- the Children's Tax Credit is claimed by an individual taxpayer. But in the case of a married couple, or a couple living together as husband and wife, there is only one credit between them. It may go to either of them or be shared if neither of them is a higher rate taxpayer. But if either, or both of them, is a higher rate taxpayer, the person with the higher income must claim; and
- Child Benefit is paid to the individual who is the person responsible for a particular child.

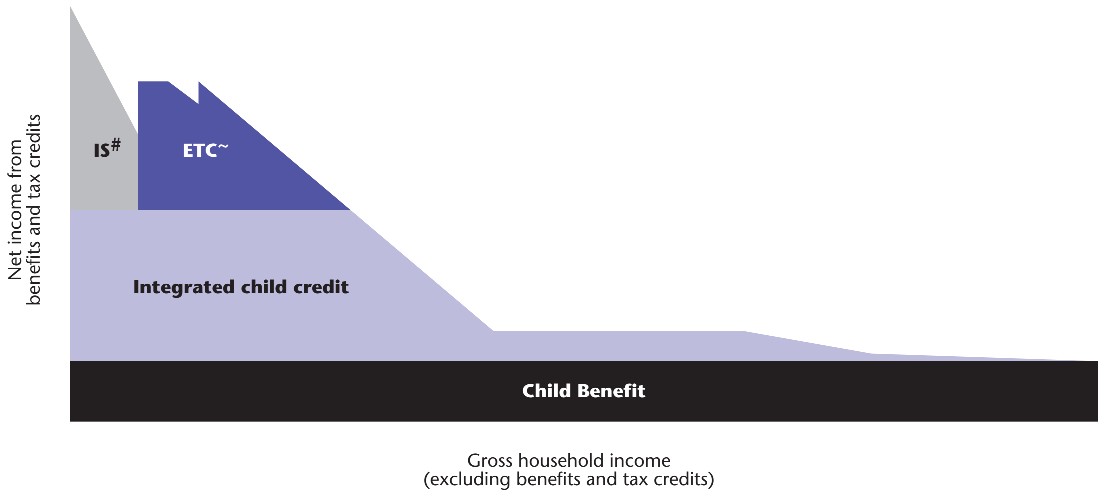
16 For the purposes of new tax credits, what we mean by a 'family' or 'household' is:

- an individual; or
- a married couple; or
- a man and a woman who are living together as though they were married.

How the system will look

17 The chart below illustrates how we envisage the shape of support in the new system for working families with children, depending on their level of income. The following chapters outline the details of our proposals for the structure and design of the new tax credits

18 *Support for working families with children*



stands for Income Support or income-based Jobseeker's Allowance.
~ stands for the employment tax credit.

2 Support for families with children

Outline

19 The new integrated child credit is intended to create a single system of support designed to:

- provide a continuing stream of income for families with children, irrespective of whether the adults in the family are in work, and which can be relied on by families who move into work;
- pay support for children to the main carer, in line with Child Benefit;
- remove the stigma attached to claiming the traditional forms of support for the poorest families, by creating one system of income-related support for all families with children; and
- enable families to access financial support from one system, even as their income rises or circumstances change.

20 There will be no work conditions attached to the integrated child credit. It will be assessed on the basis of household income and built on the foundations of universal Child Benefit, which will continue to be paid to all families.

21 The effect of the new credit will be to extend eligibility for financial support to some groups who are currently excluded from all but Child Benefit – because, for example, they are not in work or have no taxable income, but neither are they eligible for Income Support or income-based Jobseeker's Allowance. The main groups to benefit from this extension will be students and student nurses.

Structure of the new credit for families with children

22 The integrated child credit will be made up of a number of elements, recognising the differing needs of families. **From 2003, the different elements will comprise**:

- **a family element** paid to all families eligible for integrated child credit, broadly replicating the Children's Tax Credit, in recognition of the responsibility families take on when caring for children
- **a child element for <u>each</u> 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
- **a higher family element for families who have one or more children under the age of one**. This will provide additional support for the first year of a child's life. If a family has more than one child under one at the same time, the higher family element will continue until the youngest child's first birthday.

23 On top of these basic elements, there will be additional support for families caring for children with a disability. An **extra credit** will be available for each child with a disability, and it will be paid at an enhanced rate for children with more severe disabilities. We intend to base this on the disabled child credits in Working Families' Tax Credit and Disabled Person's Tax Credit, which mirror the support provided in Income Support and income-based Jobseeker's Allowance, and to use the same definitions of disability used in the current tax credits system.

24 From 2003, the integrated child credit will become the single income-related system of support for children and this provides an opportunity to rationalise how support is delivered. A small number of families with children who are currently receiving certain benefits (for example, Widowed Parent's Allowance) may also have a child dependency increase included in the amount they get. There are complex rules surrounding child dependency increases and, in most cases, they do not adequately reflect a family's financial need. We therefore propose that the integrated child credit should replace all future child dependency increases when introduced. But we are considering how best to protect the entitlement of existing recipients.

Definitions and other issues

25 The rest of this chapter looks at some of the key definitions that we propose to adopt for the integrated child credit. These cover the concept of 'main carer', which children qualify for support and how we treat certain changes in circumstances.

The main carer

26 The integrated child credit will be paid direct to the main carer for all the children in a particular family. The concept of 'main carer' is broadly similar to the approach used in Child Benefit to identify the individual who is primarily responsible for a particular child. But for the integrated child credit, we need to identify a single main carer for all the children in a family. We intend to allow main carer to take its everyday meaning – the person in the family who normally cares for the children – rather than to prescribe a specific definition. Couples will decide between themselves when they apply which of them is the main carer.

27 In a small minority of cases, the adults in a family may be unable to reach agreement about which of them is the main carer. In these cases, the Revenue would consider the facts of the case and make a decision. To assist claimants in such cases, we intend to provide guidance on the factors that Revenue staff would take into account in making a decision. If a claimant were still unhappy following the Revenue's decision, they could appeal to the income tax commissioners, an independent tribunal, to review the decision – in the same way that disputed claims to the Children's Tax Credit might be referred to the commissioners now. **We plan to produce guidance for staff and claimants on these issues, along the same lines as the current Working Families' Tax Credit guidance used when there is a dispute over who cares for a child. We would welcome views on whether this guidance is a good model or on how it could be improved**.

Which children qualify for support

28 When applying for integrated child credit, the family will need to know what we mean by a 'child'. In most benefits and existing payable tax credits, a family qualify for support if they care for a 'child', usually defined as someone aged under 16. But in Child Benefit, unconditional support continues until the 'child' reaches 16 and is no longer required to remain in compulsory education. In England, Wales and Northern Ireland, that means 1st September after the end of the educational year in which they reach 16. In Scotland, it could mean one of three dates: broadly, the start of the autumn, spring or summer term after the child has both reached 16 and left education. The integrated child credit, as part of the tax system, will operate across the whole of the UK, so we need to identify a single point at which entitlement to it, for a particular child, comes to an end. To ensure that families with children still in compulsory education do not lose support, **we propose to continue paying tax credits to families until, at least, the beginning of September following a child's 16th birthday, and would welcome views.**

29 In some, but not all, of the existing forms of support that the integrated child credit will replace, it is possible for families to claim credits for 'young people' under the age of 19 in full-time further education. This is true of Income Support, income-based Jobseeker's Allowance, Working Families' Tax Credit and Disabled Person's Tax Credit. At this stage, the integrated child credit seems the most appropriate vehicle to deliver financial support to them for 2003. But the way in which support for these young people should be provided will need to be considered further in the light of the emerging findings on the Education Maintenance Allowance, which is being piloted in a number of areas.

When should a child or young person cease to qualify for support?

30 There will also be other circumstances, as in the current systems, when support for a child a family has been caring for, comes to an end. Taking Child Benefit as a guide, **we have considered a number of events that might affect the support provided, on which we would like views**:

a) Death of a child

It is particularly important that this situation is handled sensitively and that administrative requirements should not add to a family's distress. So while families will still have to tell us that a child has died, we want to allow them some time to do so. **We are considering continuing tax credit entitlement for a specified period after the death of a child – for example, for six weeks** – to allow families time to adjust.

b) Care and Adoption

While support is already available through Local Authorities to some families adopting a child or taking on a child in care, not all families receive financial support. In particular, families with whom a child has been placed before an adoption is formalised may not receive support. The emphasis in integrated child credit on providing support to families that include someone who is the main carer for a child provides the opportunity to widen provision of support. **We propose that families should be eligible for integrated child credit for a child who has been placed with them by a Local Authority, unless the Authority is making payments for the child's maintenance**.

c) Hospitalisation

When a child is taken into hospital, the family will generally retain responsibility for the child's welfare and the main carer is unlikely to change merely because a child is ill. Under current methods of support, the family could lose their financial support for the child, or have that support reduced, even without a change in main carer. But with integrated child credit, **we propose to treat long periods a child spends in hospital in the same way as any other period during which the child is temporarily not living with the family**

Child Benefit

31 From 2003, there will be two forms of support for families with children: universal Child Benefit and the integrated child credit. It clearly makes sense for the administration of the two forms of support for families with children to be co-ordinated. To improve co-ordination, the Prime Minister announced on 25 June that responsibility for Child Benefit in Great Britain will be transferred from the Department for Work and Pensions to the Inland Revenue. This will enable claims and changes of circumstances affecting both integrated child credit and Child Benefit to be handled within one department.

32 The transfer of Child Benefit will also provide the opportunity to make some minor administrative changes to ensure Child Benefit and integrated child credit work more effectively together. The proposed changes will improve the generosity of the Child Benefit rules, in line with those we are currently considering for integrated child credit and include, for example, allowing Child Benefit to continue for six weeks after the death of a child or when a child has been in hospital for more than 12 weeks.

33 A summary of all the specific points for consultation raised in this chapter is set out in **Part 3, section 2.**

3 Support for low-income households in work

Outline

34 In October 1999, the introduction of Working Families' Tax Credit provided targeted support specifically for working families who previously faced particularly poor financial incentives to work. Alongside Working Families' Tax Credit, the Government introduced the Disabled Person's Tax Credit to help make work pay for people with a disability. The two credits established the Government's principle of providing help through the tax system and strengthened the link with work by payment through the wage packet.

35 The next stage of reform of in-work support is to build on the foundations of the existing payable tax credits with the introduction of an employment tax credit from 2003, which will extend the principle of the Working Families' Tax Credit and the Disabled Person's Tax Credit to those without children. The employment tax credit will be geared to tackling persistent in-work poverty and making work pay more than welfare, by targeting extra financial help to low-income households. It will be a flexible vehicle for providing support to particular groups according to their circumstances and it will continue the link with work established by Working Families' Tax Credit and Disabled Person's Tax Credit by being paid through the wage packet to employees.

36 The employment tax credit for families with children or people with disabilities replicates the adult support provided by Working Families' Tax Credit or Disabled Person's Tax Credit. But while the unemployment trap has historically been of particular concern for families with children, those without children can also face poor work incentives. And there are a significant number of working people without children living in poverty. The employment tax credit will be used to extend help to those households, in addition to households with dependent children and working people with disabilities. In extending support, we are also looking to build on the targeted help provided through the Employment Credit in the New Deal 50+ for people aged 50 or more returning to work.

Structure of employment tax credit

37 The employment tax credit will provide help for a variety of groups and will be made up of different elements recognising their various circumstances. **From 2003, these elements would be**:

- **a basic element payable at different rates for individuals and families** (recognising the different levels of support needed to provide satisfactory gains to work for different groups)

On top of the basic element, **extra elements for the following**:

- **working full time** (defined as at least 30 hours a week, see below)
- **being a worker with a disability**
- **being aged 50 or over and returning to work after a period on certain benefits**
- through the childcare tax credit, **having eligible childcare costs.**

Working Hours

38 Currently, Working Families' Tax Credit and Disabled Person's Tax Credit require claimants to be in remunerative work for at least 16 hours a week in order to qualify. This helps to create a clear incentive to move into work at a sufficient level to tackle in-work poverty. In addition, both existing payable tax credits include an incentive to move into full time work by providing an extra credit for those working at least 30 hours a week. As the employment tax credit is intended to provide a similar top-up to those in work, we propose to follow this approach. **We also propose to retain the basic working hours requirement of at least 16 hours a week for any worker who**:

- **is part of a family with responsibility for children, and/or**
- **has a disability or illness which disadvantages them in seeking and retaining work.**

39 **A further top-up would be available if someone in the family worked at least 30 hours a week**. The case has been put to us that this extra element should also be available to couples whose joint working hours are at least 30, although neither of them individually works 30 hours or more. This would enable couples to share their child care responsibilities more evenly, though it would, of course, have cost implications. **We are considering the strength of the case for making such a change and would welcome views.**

Families without children or a disability

40 Because of the flexible nature of the employment tax credit, it is possible to set different working hours rules for different groups. Indeed, there is a strong argument for considering a requirement to work more hours for those without children or a disability who will newly be brought within the scope of tax credits. Full-time work is more likely than part-time work to provide opportunities to gain the skills that increase a person's chance of being self-sufficient. For people with children, the 16 or more hours a week working requirement recognises that caring responsibilities may make full-time work difficult, though the 30 hour credit still provides an incentive to undertake full-time work. But that argument for requiring 16 hours' work as a minimum does not apply to those who do not have the responsibilities associated with children nor face the barriers associated with a disability. So, in general, **for these households, we propose to focus help on those without children or a disability who work full-time, by requiring an adult in the household to work at least 30 hours a week to qualify for employment tax credit**.

Defining Working Hours

41 In Working Families' Tax Credit and Disabled Person's Tax Credit, the measure of hours worked is based on a 'snapshot period' around the time of the claim. However, this approach does not sit comfortably with a credit based on annual income which runs on an annual cycle. We are considering how best we could define the working hours requirement in employment tax credit in a way that is easy to understand and apply and reflects the flexible working patterns more common in a dynamic labour market. **We would be interested in views on this issue**.

The qualifying age for employment tax credit applicants without children or a disability

42 The employment tax credit is intended to direct in-work support at those who need it most. So, in considering the extension of in-work support, we have looked carefully at how to target it effectively. **We have considered the case for setting a higher minimum qualifying age for those without children or a disability. (Following the approach in the existing tax credits, workers with a disability and/or children would be able to apply for employment tax credit from the age of 16.)**

43 On the basis of current evidence about work incentives and poverty, **we are looking at restricting the employment tax credit for those without children or a disability to workers aged 25 and over**. This is because they are more likely than the younger age group to face severe financial barriers to work and suffer persistent poverty.

44 Those aged 25 or more are more likely to suffer from poor work incentives, with a narrower gap between in-work and out-of-work incomes; in particular, they are more likely to be in couples and have housing costs. For younger people, low pay is more likely to be transitory and active, intensive labour market policies, like the New Deal 18-24, and training and education are key to helping them with employment and to improving their earnings.

45 Directing in-work financial support to those aged 25 and over is also likely to be more effective in targeting resources at the poorest households. Among households with children who have someone in full-time work, the 25s and over are five times more likely than 22 to 24 year olds to be living in households in the bottom fifth of the income distribution.

Help with the costs of childcare in the employment tax credit

46 The employment tax credit is intended to recognise the barriers to work that families can face and to provide help to overcome those barriers. One of the most significant costs of employment faced by families with children is the cost of childcare. The introduction of the childcare tax credit in Working Families' Tax Credit and Disabled Person's Tax Credit provided recognition of those costs and is helping over 135,000 low-income working families to meet them. We propose to build on this by providing a childcare tax credit within the employment tax credit which will be based on the existing childcare tax credit. The details of the new childcare tax credit in employment tax credit are covered in Chapter 4.

Disability

47 The **employment tax credit will also take in the elements currently paid through the Disabled Person's Tax Credit** for working adults with a disability, recognising the extra needs of disabled people in low-income work. To maintain a smooth transition from Disabled Person's Tax Credit to the employment tax credit, the eligibility criteria for those elements in employment tax credit will be the same as for the existing credit. **A higher employment tax credit will be paid for workers with a disability**. And to enhance work incentives for a second disabled earner in a couple, the **employment tax credit will go further and pay the higher credit for each partner who meets this criterion. We also propose to pay additional amounts of employment tax credit for any adult in the family who has a more severe disability** – this is in line with the enhanced disability credits in both of the existing payable tax credits, which recognise the extra difficulties faced by those with more severe disabilities.

Qualifying Rules

48 In Disabled Person's Tax Credit, a disabled worker must meet the 'qualifying benefit' criterion which requires that they must receive, or have recently been receiving, a 'qualifying' incapacity or disability benefit. This is because the Disabled Person's Tax Credit was designed to help people with disabilities move into work. **We would welcome views on whether there is a case for revising the eligibility rules and, if so, on how that might best be done**, in line with the aims of the tax credit.

49 We **propose to continue the current 'Fast-Track' route to the Disabled Person's Tax Credit**, allowing applications for the employment tax credit from those who have been sick and who have suffered a reduction in earnings because of illness or disability.

Linking rules

50 Currently, a worker with a disability who receives Disabled Person's Tax Credit has a reserved right to return to their previous level of Incapacity Benefit or Severe Disablement Allowance for up to two years, if they are incapacitated when their employment ceases. **We propose to retain this right for anyone who qualifies for the disability payments within the employment tax credit**. However, there may also be a case for extending this right to those who move into work at an income level which takes them out of employment tax credit and who may receive only the integrated child credit. **We are looking at options for extending the linking rule to provide protection for a wider group of workers with disabilities and would welcome views**.

Bringing Disability Premiums into the employment tax credit

51 The employment tax credit is intended to be the single vehicle for delivering targeted top-ups to those in work who remain in low-income households. So we are integrating into the employment tax credit the disability payments currently available through Disabled Person's Tax Credit. This integration brings workers with a disability into the same system as other workers, a step towards a more inclusive tax credit system. This has some potential beneficial knock-on effects, including:

- single workers with a disability will no longer start to see their tax credit withdrawn at a lower level of income than other tax credit recipients, as they do in the existing system, because there will be a single point at which the employment tax credit starts to be withdrawn;

- the introduction of disability payments for each individual who qualifies for them, so that, for example, where each partner meets the 'worker with a disability' criterion, two disability additions will be payable.

Those aged 50 or more returning to work

52 To create a single vehicle for targeted in-work financial support, **we propose to incorporate the New Deal 50+ Employment Credit payments into the employment tax credit.**

53 The New Deal 50+ is administered by the Department for Work and Pensions and was introduced nationally in April 2000, with the aim of supporting people aged 50 and over on return to employment. Currently, the New Deal 50+ provides support for a period of 12 months to anyone in this age group returning to work after six months' unemployment. It gives people access to a personal adviser, a training grant and the Employment Credit 50+, which is payable for their first 52 weeks in a job (both the grant and the credit are tax-free). The credit is paid to both the self-employed and employees, at a flat rate of:

- £60 per week to those working at least 30 hours or
- £40 per week for those working at least 16 hours

provided their individual income is below £15,000 gross a year.

54 If the employment tax credit is intended to be the single vehicle for in-work financial support, it makes sense to bring the existing Employment Credit 50+ within it. But, because of administrative constraints when the Credit was introduced, there are significant differences between it and the proposed new tax credits system. The Employment Credit takes no account of income below £15,000 a year – it is simply a flat rate payment for everyone with an <u>individual</u> income up to that level, whereas in tax credits the value of an award will be adjusted on the basis of <u>household</u> income above a set level. So the employment tax credit will better take account of the household's financial circumstances.

55 The employment tax credit will be available in the normal way to households in which one of the workers is aged at least 50. But to replicate the generous time-limited element of support provided through the Employment Credit 50+, the employment tax credit would also need to include an additional element for this age-group. Given that the 50+ credit has helped more than 30,000 people going into work, the Government believes there is merit in building on its success in the employment tax credit.

56 So, for the first 12 months of employment or self-employment, we also propose to provide an income-related payment through the employment tax credit by way of a return to work bonus for anyone aged 50 or over who moves into work

- after a period of at least six months on one of the benefits which entitle an applicant to support though the New Deal 50+ or who is the partner of someone on those benefits, and
- who is working at least 16 hours a week.

The level of the payment has still to be determined. We are also considering how best to handle the transition between the Employment Credit 50+ and employment tax credit.

57 In line with these proposals, the employment tax credit would provide income-related support for:

- households with children or someone with a disability, in which at least one adult worked 16 hours a week or more;
- households without children and in which no-one had a disability, if at least one adult worked 30 hours a week or more.

It would also provide a 'back to work' bonus for a year, for a household in which someone aged 50 or more had returned to work after a period of unemployment.

Paying the employment tax credit

58 The employment tax credit will support people who are in work and will be paid to the person in remunerative work. If that worker is an employee, their employer will pay the credit through the wage packet. If the worker is self-employed, payment will be made direct by the Revenue, as occurs now in Working Families' Tax Credit or Disabled Person's Tax Credit. But, unlike these credits, which are fixed for six months, eligibility for employment tax credit will stop at the point when employment or self-employment ceases.

59 As the employment tax credit will be the vehicle for targeting support to those in work, it will be paid to the person who is in work. It will not be possible for couples to opt for payment of employment tax credit to a non-working partner (although the main carer in families with children would receive the integrated child credit direct). Where the partners in a couple each work at least 16 hours a week, they will be able to choose who receives employment tax credit.

Payment via the employer

60 Payment through the wage packet is a key element in reinforcing the message that work pays and in demonstrating the link between receiving employment tax credit and being in employment. We are committed to working closely with employers to ensure the system is as simple to understand and easy to administer as possible. The introduction of the employment tax credit is an opportunity to look closely at the way payment through the employer works, to build on the lessons and experiences of the introduction of Working Families' Tax Credit and Disabled Person's Tax Credit and to look at possible changes which could make payment through the employer run more smoothly for both claimants and employers. We anticipate that overall compliance costs for employers will be broadly unchanged in the new tax credits and may fall in the longer term. **We outline below some changes that we expect to follow from the introduction of new tax credits and on which we would like views.** They include:

Paying employment tax credit on an annual cycle

61 The employment tax credit will be based on annual income and entitlement will be reviewed on an annual basis (this is covered in more detail in Chapter 6). This will change the way employers have to handle payments of tax credits through the payroll. In the current system, Working Families' Tax Credit and Disabled Person's Tax Credit awards run for 26 weeks and, at the start of each award, employers are given the dates on which they must start and stop paying the tax credit. When an employee remains eligible for those credits, they are required to reapply for a new award after six months. The lead times required to allow employers to update their payroll systems mean that there is always a gap between the end of payments made by the employer for one award and the start of payments of the next award. This gap is filled by direct payments by the Revenue. The

stop-start nature of the payments by employers is cumbersome for them and can be confusing for applicants.

62 The annual cycle of the new tax credits will mean a reduction in this administrative complexity and an end to the stop-start nature of payments. Employment tax credit awards will run for up to a year and be reviewed at the end of each tax year. The employer will continue to make payments at the existing rate while the employee's renewal is being dealt with and will only have to change it when the Revenue notifies them of a new rate of payment and the date from which it should start. As long as the employer applies the new rate from the correct day, it will be the responsibility of the Revenue to make sure that the rate takes account of any adjustment that is needed because of payment at the old rate during renewal. This means that for continuing employment tax credit cases with the same employer, there should not be a gap in payment through the wage packet.

63 When an employee first becomes entitled to employment tax credit, the employer will be given details of the amount that needs to be paid and the date to start paying, and should continue to pay at that rate until told by the Revenue to change it.

Certificate of Payments

64 It follows from the focus of employment tax credit on supporting those in work, that payment should only be made as long as the recipient is in work and eligible for employment tax credit and that payment should end if they leave employment or self-employment. This is different from the current system in which entitlement to Working Families' Tax Credit and Disabled Person's Tax Credit continues for the full six months, even if the applicant becomes unemployed. If this happens to someone in employment now, the Revenue takes over responsibility for paying the balance of the tax credit due to the ex-employee. To confirm how much has been received already, and how much is still to be paid, the ex-employee is asked to provide proof of the payments made by the employer. This is in the form of a Certificate of Payments that employers are required to provide to every employee in receipt of a tax credit who leaves their employment. **Because employment tax credit ceases when a recipient leaves employment, there will no longer be any need for the Certificate of Payments**.

Requests for information about earnings

65 In Working Families' Tax Credit and Disabled Person's Tax Credit, applicants are asked to provide documentary proof of their earnings. Where they are unable to do so, employers are asked to provide the details. With the new tax credits, in line with the move to encourage electronic applications, claimants will not be asked to provide documentary proof of income with their application, although the Revenue will reserve the right to check the information provided with them or with employers. This will **remove the need for the Revenue routinely to contact employers for proof of an employee's earnings**.

Notice period

66 When notifying employers to pay the current tax credits through the payroll, we give them at least 14 days' notice before they start paying tax credits to a weekly paid employee and at least 42 days' notice where the employee is paid less frequently than weekly. **We are considering simplifying this process by standardising the notice period for all employers and introducing a single 42-day notice period for all employment tax credit cases**. During that period, employees newly entitled to employment tax credit would get payment direct from the Revenue, as they do now.

Funding

67 We intend to take the same approach to funding employers for the employment tax credit as in the current tax credit systems. Employers will continue, where possible, to pay tax credits out of the PAYE tax, National Insurance contributions and student loan deductions which they are due to pay over to the Revenue each month or quarter. If these amounts are not enough to cover the tax credits they have been asked to pay, they will be able to apply to the Revenue in advance for funding. **We are looking at the possibility of automatically increasing the amounts of funding we pay to an employer already receiving advance funding, when a new employee of theirs becomes entitled to employment tax credit**.

Changing the rate of the employment tax credit

68 Working Families' Tax Credit and Disabled Person's Tax Credit amounts are fixed for the 26 weeks of an award and we tell employers the daily rate at which they must pay the tax credit. We do not ask the employer to alter that daily rate during the period for which he or she is responsible for paying tax credit. Employment tax credit awards, however, will, in certain circumstances, respond to changes and it may be necessary for us to ask the employer to alter the daily rate of employment tax credit for an employee within a pay period.

Longer Term Developments

69 The employment tax credit is being introduced as a flexible tax credit that can be used to direct extra help to households who face particular work incentive issues and in-work poverty. Beyond the proposals outlined above for extending in-work support to workers without children or a disability, the Government wishes to look at longer term options for helping other groups.

70 In particular, the Government is aware that a number of groups without children, such as those with other caring responsibilities, still have constraints on their ability to work because of those responsibilities. It recognises the problems these groups face moving into work or breaking out of poverty. For example, people currently qualify for Invalid Care Allowance if they care for someone who receives Disability Living Allowance or Attendance Allowance. However, they must be carrying out this care for an average of 35 hours a week and earn less than £72 a week. Equally, there are those who cannot meet the Invalid Care Allowance requirements, but whose care responsibilities restrict their ability to work full-time or to take better paid employment.

71 There may be a case for extending support to these people by reducing the working hours requirement for them. One of the most difficult issues around developing options for the longer term would be finding a reliable definition of 'caring'. But the Government intends to continue to look at this issue with a view to the longer term. So **we would be interested in views on a workable definition of 'carer' that could be used to identify those who are disadvantaged in the labour market by their caring responsibilities**. Any definition would need to be capable of being verified so that it was possible to check an individual met the eligibility criteria, without imposing an unreasonable burden upon them.

72 As discussed in paragraph 48 (on page 20), there are also aspects of the current rules associated with payments for workers with a disability that could be reconsidered in the longer term. The Revenue wants to develop ideas in this area in consultation not only with other government departments but also with other interested parties. **As a first step in this longer term development, initial views on how to take this issue forward would be welcome**.

73 A summary of the specific points for consultation is set out in **Part 3, section 3.**

4 Support for childcare costs

Outline

74 Childcare costs can represent a significant barrier to parents moving into work. The childcare tax credit in Working Families' Tax Credit and Disabled Person's Tax Credit has been effective in recognising the extra burdens faced by working parents with childcare needs and the introduction of employment tax credit is an opportunity to build on its success, learn lessons from the way it works and examine whether it can be improved in the new tax credits system. Consistent with the overall role of the employment tax credit, as a flexible tool for providing in-work support through the tax system to specific groups of working households, the childcare tax credit will form an essential element of this support, as it does now in the current tax credits.

Supporting Working Families With Childcare Costs

The introduction of the childcare tax credit in Working Families' Tax Credit and Disabled Person's Tax Credit established a more generous and better targeted vehicle for delivering support to working families who incurred childcare costs. Families can receive extra tax credits equivalent to up to 70% of their eligible childcare costs, subject to limits on those costs of £135 a week for one child and £200 for families with two or more children in childcare. Family Credit, which was replaced by Working Families' Tax Credit, included an income disregard for childcare costs. This disregard provided lower levels of support for allowable childcare costs (£60 for one child/£100 for two or more children) and, as a disregard, it did not help the poorest working families who were already entitled to receive maximum Family Credit.

Over 135,000 families currently benefit from the childcare tax credit in the Working Families' Tax Credit and the Disabled Person's Tax Credit, getting an average of £35 a week extra in tax credit. This is nearly treble the number of families who benefited from the Family Credit disregard.

Qualifying Conditions

75 The childcare tax credit is intended to help working families with the costs of registered childcare incurred as a result of the parents' employment. Hence, in Working Families' Tax Credit and Disabled Person's Tax Credit, families qualify for the childcare tax credit where a lone parent or both parents in a couple work for at least 16 hours a week, reinforcing the role of the credit in supporting working parents with recognisable childcare needs. The childcare tax credit in the employment tax credit is similarly about recognising extra costs incurred by working parents. It is essential that the link to work established in the existing tax credits is maintained. Therefore, **we propose to retain in the employment tax credit the working hours rules used for the childcare tax credit in Working Families' Tax Credit and Disabled Person's Tax Credit**. This means that, for couples to qualify for the childcare tax credit in the employment tax credit, they must **both** be working at least 16 hours a week (or one be working at least 16 hours and the other incapable of looking after the children) and, similarly, that a lone parent must work at least 16 hours to qualify.

Paying the childcare tax credit element of employment tax credit

76 The childcare tax credit in the employment tax credit will be a distinct element, paid in specific recognition of childcare costs. This means that, in principle, like the rest of the credit, it should be paid with wages. We have had representations, however, arguing that paying childcare tax credit through the wage packet has some drawbacks because:

- the recipient is not necessarily the person who is responsible for arranging and paying childcare; and
- when people move into work, childcare providers often require payment in advance or an advance deposit and tax credits are not payable in advance. On this issue, it is worth noting that, for lone parents moving into work, the Government announced extra help with the up-front costs of childcare in this year’s Budget. Eligibility for the Jobseeker’s Grant has been extended to lone parents who have been on Income Support for over six months. This provides funds for immediate expenses, such as deposits for childcare.

77 One proposal that has been put to us, as a way of addressing the issues above, is to pay the childcare tax credit element of employment tax credit direct to the the main carer, who is the person most likely to be arranging and paying for the childcare. This may help tackle the cash flow issues while retaining childcare tax credit as an essential part of the employment tax credit. There is a case to be made on both sides – the link with work pointing to payment through the wage packet, the link to care for the children pointing to payment direct to the main carer. **We would welcome views**.

Childcare Providers

78 In line with the National Childcare Strategy commitment to encourage parents to use safe, good quality childcare, we propose to follow the same definitions of eligible childcare for the childcare tax credit in the employment tax credit as are currently used in Working Families’ Tax Credit and Disabled Person’s Tax Credit. This will include registered childminders and nurseries, along with Department for Education and Skills accredited pre- and after-school schemes, including any new accreditation schemes in place by 2003. The Government is also considering how to help families who need to use formal childcare in their own homes.

Responding to changes in childcare

79 The childcare tax credit in the employment tax credit is intended to be more responsive to changes in childcare requirements, in line with the overall move towards a more responsive system of tax credits as outlined in Chapter 6. This would include responding to changes in childcare arrangements. This could mean recalculating the amount paid whenever a family changed provider, when a child was removed from an eligible provider and the parent no longer used eligible childcare, or even when childcare charges changed. **To make this work, a family would be required to tell us about changes.** So, for example, when a parent decided to use a different provider or put a second child into childcare, they would have to tell us about the change.

80 We are considering the most effective way to verify the information given by claimants about childcare charges and providers. For example, claimants could be asked to keep receipts and/or to get confirmation of the charges in writing from childcare providers. In addition, the Revenue could use information given by claimants to monitor a proportion of the claims by checking with claimants or providers. **We would welcome views on the most practical and effective way forward.**

81 A summary of the specific points for consultation raised in this chapter is set out in **Part 3, section 4**

5 A targeted means of support

82 The systems that the new tax credits will replace use various income definitions to target support according to need. The introduction of new tax credits offers the opportunity to look again at these definitions and establish in their place a single, consistent definition of income for income tax credits. The Government believes that a single definition of income is essential if the new tax credits are to target support effectively, and if they are to be simple for people to understand and for Government to administer.

83 This chapter discusses how that single definition of income might be framed and covers five key points:

- the general principles that inform our work on the definition of income;
- the categories of income we propose to look at;
- what to do about capital, and income from capital;
- whether to use 'net' or 'gross' income;
- whose income we should look at.

General principles

84 Any system of targeted support – an out-of-work benefit like Income Support, a tax credit like Working Families' Tax Credit or a relief from income tax like the Children's Tax Credit – relies on information about people's income. This will also be true of the new tax credits. To keep things as straightforward as possible, we aim to ensure that, wherever possible, the information we require to calculate entitlement to new tax credits is information that is already available to individuals and Government for other purposes.

85 We propose to base entitlement to new tax credits on annual income. (This is explained in more detail in Chapter 6.) We think this will deliver a system that is fair and targeted, without being intrusive or imposing undue burdens on claimants. The income tax system operates according to annual income and a range of information about annual income is therefore already available. For example:

- employees should all be given a statement of their earnings by their employer (on form P60) after the end of each tax year;
- people who are self-employed already keep records of their annual profits so that they can fill in their self assessment return; and
- banks issue certificates of annual interest to depositors for tax purposes.

86 With this as a base, we see it as logical **to take the treatment and definitions of income used for income tax purposes as the starting point for the definition of income to be used for new tax credits**. This should:

- minimise additional requirements on employers, because much of the information needed will be information they already give their employees for tax purposes – for example, on payslips and forms P60 and P45 which have to be produced as part of the Pay As You Earn system;
- minimise additional requirements on self-employed people, who will be able to use books and records they already keep for self assessment to support their application for new tax credits;

- ensure the system is as straightforward as possible for claimants, who will be able to use information they already receive for tax purposes when applying for the credits.

87 Taking the tax definition of income as our starting point will also underline the fact that tax credits are part of the tax system. This should further reinforce the bridge between welfare and work, helping to make the transition from the benefits system to the tax system more transparent to people moving into work.

Categories of income

88 While we think the definition of income in the tax system offers a sensible starting point, we also recognise the need for the new tax credits to be transparent and accessible to claimants. This is important if we are to maximise take up and ensure that support goes to those who need it most. It is essential to avoid unnecessary complexity in defining income, to minimise the risk that those most in need of support fail to claim the credits when they could and should do so, or that people receive the wrong amount of credit because they do not understand what information they ought to provide.

89 So rather than attempt to mirror the income tax system in its entirety, we propose to concentrate on categories of income which are likely to have a material effect on the amount of support a family will receive. Our research shows that, for the vast majority of households, income comes from one or more of four main sources:

- earnings;
- pensions;
- profits from self-employment; and
- social security benefits.

90 We therefore propose that the income taken into account for new tax credits should concentrate on these categories of income. Households will be asked to report income from other sources only where that income exceeds a certain level. We believe that any attempt to target support more closely by taking relatively minor sources of income into account would be counter-productive, because the resulting increase in complexity could deter those entitled from claiming the credits at all.

Earnings and pensions

91 Both claimants and the Revenue will be able to use the information already provided by employers and pension providers – such as forms P45 and P60, issued for the purposes of Pay As You Earn – to ascertain annual earnings and pension income and to calculate tax credit entitlement.

92 Some employees receive 'benefits in kind', such as a company car, from their employer. The income tax system treats benefits in kind as earnings and taxes them accordingly. This raises the question of whether it would be appropriate to take such benefits in kind into account as income for the purposes of new tax credits.

93 There is certainly a case for this. Not to do so would mean that the amount of credit a household received could be affected by the way in which their employer chose to pay them. This is precisely the reason benefits in kind are subject to income tax. We anticipate that the new tax credits will be available to people whose remuneration packages are likely to include benefits in kind.

94 On the other hand, the nature of benefits in kind means that the tax rules dealing with them are, necessarily, quite complicated. Many employees receive benefits in kind of only a limited value, so that, even if they were taken into account as income for new tax credits, the effect on a household's overall award would very often not be material. This might suggest that the additional complexity involved in including rules to take such benefits into account as income would not be justified by the effect on the majority of claimants' awards. This is why both Working Families' Tax Credit and Disabled Person's Tax Credit do not treat the vast majority of benefits in kind as income.

95 There is a clear trade-off here between equity and simplicity. **There are three main approaches on which we would welcome views**:

- ignore all benefits in kind, and keep the rules simple at the expense of some inequity and poor targeting;
- take all benefits in kind into account, ensuring fairness and better targeting, and accept that the price paid for that is a certain increase in complexity for employees receiving benefits in kind; or
- take into account only the most common benefits in kind of a significant value (the most obvious examples being company cars and associated fuel payments).

Profits from self-employment

96 The Government is committed to encouraging enterprise and small business. We therefore need to ensure that self-employed people who wish to claim the new tax credits are able, like employees, to do so without unnecessary difficulty or cost. In particular, we see it as essential to keep the rules on the treatment of self-employed profits as simple as possible and to deliver, as far as possible, consistency of treatment across the income tax and tax credit systems. **We therefore propose, for the purposes of the income definition for new tax credits, to take account of taxable profits from self employment**.

97 This would mean that self-employed people would have their award based on their profits in the most recent accounting period for which a self assessment had been made. In some cases, this would exaggerate the time lag between the period covered by the award and the income on which it was based. But we believe the priority must be to keep the system as simple as possible for all claimants, regardless of their employment status.

98 Taxable profits for any period will be those earned in the period. That is, the figures that are required to be shown on the self assessment tax return (for taxpayers whose business turnover is below £15,000 a year, the figure will be drawn from a simple three line account). Having awards based on taxable profits in this way can offer certain advantages. For example, we are looking at the case for allowing self-employed people to benefit from reliefs such as capital allowances and the set-off of trading losses.

Social security benefits

99 For some families eligible for new tax credits, social security benefits will be a significant part of their income. As for other sources of income, we propose to take the income tax treatment of social security benefits as the starting point for deciding whether or not they ought to be treated as income for the purposes of new tax credits. This means that non-taxable benefits, such as Income Support, Housing Benefit and Child Benefit, would not be taken into account as income for new tax credits. But we recognise that, for other benefits, this is an area in which the tax treatment may be quite different from that in Working Families' Tax Credit, Disabled Person's Tax Credit or income-related benefits because of the variety of disregards within those systems.

100 We **propose** therefore **to look at each benefit in turn and its treatment for the purposes of other benefits or existing payable tax credits and to consider, on a case-by-case basis, what approach we should take for new tax credits**. We would particularly welcome any views about the appropriate treatment of specific benefits in new tax credits.

Other income

101 As mentioned at paragraph 89, our research suggests that earnings, pensions, profits from self-employment and social security benefits are the most significant categories of income for most households. However, some households may also have income from other sources – for example, income from rents. Such a source may well represent a significant income stream for a particular family. It would be unfair wholly to disregard such income, when we would take, say, earnings wholly into account. On the other hand, requiring people to report every last detail of their income from a range of minor sources, which, in most cases, would make no material difference to the size of their award, would risk imposing an unnecessary burden on claimants for no real gain.

102 We therefore **propose to take other forms of income into account only where, in aggregate, they exceed a certain level, although we need to consider carefully what that level should be. We would welcome views**. As for the other sources of income considered earlier in this chapter, our starting point would be to take income into account only to the extent that it is taxable.

Child maintenance

103 The possible treatment of maintenance income is an important issue for a significant number of lone parents. Since the introduction of Working Families' Tax Credit and Disabled Person's Tax Credit in 1999, child maintenance payments have been fully disregarded in the hands of recipients in work. This measure was introduced to improve work incentives for lone parents and to allow them to keep more of the income they receive for the support of their children. We should like to retain these arrangements, which would be consistent with the fact that maintenance payments are no longer taxed in the hands of the recipient. **We would be interested in views on whether the approach currently taken achieved its objectives, and whether child maintenance payments should similarly be disregarded for the purposes of new tax credits**.

Statutory Maternity Pay

104 Statutory Maternity Pay is not currently taken into account as income for the purposes of Working Families' Tax Credit and Disabled Person's Tax Credit. This disregard was intended to make it easier for working mothers to choose to stay at home during the first few months after the birth of their child. However, Statutory Maternity Pay is chargeable to income tax. This is because it is, in effect, a substitute for earnings. The Government remains committed to providing an environment in which working mothers, whatever their income, can exercise choice about how they support their children in the months following birth. We therefore **see a case for following the Working Families' Tax Credit and Disabled Person's Tax Credit treatment of Statutory Maternity Pay and disregarding it as income for the purposes of new tax credits**. However, this does, clearly, involve a departure from the general principle of mirroring the tax treatment of earnings. It could also make it more difficult for mothers receiving Statutory Maternity Pay to know what is the correct level of earnings to include on their application for new tax credits.

Student loans

105 Existing tax credits treat student loans as income when they are received, but do not deduct loan repayments when they are made. **We would welcome views on whether it would be appropriate to follow this approach for the new tax credits.**

Capital

106 The tax system charges income tax on the actual income arising from a particular capital holding. Tax is not charged on capital itself, although it may be charged on any capital gains when the capital is disposed of.

107 The treatment of capital in the existing payable tax credits was inherited from Family Credit and follows the approach taken by the benefits system. If households have capital worth more than £8,000, they are not entitled to claim any Working Families' Tax Credit. Households holding capital of less than £8,000 are treated as receiving income of £1 a week for every £250 of capital over £3,000. Capital up to £3,000 is ignored. The rules for Disabled Person's Tax Credit work in a similar way, although the thresholds are higher.

108 The Government has said that it sees a case for reviewing the treatment of capital and income from capital. In the 2000 Pre-Budget Report, the Government made a commitment to:

> 'ensure savers are not unfairly penalised ... The next phase of modernisation of the tax and benefit system offers an opportunity for a thorough review of the treatment of income and capital in assessing entitlement to support. The aim is to create a modern system with incentives to work and save.'

Against that background, we see a strong case for bringing the treatment of capital and income from capital for the purposes of new tax credits into line with their treatment in the income tax system. We therefore **propose that there should be no upper capital limits or rules for calculating notional income from capital for the new tax credits**. Rather, we will treat income from capital like income from any other source – taking actual taxable income into account. This will not only underline the conceptual symmetry between the income tax and tax credit systems but should also encourage people to build up their savings, by removing the concern that they will be penalised by losing the support they were receiving through tax credits.

109 In line with our general principle of concentrating on taxable income wherever appropriate, we propose to ignore income derived from tax-free savings vehicles, such as Individual Savings Accounts (ISAs). In this way, we can be sure that the rules for new tax credits will not cut across wider Government initiatives to encourage saving. This approach should enable people on lower incomes, for whom tax incentives to save can sometimes be of limited value, to make the most of their savings because, by putting those savings in an ISA, they will be able to ensure that their tax credit entitlement is not affected.

110 One consequence of taking actual income from capital into account will, of course, be a requirement on households to report this income. The rules for benefits and existing payable tax credits provide that capital holdings worth less than a certain amount (£3,000 for Working Families' Tax Credit) are wholly ignored – the actual income is not taken into account and the notional income generated is assumed to be nil. This means that people with small capital holdings do not need to report any income arising when they claim their benefits or tax credits.

111 We have explained in paragraph 102 that, while we intend to take account of significant amounts of income claimants may have from sources other than earnings, pensions and benefits, we want to avoid imposing a requirement to tell us about small amounts of such income. As part of that approach, and in particular, in setting the threshold below which income need not be reported, we will want to pay close attention to the potential impact on those with amounts of capital small enough to be ignored in current systems.

Net income and gross income

112 Currently, entitlement to social security benefits and to Working Families' Tax Credit and Disabled Person's Tax Credit is based on net income – that is, income after income tax and National Insurance contributions have been deducted. This can produce some slightly quirky effects. For example, items such as underpayments of income tax from previous tax years can affect current entitlement to tax credits and benefits if they are coded out through the Pay As You Earn system. Also, tax credit and benefit recipients who pay income tax may not gain the full amount of any reductions in income tax or National Insurance contributions, because the effect of such reductions is to increase their net income, which in turn reduces their entitlement to income-related benefits and tax credits.

113 There is a case for basing entitlement to new tax credits on a household's gross income – that is, on taxable income before income tax and National Insurance contributions are deducted. In addition to resolving the awkward effects mentioned above, this would help to integrate new tax credits more fully into the income tax system. It would also mean that information already available for income tax purposes – for example, on P60s and self assessment returns – could be translated directly onto applications for the new credits.

114 Basing entitlement to tax credits on gross income would have implications for the level at which it is appropriate to set the threshold at which the new tax credits will start to be withdrawn, and also for the rate for that withdrawal. The level of the withdrawal rate has still to be set. The marginal deduction rates faced by families in different situations will be a factor in that decision. But, provided adjustments were made to reflect the change, the Government believes it could continue to avoid the unacceptably high marginal deduction rates faced by large numbers of families in the past. Making adjustments to reflect the move to gross income would tend to help households who pay less tax and National Insurance contributions as a proportion of their income. Similarly, using gross income could improve incentives for the second adult in a household to move into work.

115 The Government will consider these factors in reaching a final view on whether to move away from the net income basis used in the current tax credits.

Whose income should we look at?

116 As outlined in Chapter 1, we propose to base entitlement to new tax credits on household income, by which we mean the income of individuals or couples (be they married couples or unmarried couples living together as husband and wife) as appropriate.

117 **We do not propose to take into account income from other adults living in the same house (but not forming part of the household)**. This is because we do not think that the income rules for new tax credits ought to discourage families from caring for elderly relatives or providing a home for older children if they wish to do so. Moreover, we think that, in many cases, the income of additional adults in the household will tend to be used to meet, or to contribute towards meeting, the additional costs associated with having an extra person living with the family. There will be some instances where the income of other adults living in the same house really does boost the living standards of tax credit

claimants, but we think these cases will be few and difficult to identify. Therefore, we do not think the additional complexity, for Government and claimants, associated with trying to take account of such income would be justified.

118 Working Families' Tax Credit and Disabled Person's Tax Credit take account of children's income, but the income tax rules that apply to the Children's Tax Credit do not. In practice, the rules concerning children's income in the existing tax credits are hardly ever invoked and we would not expect the position to change significantly after 2003. Most children do not have significant amounts of their own income and, again, it is very difficult to identify those cases where they do. We therefore **propose to ignore the income of children in the household in calculating entitlement to new tax credits**.

119 A summary of all the specific points for consultation raised in this chapter is set out in **Part 3 Section 5.**

6 How the system might work

120 The Government's modernisation objective for the tax and benefit systems aims to ensure that they are:

- accessible, so that people can and do claim the support to which they are entitled;
- responsive, to target support at those who need it, at the time they need it; and
- transparent, so that people understand how the support they receive relates to their circumstances.

121 These principles have informed the design of the new tax credits. Where family circumstances remain more or less constant, we wish to minimise the need for people to contact us. So we plan to base the tax credit award on the previous year's annual income and pay it out on an annual cycle. The design and operation of the credits will also allow the amount of an award to change during the year to reflect changes in a family's circumstances or substantial changes in income. This chapter looks in more detail at how the new tax credits will operate in practice. It deals with three key areas:

- how people will apply for their tax credits;
- key features of the new tax credits; and
- how the credits will be paid.

Applications for new tax credits

122 In line with the Government's modernisation agenda, people must be able to gain access to the new tax credits through the most appropriate gateway for them, and the application process must be made as simple as possible. Our strategy for achieving this is as follows:

- households entitled to Income Support or income-based Jobseeker's Allowance, or pensioner households benefiting from the minimum income guarantee and other prescribed benefits, will be able to access the new tax credits at the same time as they claim these social security benefits. They should only need to provide information about their income and circumstances to a single agency – Jobcentre Plus for people of working age, and the new Pension Service (due to be introduced from 2003) for people of pension age;
- people moving into work from benefits will be able to ask staff at Jobcentre Plus for assistance in completing their application for new tax credits, and information on tax credits will form an integral part of the information provided by Jobcentre Plus when a person moves into work. Jobcentre Plus will pass details of the application to the Revenue. This will mean that people will need to deal with only one Government organisation at the point at which they newly enter or return to the workplace; and
- households which have no contact with the benefits system will be able to contact the Revenue in person, by post, or electronically.

123 For Working Families' Tax Credit and Disabled Person's Tax Credit, couples make an application on one form which they both have to sign. Similarly, families and households will make a single application for the new tax credits. For couples, the information provided by both partners will affect the couple's tax credit entitlement and they will make a joint application. **We propose that both partners should be responsible for the information in a tax credits application**.

Key features of the new tax credits

124 Awards of the new tax credits will run for up to a year and will be set on the basis of income in the previous tax year. This is quite different from the way the benefits system or the current tax credit system works:

- the benefits system is essentially a weekly system. Social security benefits are paid out for a week based on a household's income and circumstances in that week;
- entitlement to Working Families' Tax Credit and Disabled Person's Tax Credit is based on a 'snapshot' of a family's income and circumstances at a particular point in time. This information sets the award, which is then paid out at the same rate over the next 26 weeks and cannot normally be altered to reflect changes in family circumstances or income;
- the Children's Tax Credit is a relief set against the annual income tax charge and is based on the claimant's income in the tax year for which it is claimed.

125 Each system has advantages and disadvantages. The weekly benefits system is able to respond quickly to changes in circumstances. But that can make for a system which is intrusive and imposes significant compliance burdens on claimants. On the other hand, the fixed nature of Working Families' Tax Credit and Disabled Person's Tax Credit awards keeps contact between applicants and the Revenue to a minimum and gives families certainty from week to week as to the level of support they will receive. But it also means that these existing credits are largely incapable of responding to families' changing needs. It can also be unfair to families with fluctuating income, because the amount of credit they receive depends on the level of their income at a particular point in time, however unrepresentative that might be. It is also possible to 'manipulate' household income within the snapshot period – for example, by varying overtime patterns – to maximise a tax credit award. This can mean that support is not always targeted to those who need it most.

126 The challenge in introducing the new tax credits is to try to design out the disadvantages of each of the existing systems while retaining the advantages. To achieve that, we propose a radical approach to the cycle of awards. **We propose that entitlement to the new tax credits should be set on the basis of annual income for the previous tax year, but that they should be adjusted to reflect significant changes in income levels in the current year**.

An award based on annual income

127 Basing entitlement on annual income has several advantages. It should eliminate the unfairness and potential for manipulation associated with Working Families' Tax Credit and Disabled Person's Tax Credit snapshots, whilst avoiding the burdens and intrusiveness associated with weekly means testing in the benefits system. Moreover, using annual income will further reinforce the links between tax credits and the income tax system, which is a fundamental objective of this phase of the Government's tax-benefit reforms[1].

[1] The rationale for integrating tax credits with the tax system is discussed in more detail in Chapter 1 and Chapter 5.

128 Once both tax credits and income tax operate according to annual income, claimants, employers and the Revenue will all be able to make use of information that already exists for tax purposes to establish the appropriate level of a household's award. This should minimise burdens on business and individuals and enable the Revenue to streamline its administrative procedures. Unlike now, in most cases there will be no need to carry out separate calculations of income for the purposes of making or verifying a tax credit claim. Using annual income for tax credits will also ensure that the interaction between the tax system and the tax credit system is more transparent.

An award set on the previous year's income

129 Basing entitlement at the point of claim on the previous tax year's income, rather than on an estimate of the current year's income, **will provide claimants with a level of certainty about the amount of their award**. But it is also important to ensure that support goes to those who most need it, at the time they need it, and to preserve the incentive for people to take up work or increase their hours, while at the same time making sure that the system is not open-ended in terms of cost to the Exchequer.

Responding to falls in income

130 Basing awards on the previous year's income without responding to change could mean that a household experiencing a drop in income during the current year would have to wait several months before an award could be adjusted to take account of that change. The Government **believes that a tax credit system based initially on the previous year's income must include the facility to respond immediately to people who lose their jobs or to significant falls in income**, if it is to provide adequate support to the most vulnerable families at the time they need it.

a) People who move onto income-based adult support

131 To prevent low-income families from undergoing multiple income tests, we see a strong case for ensuring that any **household with an income low enough to qualify for Income Support or income-based Jobseeker's Allowance will automatically receive in full the maximum integrated child credit to which they could be entitled**.

132 The facility to receive maximum integrated child credit whilst on Income Support or income-based Jobseeker's Allowance would be available at any point in the year. In effect, a successful claim for either of these social security benefits would supersede the normal annual income test for tax credits. So families whose income fell to a level low enough to entitle them to out-of-work benefits would immediately become eligible for maximum support for their children through the integrated child credit, for as long as they remained entitled to that benefit.

133 If the family's income subsequently increased, so that they floated off Income Support or income-based Jobseeker's Allowance, the previous-year basis of entitlement for tax credits would be switched back on at that point.

b) Other falls in income

134 Where there is a more modest fall in a household's current year income by comparison with the previous year, but they do not qualify for Income Support or income-based Jobseeker's Allowance, we believe that the position is more finely balanced.

135 The Government sees a case for allowing households that expect their annual income for the current tax year to be significantly lower than their previous year income to apply to the Revenue to have their award re-assessed on the basis of a forecast of their current year income. This would mean that a tax credit award could be increased during the year to reflect the family's lower income, so that the increased tax credit would partially offset the fall in income. The household would not have to wait until the start of the following year to see the change in income reflected in an increased tax credit award.

136 On the other hand, any household that did choose to switch to an award based on a forecast of current year income would no longer enjoy the certainty offered by an award based on previous year income. Awards based on a forecast of current year income would have to be reconciled at the end of the year against actual income for the year. Where the forecast had been unduly pessimistic, and the household had received a higher tax credit award for that year than proved to be merited, repayment of the overpaid credit would be necessary.

c) Rises in income

137 The corollary to enabling people to have their award re-assessed if they expect their current year income to be lower is that significant rises in current year income by comparison with the previous year should also lead to an adjusted tax credit award. There is a balance to be struck here between the proper targeting of Government resources and the impact on families of the risk that tax credits would have to be repaid. But, to target resources effectively and manage expenditure, we believe that new tax credits will have to respond to rises in income, if they respond to falls, and that families should be asked to report significant rises in annual income, while they remain in work, if they wish to avoid running up an overpayment.

d) Thresholds for changes in income

138 **We would welcome views on the level of an appropriate threshold for changes in income to which the new tax credits should respond.**

Responding to changes in circumstances

139 Although entitlement to tax credits will be based on annual income – normally, income in the previous year – we propose that awards should reflect *current* (non-financial) circumstances: for example, the number and ages of children or whether someone has a disability.

140 **Awards will be set to run for up to a year**. But this does not mean that they will always run for 52 weeks. A household will be able to make an application at any point in the year. The award will then run for the remainder of the year, at which point it will need to be renewed. Once a claim is up and running, a household's entitlement will run on an annual cycle, with payments being made throughout the year up to the next renewal.

141 The fact that awards will last for up to a year does not mean that the amount a household can receive will be set in stone for 12 months at a time. Where circumstances change during the year, it will be possible to alter the amount of the award to reflect those changes as soon as they occur. So the new tax credits will be much more responsive to a family's changing needs than Working Families' Tax Credit and Disabled Person's Tax Credit are now.

142 We have already explained that a household's circumstances (as well as its income) can affect the amount of its tax credit award:

- Chapter 2 explains that the number of children for which a household is responsible will affect the amount of integrated child credit to which it is entitled; and
- Chapter 3 explains the range of factors – including the number of hours worked and whether or not someone is disabled – that can affect entitlement to the employment tax credit.

143 The current tax credits and benefit systems react to changes in circumstances at different speeds. Because Income Support and income-based Jobseeker's Allowance are essentially weekly benefits, they are able to respond to changes in circumstances as they occur. In other words, where a household's circumstances change (for example, they newly become responsible for another child) the benefits can be increased to reflect that change almost immediately. To date, it has not been possible to offer a similar degree of responsiveness through the tax credit system. In particular, both Working Families' Tax Credit and Disabled Person's Tax Credit are paid as six-month fixed awards, determined according to family circumstances at the point of claim. Although Working Families' Tax Credit and Disabled Person's Tax Credit 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.

144 The introduction of new tax credits, however, provides an opportunity to remove rigidity from the tax credit system and design a system with the flexibility to respond to changes of circumstances as they happen.

145 **Where family circumstances change – on the birth of a child, for example, or the onset of disability – claimants will be able to tell the Revenue and have their tax credit award adjusted from the date of the change**. Some changes may reduce the amount of tax credit payable – an example might be where the main carer for a child changed or a young person left full-time education. Adjusting awards in response to changes will enable resources to be targeted most effectively.

146 Although we would normally expect people to notify us immediately a change of circumstances affecting their award occurred, there may be instances where it is not reasonable to expect that to happen. For example, when a new baby is born, the parents are likely to have things other than tax credits uppermost in their minds. We are therefore **considering whether, in these cases, it would be fairer to allow changes in the award to be backdated for a limited period of, say, three months**.

How the credits will be paid

147 Currently, structural limitations largely dictate which members of a household can receive payments of government support. For example, only people who are taxpayers can receive the Children's Tax Credit and, for couples including a higher rate taxpayer, the partner with the higher income must claim the whole of the credit. Similarly, because in Working Families' Tax Credit and Disabled Person's Tax Credit, payments to support children are wrapped up with work incentive measures in a single instrument of support, it has not so far been possible to make separate payments to the working partner and the main carer. However, the introduction of the new tax credits will make it possible to target payments in that way.

148 **In the vast majority of cases, the employment tax credit will be paid through the wage packet at the same time wages are paid**. Couples in which both partners work will be able to choose which of them should get the credit. In certain circumstances – specifically, where the applicant is self-employed or works for an employer who is not required to operate a Pay As You Earn scheme – the employment tax credit will be paid direct.

149 The integrated child credit is intended to help people with the costs of bringing up children. It will be paid direct to the person who is the main carer for those children – that is, the person who is mainly responsible for looking after them.

Payment into bank or other accounts

150 In line with the Government's wider commitment to modernise systems for delivering support, social security benefits will start to be paid directly into bank accounts from 2003. Payment in this way is the most efficient, secure and flexible way of delivering direct payments. The responsive nature of new tax credits means that the flexibility offered by direct payment into accounts is particularly important. **We therefore propose to make all direct payments of new tax credits into claimants' bank accounts**.

151 We recognise that some families do not currently hold a bank account or may have difficulty opening one. However, the Government is currently spearheading a drive to tackle financial exclusion. Work to ensure that those without bank accounts will be able to open a suitable account into which we can pay tax credits is being taken forward together with the Post Office and major banks.

Frequency of Direct Payment

152 We are considering the frequency with which direct payments of new tax credits ought to be made. New tax credits will be paid to a wide range of people – from benefit recipients and low-income households for whom the credits will be a major source of income, to higher-income households for whom tax credits will represent only a top-up of their existing income. In view of this, we want to maximise the choice families have about how frequently they receive their tax credits. **We propose to allow families to choose whether to receive direct payments of tax credits weekly or once every four weeks**.

153 A summary of all the specific points for consultation raised in this chapter is set out in **Part 3 Section 6.**

7 Bringing the tax and benefits systems closer

154 The introduction of the new tax credits represents a major reform of existing systems of support for working families with and without children. Moving to new tax credits will involve splitting the current Income Support and income-based Jobseeker's Allowance, Working Families' Tax Credit and Disabled Person's Tax Credit payments into their constituent parts for adults and for support for children. All but the adult elements of Income Support and income-based Jobseeker's Allowance will then move into one of the new tax credits. The remaining adult elements of these benefits will be the basis of support for adults not in work. This chapter discusses the impact of the move to the new tax credits for the social security system.

155 As part of the work on new tax credits, we are also looking at how to replace the financial support currently provided in the New Deal 50+ for those individuals aged 50 or over moving into work. This is discussed in Chapter 3 which covers the employment tax credit.

Income Support and income-based Jobseeker's Allowance

156 The significant restructuring of financial support for families with children means that, although the overall level of support for families on these benefits will remain at least as generous, a smaller proportion of it will be provided by Income Support or income-based Jobseeker's Allowance. We are currently looking at the implications for other social security benefits, including the social fund. As a consequence of removing the child premia from Income Support and Jobseeker's Allowance, the means test for them will no longer take children's income into account.

157 Separating the child premia from the adult payments in Income Support and income-based Jobseeker's Allowance will reduce, or even remove, the dependence that some families with children have on these benefits. Those families who have some element of other income may find that the greater proportion of their financial support will come from that and from the integrated child credit. In cash terms, these families will be better off. Some families who are floated off Income Support or income-based Jobseeker's Allowance completely, however, because their income exceeds the remaining adult payments, might lose the automatic access to parts of the social fund and certain welfare benefits that receipt of these particular benefits provides. We are looking at how best we could make alternative arrangements for families in this situation.

Passported Benefits

158 As well as these welfare benefits, other Government Departments, devolved administrations and local authorities currently use Working Families' Tax Credit, Disabled Person's Tax Credit, Income Support and income-based Jobseeker's Allowance to provide a ready-made income-based peg as a trigger or 'passport' for entitlement to certain benefits they administer. These range from access to free prescriptions and free school meals, to help with improving heat efficiency in homes.

159 The new tax credits will continue to provide a means of passporting benefits, though the administrative arrangements will need to change. Tax credits will provide an opportunity to base eligibility to passported benefits on a single, widely-applicable measure of income. This income information will appear on the award notice. Access to passported benefits could

continue to be linked either to receipt of specified social security benefits or tax credits, or be based on particular household income levels, depending on the overall policy objectives. It will still be open to local authorities and devolved administrations to continue their current passports. Or they might prefer to set an income threshold below which tax credit recipients would be granted entitlement. If so, the tax credits award notice could be used to verify entitlement. The Government is considering these issues, to ensure that families receive an appropriate package of support, particularly those on the lowest incomes.

Housing Benefit and Council Tax Benefit

160 Currently, those on Income Support and income-based Jobseeker's Allowance are passported onto maximum Housing Benefit and Council Tax Benefit entitlement, while those in work or with income above these levels have their entitlement calculated on the basis of their household income. We envisage that this passport will continue for those remaining on Income Support or income-based Jobseeker's Allowance adult payments.

161 For those not on Income Support and income-based Jobseeker's Allowance, our overriding aims are to ensure that families see the gain from new tax credits, to minimise administrative complexities and preserve work incentives. So we are looking carefully at how the two streams of support will interact. As a minimum, we will need to ensure that Housing Benefit and Council Tax Benefit calculations reflect the new tax credits.

162 We are aware that those claiming Housing Benefit or Council Tax Benefit and not on Income Support or income-based Jobseeker's Allowance who also claim new tax credits may find themselves subject to different income and capital tests. More radical integration of Housing Benefit and Council Tax Benefit with tax credits is an issue for the longer term. But there may also be opportunities in the short term to simplify the means tests in these benefits in cases where tax credits are in payment, or, as a minimum, to ease the fit between the two systems. **We would welcome views on how this could be achieved**.

Pension Credit

163 The new Pension Credit, for which proposals were published in November 2000, is due to be introduced from 2003. A key element of the Pension Credit will be a guaranteed level of income below which no pensioner should see his or her income fall. This is expected to be around £100 a week in 2003 for single pensioners and £154 for couples. To reward those who have savings income, there will be a cash addition for income over basic state pension levels, for single pensioners with incomes up to £135 a week and for couples on incomes of up to £200 a week. Support for children within pensioner families will be provided by the integrated child credit.

164 Because those of pension age may be eligible both for the Pension Credit and the employment tax credit, if they or their partner is in work, we need to look closely at how the two forms of support will interact. There are a number of ways we might tackle the potential overlap including, for example, making Pension Credit and employment tax credit mutually exclusive or taking one credit into account when assessing entitlement to the other. **We are considering which of the options best fits with the Government's aims for these two credits and would welcome views**.

165 A summary of all the specific points for consultation raised in this chapter is set out in **Part 3 Section 7.**

Part 2
Partial Regulatory Impact Assessment

NEW TAX CREDITS CONSULTATION DOCUMENT JULY 2001

CONTENTS

1 Introduction

1.1 This Regulatory Impact Assessment considers the costs and benefits of the proposed changes to the tax credits system outlined in the New Tax Credits Consultation Document, July 2001.

1.2 The introduction of the new credits is a further stage in a series of reforms aimed at relieving child poverty and encouraging people into work by making work pay. It is proposed that these objectives will be achieved through the introduction of two tax credits.

- The integrated child credit: a single payable tax credit drawing together the various strands of support for families with children to provide support to them regardless of whether or not they are in work; and
- The employment tax credit: more financial help for working households on low incomes, including those without children, and extra financial support through a childcare tax credit for working households for whom childcare costs represent a barrier to work.

1.3 These new tax credits will replace support currently available under Working Families' Tax Credit, Disabled Person's Tax Credit, the child elements of Income Support and income-based Jobseeker's Allowance, the Children's Tax Credit (which from April 2002 will include the new Baby Tax Credit for children under one), the child dependency increases in various non-means tested social security benefits and the New Deal 50+ Employment Credit. The structure of the new tax credits is summarised in the diagram on page 48.

2 Purpose and intended effect of the measures

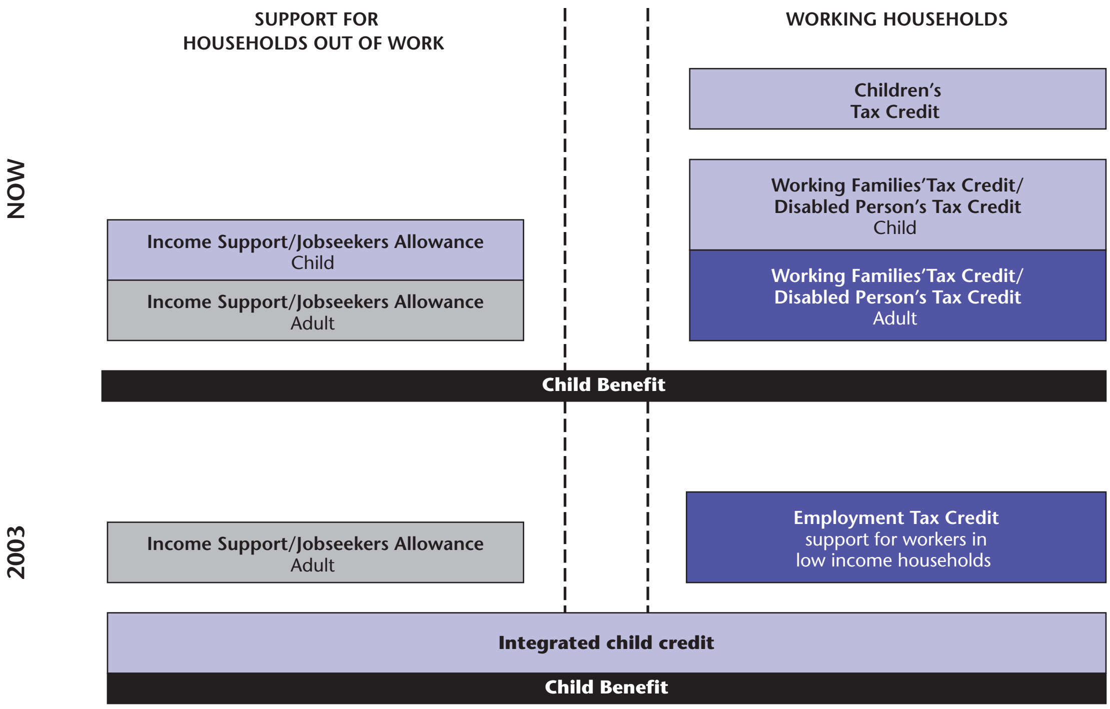
2.1 The new tax credits will extend the coverage of tax credits, building upon the framework established in Working Families' Tax Credit, Disabled Person's Tax Credit and the Children's Tax Credit. The aim of the reforms is to separate the support for working adults in a household from support for children, through distinct elements to:

- *provide financial support for families with children and tackle child poverty*, by providing a seamless, portable and secure system of support for all children in a household; and
- *enhance work incentives for low-paid workers and relieve in-work poverty,* with more financial help to those in low-paid work, whether or not they have children, encouraging people into work by making work pay.

2.2 To ensure these aims are achieved, it is proposed to:

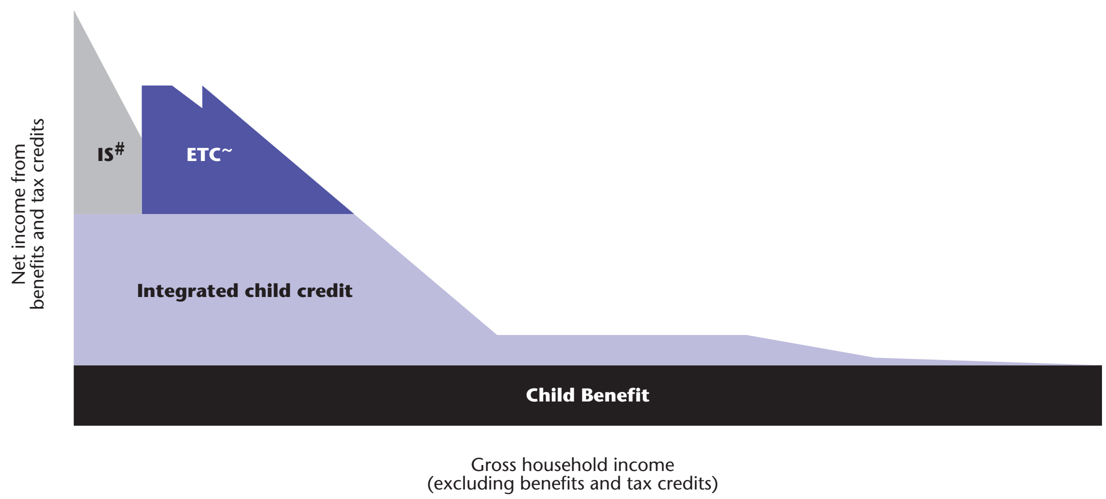
- target support at those who need it most by assessing entitlement to new tax credits on a household basis;
- maximise take-up by streamlining the systems for claiming support;
- improve customer service and increase efficiency in government by bringing the administration of tax and benefits closer together.

2.3 Structure of new tax credits compared to the existing system



2.4 The amount of new tax credits that a household will receive will be dependent on the household's income. The chart below is an illustrative example only, as the tax credits and benefits available will vary by family type. Decisions on rates of credit, tapers and thresholds will be made nearer the time of introduction, as part of the Budget process.

Support for working families with children



stands for Income Support or income-based Jobseeker's Allowance.
~ stands for the employment tax credit.

3 Assessment of the Impact of New Tax Credits

3.1 We have made an initial assessment of the impact of the new tax credits as they are envisaged at this stage. As the design of the system is refined, and in the light of responses to this document, the assessment and underlying assumptions may change. This will be reflected in the Final Regulatory Impact Assessment, which will be published alongside the Tax Credits Bill. Where specific options are currently under consultation, we have made an initial assessment of the options.

3.2 We would welcome views on the impact of new tax credits. In particular, we would appreciate input on the methodology for calculating benefits/costs to employers and the measurement of the impact on equality of treatment across various groups.

4 Benefits of New Tax Credits

4.1 There are currently around 5 million households in the population for the existing tax credits. The introduction of the new tax credits will bring more households within their scope, because they will bring in families with children getting Income Support or income-based Jobseeker's Allowance at present, as well as low-income working households without children. However, as the final details of the policy are still to be confirmed, it is not possible to say at this stage what the final size of the new tax credits population will be, nor to specify the average gains to households from each aspect of the policy.

4.2 The main benefits of the new tax credits are:

- **A seamless, secure & transparent** system of income-related support for all families with children receiving the integrated child credit, which will replace the various child-related elements in existing credits and benefits. It will be payable to families with children, subject to the household's income, irrespective of whether the adults in the family are in work or not. In place of the variety of rules and definitions in current systems, the new tax credits will use common rules and definitions to create a more consistent basis for support.

- **A separate stream of payment** for families with children, enabling direct payment of integrated child credit to the main carer. This will ensure that support is paid to the person mainly responsible for caring for the children.

  Direct payment will give families the flexibility to choose whether payments are made weekly or 4 weekly. Making payments into bank accounts will also be a more secure and flexible method of delivering payments. Work is being taken forward with the Post Office and major banks to ensure that those without bank accounts will be able to open a suitable account into which we can pay tax credits.

- **Greater continuity of payments** for households through an annual cycle of assessment. New tax credit awards will run on an annual cycle with entitlement being assessed each year and continuing unless a household's circumstances change significantly. This will ensure greater certainty about the level and continuation of support.

- **Financial support extended** through the integrated child credit to poorer families who are currently excluded from financial support, such as those headed by students and student nurses, who do not qualify for either in-work or out of work support but who do qualify for Child Benefit.

- **Relieving in-work poverty & enhancing work incentives** for low-income working households without children. The employment tax credit extends financial support to workers without dependent children, a disability or illness, provided they are in full time employment.

  An employment tax credit award will run for up to a year, initially based on the previous year's income, providing greater continuity for households receiving employment tax credit.

Calculating the level of household income on the basis of gross rather than net income would help households who either pay no tax or are in the 10p tax band. This would have a beneficial effect on levels of in-work poverty.

Similarly, assessing income on the basis of gross income could improve work incentives for the second adult in a household, compared to a net income measure.

- **A single system of support** for working households. The employment tax credit incorporates all the elements of support for working adults from Working Families' Tax Credit and Disabled Person's Tax Credit, creating a single mechanism to support low-income working households with and without children. Having a single tax credit will bring disabled workers within a common framework based on work, rather than singling them out because they have a disability.
- **More generous support for workers with a disability or illness**. Making an additional payment for each disabled worker in a household will benefit households where both workers in a couple have a disability or illness.
- **The nature of support for workers with a disability or illness** will reduce stigma and make it easier for those with fluctuating disabilities or illnesses to claim. It will be less easy for employers to identify which tax credit recipients have a disability, as those with and without children can both receive employment tax credit.
- **A more responsive approach to changes in childcare arrangements**. The childcare tax credit in employment tax credit will be more responsive to changes in childcare arrangements, as it will be recalculated whenever a household changes provider, or a child is placed with or removed from an eligible provider, or even when childcare charges change.
- **A simpler application process**. Low-income working households with children will be able to apply for the new tax credits through a single application covering both integrated child credit and employment tax credit.

  Moving to an award running for up to 12 months, based on the tax year, will minimise the work involved in applying for the credits. In particular, households will be able to refer to information already provided for tax purposes, such as P60s and Self Assessment returns.

  For households who will be entitled to both Income Support/income-based Jobseeker's Allowance and integrated child credit, the integrated child credit award will automatically be set at the maximum rate while they remain on these benefits.
- **More straightforward application for the self employed**. Basing the income assessment for the self-employed on their taxable profits is designed to make the assessment of self-employed income as simple as possible, creating consistency of treatment across tax and tax credit rules. Under these proposals, self-employed people who currently provide figures for the previous six months when applying for tax credits, will be able to use information they already have from their most recent Self Assessment return to apply for the new tax credits.

  Self-employed people who currently qualify for the Children's Tax Credit by providing details through their Self Assessment return will have to apply for the integrated child credit separately.

- **Simpler and less time consuming for employers to implement** (see section 5.1 for more details).

5 Impact of New Tax Credits on Specific Groups

5.1 Impact on businesses

Employers

5.1.1 New tax credits will have an impact on employers because employment tax credit recipients will receive their tax credits with their pay, in the same way as many current tax credit recipients.

5.1.2 We estimate, based on current rates of support, that the total number of individuals receiving their tax credits though the wage packet will be unchanged, although some of the actual recipients will change. This is because some of the households who would previously have been paid via the employer will receive integrated child credit only, which will be paid to them directly. This reduction will offset the extension of the employment tax credit to households without dependent children.

5.1.3 By 2003, we expect around 300,000 employers[i] to be paying Working Families' Tax Credit and Disabled Person's Tax Credit through the payroll. As the total number of tax credit recipients paid via the employer is not expected to change, we think that the number of employers paying new tax credits will stay much the same.

5.1.4 There are several areas where the new credits have been specifically designed to make it easier for employers to pay tax credits, and these changes represent significant cost savings.

- First, the move to an annual cycle of awards with no specified end date will eliminate the work created by the six monthly stops and starts, which are a feature of Working Families' Tax Credit and Disabled Person's Tax Credit. This is expected to reduce employer costs by around £9.5million.[ii]
- Second, because the employment tax credit will cease when a recipient leaves employment, employers will no longer be required to complete a Certificate of Payments, saving employers an estimated £850,000 per year.[iii]
- Third, employers will not routinely be required to complete an earnings enquiry form as the new tax credits application form will use information already available to the claimant, for example, P45s, P60s and Self Assessment Returns.

5.1.5 We are considering standardising the system for all employers by introducing a single 42-day notice period for all employment tax credit cases, rather than the current 14 days where an employee is paid weekly. We are also considering automatically increasing the amount of advance funding paid to an employer when a new employee becomes entitled to the employment tax credit through the payroll (see section 6.2).

5.1.6 The move to a system of awards running for up to one year rather than 6 months will mean many employers will need to make fewer adjustments to the amounts paid via the payroll. On the other hand, the more responsive nature of the new tax credit system could result in some employers having to adjust the amount they pay to individuals during the year. The net effect of this change on employers will depend on the level of responsiveness of the system.

Transition

5.1.7 Employers who run PAYE schemes will have to be prepared by 2003 for the introduction of the new tax credits, as some of their employees may apply for employment tax credit which is paid through the wage packet. As with any change to an aspect of payroll systems, employers will need to make sure that their systems are ready in time for the new system starting. The system of paying the employment tax credit through the payroll will be broadly the same as that used to pay Working Families' Tax Credit and Disabled Person's Tax Credit, so for employers that currently pay Working Families' Tax Credit or Disabled Person's Tax Credit, we expect that they will not have to make any significant changes to their systems.

5.1.8 Those employers who have to pay tax credits for the first time are likely to have to spend more time becoming accustomed to tax credits than those who are already paying tax credits. We will be investing in a programme of education and assistance to ensure that employers are given all the help necessary from the Inland Revenue to enable them to pay tax credits. We will also be considering the impact of these changes on small employers and the potential for a differential impact amongst certain sectors of business.

5.1.9 To help employers familiarise themselves with the employment tax credit and systems needed to operate payment via the employer, we are considering whether to suspend payment via the employer for Working Families' Tax Credit and Disabled Person's Tax Credit in the months before the introduction of employment tax credit.

In summary,

5.1.10 The move to new tax credits is likely to affect employers in the following ways:

- In general, employers will pay employment tax credit recipients through the payroll in the same way as they pay Working Families' Tax Credit/Disabled Person's Tax Credit at present.
- However, some employers who now pay Working Families' Tax Credit/Disabled Person's Tax Credit will not have to pay the employment tax credit in future, whereas other employers who do not currently pay tax credits may have to pay employment tax credit via the wage packet.
- Employers will be notified to pay the employment tax credit on an 'until further notice' basis and employers will be notified when they need to stop or change the payments.
- Employers will not have to deal with six monthly starts and stops as the system will run on an annual basis.
- Employers will not have to complete Certificates of Payments.
- Employers will not have to complete Earnings Enquiries forms.
- Some employers may be asked to adjust the daily rate they pay to individuals part way through the year.

We do not expect the numbers of employers involved in the payment of the tax credits to increase. And, because of the changes we propose in the way the system works, we expect the compliance costs for employers to be unchanged, or even to fall once the transition period is over.

5.2 Impact on Government

5.2.1 The move to new tax credits will entail transitional costs from the development of new IT and telephony systems. The Inland Revenue and the Department for Work and Pensions will face increased costs as IT systems are adapted for the changes in Income Support/income-based Jobseeker's Allowance and the introduction of new tax credits. The transition from the existing systems to the new tax credits will also involve some increases in administration costs which will last for the duration of the transition.

5.2.2 These costs need to be balanced against the gains from putting in place a modern and efficient system for delivering targeted support for families, that will be simple and easy to access. Systems and processes are constantly updated so that Government can continue to provide an improving service. It makes sense to invest in updating systems at this time to complement the policy changes which are being put in place to deliver a secure and easily accessible new tax credits system.

5.2.3 In the lead up to 2003, Inland Revenue and Jobcentre Plus (the new agency of Department for Work and Pensions) will be investing in publicity and educational materials to ensure that those eligible for the new tax credits will be aware of what they need to do. Those currently receiving support through tax credits and social security benefits will be specifically targeted to ensure that they make a seamless transition to the new tax credits.

5.2.4 There will be some costs associated with the adaptation of processes for the handling of benefit and tax credit applications by Jobcentre Plus, the Pension Service, Inland Revenue and local authorities, including the transfer of information between these organisations. However, some of these increased administration costs will be offset by lower long-term administration costs for the Department for Work and Pensions, as from 2004, Income Support and income-based Jobseekers Allowance applications will be simpler and there will be fewer cases.

Passported benefits

5.2.5 For administrative simplicity, other Government Departments, Devolved Administrations and Local Authorities currently use the existing Working Families' Tax Credit, Disabled Person's Tax Credit, Income Support and income-based Jobseeker's Allowance systems to provide ready-made income based 'passports' to certain benefits which they administer. These benefits range from access to free prescriptions and free school meals to help with improving heat efficiency in homes. The 'passport' is either receipt of a tax credit or benefit or receipt of a certain level of tax credit.

5.2.6 Those who provide these passported benefits are reviewing the methods by which they will assess entitlement, once new tax credits are in place. This represents an opportunity for rationalisation and simplification of the way these passports are administered. The new tax credits will provide a vehicle for better targeting these passports according to family income. This transition process may mean some extra work for other Government Departments, devolved administrations and Local Authorities but any resulting costs will depend on the extent of change to existing systems.

5.3 Impact on claimants

5.3.1 The new tax credits will provide targeted support, with awards based on household income. This will make it possible to direct resources to those households whose needs are greatest. The financial impact on different types of household cannot be established until the rates and thresholds for the new tax credits are decided, which will be nearer the time of implementation.

5.3.2 The Children's Tax Credit is a relief from income tax available in respect of a particular tax year. In practice, around two and a half million households out of the five million who are eligible to receive the Children's Tax Credit are likely to have to make a formal claim for Children's Tax Credit only once. For the integrated child credit, we are aiming to make the application and renewal process as simple as possible and we are considering whether we could remove the need for annual renewals from households who are unlikely to see their entitlement change from one year to the next.

5.3.3 At present, Working Families' Tax Credit and Disabled Person's Tax Credit awards are fixed for six months. During this time, the award does not respond to any changes in household income. If, after six months, the household reapplies for a tax credit, the household's income is re-assessed at that point. From 2003, tax credit entitlement will be based on a household's income for a tax year. Initially, the award will be based on income in the previous year. It will run until the end of the tax year unless there is a significant change in the household's circumstances, which would affect their tax credit entitlement. Households could have their award re-assessed during the year so that the new tax credits will respond more quickly to changing need, including when their income in the current year is expected to be significantly higher than last year's.

5.3.4 Households who claim the childcare tax credit element of the employment tax credit will be asked to keep sufficient records to show that the information they provided about childcare costs is accurate. We are considering whether there are alternative approaches to the current requirement for childcare providers to certify the arrangements made with parents, which would reduce administrative costs for providers.

Transition

5.3.5 As with any significant changes to tax and benefits systems, people will initially need to take some time to fully familiarise themselves with the new system. However, information and education in advance of the transition should ensure that all those eligible to apply for the new tax credits will be aware of what they need to do.

5.3.6 During the transition from Working Families' Tax Credit and Disabled Person's Tax Credit to new tax credits, some households may have both to apply for these credits and complete an application for new tax credits in close succession. We aim to minimise the administrative requirements on claimants and want to avoid this situation as far as possible. Therefore, we are considering lengthening some Working Families' Tax Credit/Disabled Person's Tax Credit awards so that claimants do not have to make Working Families' Tax Credit/Disabled Person's Tax Credit applications in 2003 for very short awards.

5.3.7 Those who receive Income Support or income based Jobseeker's Allowance and have children (around 1.3 million families*) will have their records automatically transferred to the integrated child credit in 2004. They will not have to go through a new application process. They will receive the maximum child credit they are entitled to, for as long as they remain on Income Support and income-based Jobseeker's Allowance.

6 Impacts of Additional Measures

6.1 The impacts outlined in sections 4 and 5 above do not include the possible impacts of the following measures which are outlined in the consultation document.

6.2 Advance funding for employers (Consultation Document Chapter 3)

6.2.1 Option [i]: No change to current arrangements – any change in funding requirements would require employers to reapply for the appropriate new level of funding.

- Employers currently operating payment via the employer are already familiar with the current system;
- Employers would know exactly what funding they would be receiving from one month to the next.

6.2.2 Option [ii]: Once an employer has advance funding to pay the employment tax credit, the Inland Revenue would automatically adjust the level of funding whenever the number of employees entitled to the employment tax credit through that employer's payroll changed.

- On the basis of Working Families' Tax Credit and Disabled Person's Tax Credit experience, we expect that from 2003, around 50,000-60,000 employers will receive funding at some point during the year. This option would limit the extent to which employers had to contact the Inland Revenue to revise their advance funding arrangements.
- Where employers already have systems in place to apply for funding, they might need to adapt them to take account of this.

6.3 Payment method for the childcare tax credit in the employment tax credit (Consultation Document Chapter 4).

6.3.1 Option [i]: Paying the childcare tax credit with the employment tax credit <u>via the employer</u>.

- Paying the childcare tax credit in the employment tax credit via the employer would strengthen the link between work and help with the costs of childcare.
- Many households currently receiving help with their childcare costs through Working Families' Tax Credit or Disabled Person's Tax Credit already receive this support via the employer, and so would be familiar with the system. Any changes could require households to familiarise themselves with the new system and, where necessary, make changes to their household's financial arrangements.

6.3.2 Option [ii]: Paying the childcare tax credit element of the employment tax credit <u>direct</u> to the main carer.

- Paying childcare tax credit direct would mean some recipients received payments more frequently, which might help those who make frequent payments to their provider.
- Paying the childcare tax credit in the employment tax credit direct could facilitate faster changes to childcare payments if childcare arrangements changed.
- Employers would have to make fewer employment tax credit payments, as a number of recipients would only be receiving the childcare element of the employment tax credit.
- Not having to pay the childcare tax credit with the rest of the employment tax credit payment could also reduce the number of employers needing funding, thus reducing costs to employers.

- Paying to the main carer ensures that the person more likely to be responsible for arranging childcare receives the support.

6.4 Treatment of Benefits in Kind (BiK) (Consultation Document Chapter 5)

6.4.1 Option [i]: Continue to ignore broadly all BiK in the assessment of income.

- This option would make the application process simpler, as claimants would not have to provide details of BiK.
- This option would impose no additional costs on employers.

6.4.2 Option [ii]: Take into account all BiK, however small, and require everyone who applies for tax credits to report their value

- Taking into account all BiK would be the fairest way of assessing households' resources and be consistent with income tax treatment.
- This option would increase reporting requirements for many employees who only get insignificant amounts of BiK.
- As tax credit claimants would use information already provided on P11Ds, employers will not have to make any separate calculation of BiK.

6.4.3 Option [iii]: Take into account only the commonest high value BiK such as company cars and associated fuel payments.

- Taking into account high value BiK would be a fairer way to assess a household's resources than the system used at present but retains some of the scope for inequities arising from not taking BiK into account.
- This option would increase reporting requirements for some employees who get significant amounts of BiK.
- As tax credit claimants would use information already provided on P11Ds, employers would not have to make any separate calculation of BiK.

7 Securing Compliance

7.1 It is important that new tax credits are paid only to those who are genuinely entitled, and that the system is as secure against fraud as is practicable. The more supporting information applicants are required to provide, the more checks are able to be carried out, but the greater the danger that those genuinely entitled will be put off by the complexity of the application process.

7.2 We believe that we have got the balance broadly right for Working Families' Tax Credit and Disabled Person's Tax Credit, but there are a number of changes with new tax credits which should reduce the administrative costs on claimants, employers and childcare providers, and maintain or enhance the security of the system.

7.3 Income for new tax credits will broadly be based on annual income, unlike income for Working Families' Tax Credit and Disabled Person's Tax Credit purposes, which is based on take home pay for a 'snapshot' period. This means that employed claimants will no longer have to do a calculation based on a number of payslips, but can use the figure from their P60. The self-employed can use the same income figure they submit for tax purposes.

7.4 As well as making things easier for claimants, this means that the Inland Revenue can check reported income against their PAYE and SA systems. While with Working Families' Tax Credit and Disabled Person's Tax Credit, the Revenue can compare a claimant's income for tax credits with that for tax purposes, this is often of little value because the two incomes are determined on different bases and over different timeframes.

7.5 Claimants will still be required to supply details of their employer and, if applicable, their childcare provider, and these will be subject to targeted checks. However, they will not need to ask employers to fill in earnings enquiry forms.

7.6 This, along with the Revenue's ability to check against information provided for tax purposes, will provide a more effective way of spotting fraudulent applications, as well as reducing the overall administrative costs for claimants and employers.

8 Impact on Small Business

8.1 We think that the costs of the new tax credits to small employers should be less than under Working Families' Tax Credit/Disabled Person's Tax Credit. The absence of Earnings Enquiries and Certificate of Payments forms will benefit all employers. Small employers could also benefit from the proposal to automatically increase the funding amount when additional employees become entitled to the employment tax credit without having to submit a revised funding application.

8.2 As the system of paying the employment tax credit through the payroll will be broadly the same as that used to pay Working Families' Tax Credit and Disabled Person's Tax Credit, we expect that the transition from the existing tax credits to the new tax credits will not require employers to make significant changes to their systems. However, to help small businesses and other employers familiarise themselves with employment tax credit, the Inland Revenue will be providing comprehensive help and guidance and in addition we are considering whether to suspend payment via the employer for Working Families' Tax Credit and Disabled Person's Tax Credit in the months immediately before the transition to the new tax credits. We plan to consult groups of small employers during the consultation period to explore whether these changes will make the system easier for small employers.

9 Equality Issues

9.1 In addition to assessing the regulatory impact of the new tax credits, we are assessing whether this policy has any differential impacts on the equality of treatment between various groups in society[1]. This is being carried out in accordance with Cabinet Office guidelines and our duties under s75 of the Northern Ireland Act 1998. We will therefore be looking at available data and research to establish what impact replacing the current methods of support by new tax credits will have for different groups.

9.2 The aims and the general shape of the proposed policy are set out in our consultation document. This partial RIA sets out our initial thoughts on the major impacts of the new system by comparison with the current systems of support available. From our initial policy assessment, against the background of the information currently available to us, we believe that this policy should generally have a positive impact on all potential recipients, improving the position of some of the more disadvantaged groups in society.

9.3 The new tax credits are intended to promote equality of opportunity: helping families with children; making work pay for those who face financial barriers into the labour market and tackling poverty .

The new system will:

- For the first time, extend access to in-work support to people without children or a disability, recognising that they can face financial barriers too, and therefore offering more equal treatment for this group compared to the current system.
- Offer access to support for the first time to certain groups with children who have been denied it to date, namely those who fall between the classifications of work and benefit, such as students and student nurses.

Looking at specific groups, the precise impact will depend on the final rates and thresholds which have not yet been decided. However, we can say the following:

- Much of the benefit of the new integrated child credit will go to women, since they are more likely to be the main carer for children in a couple and will now receive the integrated child credit direct. Also, lone parents make up around a quarter of families with children and over 90% of them are women.
- Disabled people will continue to benefit from support as now.
- Amongst people without children, extra help is being targeted on those aged 25 or more. This reflects the labour market objectives of the employment tax credit, and the greater labour market problems faced by this group, as explained in Chapter 3 of the Consultation Document. The exclusion of younger people enables the employment tax credit to fulfil its objectives of helping those caught in the poverty trap, rather than those in their first jobs with potential for substantial wage progression.

[1] The areas we have specifically considered are: gender, disability, marital status, sexual orientation, those with dependants, age, race, political and religious beliefs.

- The consultation document discusses the issues around the proposal to move the New Deal 50+ Employment Credit into the employment tax credit. The basis for providing additional support to this age group is not being assessed here, as we are replicating support already available to this age group, which has gone through a separate policy assessment. But a consequence of this change is to move applicants onto a household basis of assessment. This may (subject to final decisions on policy design, rates and tapers) affect the levels of support available to those in this age group, who meet the other basic eligibility criteria, where there is a second or even main earner in the family. We believe that the change to a household assessment should enable us to target support to those older families living in low-income households.
- Women are statistically more likely to work part-time than men (part-time is defined as working 16-29 hours per week), although for those without dependent children this divide reduces slightly. Part of this difference may be due to other caring responsibilities. The aim of the employment tax credit is to encourage those without caring responsibilities to move into full-time work, as evidence indicates that this increases their long-term attachment to work and improves their chances of moving out of poverty.
- We do not believe that there will be any negative differential impacts arising from a person's sexual orientation, political or religious beliefs. The policy follows the general approach across government and replicates the current treatment in Income Support, Jobseeker's Allowance, Working Families' Tax Credit, Disabled Person's Tax Credit and Children's Tax Credit.
- The new tax credits, in line with the current systems of support, are not designed to provide support to those caring for adult dependants. But, as the consultation document makes clear, we are keen to explore how support could be extended to this group. Subject to any developments in this area, we will broadly be following existing policy, so we do not anticipate that new tax credits will have any greater differential impact on this group.
- The concept of paying support to the 'main carer' is not gender specific, but women are more likely to care for children and so benefit from support for families with children. Payment of this support direct to the main carer, rather than to the person in work in a household, will shift support towards women and away from men. We are also looking at the possible impact of directing employment tax credit payments to the person in work on the balance of payments to men and women. Also, the extension of support to those not designated as being in work – for example, students and student nurses – will again target support mainly towards women.

9.4 We will continue to monitor the equality impact of the new tax credits and this, together with the data available from our analysis of the current tax credit systems, will inform our full equality impact assessment.[2]

[2] The final equality impact assessment will form part of the final RIA to be published after the conclusion of this consultation period.

10 Consultation

This Partial RIA forms part of a wider consultation document issued by the Revenue on 19 July 2001 at the start of a 12-week period of consultation that ends on 12 October 2001. This consultation covers all aspects of the new tax credits proposals and we are looking for responses from a wide range of individuals and organisations to assist us in setting the final policy prior to legislation. In addition to this consultation, we have already held informal discussions with representatives of employers and payroll software developers and also spoken informally to representatives from disability, children and family-related groups about our proposals. We are looking to continue and expand these discussion groups over the formal consultation period. We intend to reflect the results of these consultations and discussions in the final RIA and draft legislation in the autumn.

Notes

i This estimate is based on information taken from the latest Working Families' Tax Credit administrative statistics.

ii At present, around 1 million Working Families' Tax Credit and Disabled Person's Tax Credit recipients who are paid via the employer renew their tax credit award each year. We assume that the move from a 6-month award to a 12-month award period will eliminate around half of all renewals. Secondly, we assume that removing the need to stop payments in advance of a renewal will halve the time taken by an employer to stop and then restart an award, implying a cost saving for the remaining 500,000 renewals.

The Working Families' Tax Credit and Disabled Person's Tax Credit RIA estimated that around 35% of tax credit recipients paid via the employer work for small or medium-sized employers, and that to manually stop or start a tax credit would involve around 30 minutes' work by a proprietor or adviser at a cost of £20 per hour. For large employers with more sophisticated systems, a stop or start is likely to take no more than 30 minutes for a payroll operator, at £10 per hour.
On this basis, reducing the need for stops & starts will decrease employer costs by an estimated £9.5 million per year.

iii By 2002-03, an estimated 85,000 Certificates of Payments will be issued each year under Working Families' Tax Credit and Disabled Person's Tax Credit. As set out in the Working Families' Tax Credit and Disabled Person's Tax Credit RIA, we assume that Certificates of Payments are always completed manually, and take 30 minutes to complete, at, say, £20 per hour. On this basis, this change will reduce costs to the employer by around £850,000.

Part 3

1 Summary of Consultation points

The following questions bring together the issues we have raised for consultation.

2 Support for families with children (Chapter 2)

- We plan to produce guidance along the same lines as the current Working Families' Tax Credit guidance, which would be available to staff and to claimants indicating the types of facts we would look at to determine who was the main carer for a child. We would welcome views on whether this guidance is a good model or on how it could be improved.
- As integrated child credit will run as a single system across the whole UK, we propose to continue entitlement until the September after a child's 16th birthday. We would welcome views on this.
- We have the following proposals on circumstances that may affect when a family qualifies for support, on which we would like views
  - continuing tax credit entitlement for a specific period after the death of a child, for example, for six weeks;
  - paying tax credits for a child placed in care or for adoption with a family by a Local Authority, unless that Local Authority is making payment for that child's maintenance;
  - treating long periods in hospital in the same way as any other period during which the child is temporarily not living with the family.

3 Support for low-income households in work (Chapter 3)

- We would welcome views on the case for making the 30 hour element of employment tax credit available to couples with children who jointly work 30 hours or more a week, even if neither of them individually works 30 hours.
- We are considering how best we could define the working hours requirement in employment tax credit in a way that is easy to understand and apply and reflects the flexible working patterns common in a dynamic labour market, and would be interested in views.
- We would welcome views on extending the current two year linking rule for those on disability benefits, to provide protection for a wider group of workers with disabilities.
- We propose to incorporate the New Deal 50+ Employment Credit payments in the employment tax credit, and we would welcome views on our proposals.
- There are a number of areas where we are considering changing the current arrangements for making payments via the employer, to make the system run more smoothly. These include:
  - paying tax credits on a continuing basis, removing the gap in payment inherent in the current system;
  - removing the requirement to provide Certificates of Payments when an employee leaves employment;

– removing the current routine request for information on earnings and hours at the start of an award;

– automatically increasing the funding paid to employers when a new employee becomes entitled to employment tax credit;

– giving employers 42 days' notice of employment tax credit payments.

- We would be interested in views on a workable definition of a 'carer'; to identify those who are disadvantaged in the labour market by their caring responsibilities for other adults.

- As a first step in the longer term development of the employment tax credit, we would welcome initial views on how to revise the elegibility criteria for those with a disability.

4 Support for childcare costs (Chapter 4)

- We are considering the arguments for paying the childcare element of the employment tax credit direct to the main carer, and would welcome views.

- We would like views on the options for assessing and verifying the amount of childcare costs eligible for support outlined below:

– basing the assessment of costs on current childcare costs notified to us by the household;

– requiring families to notify us of changes in childcare arrangements to enable us to respond to changes in their childcare needs;

– requiring households to keep adequate records of childcare costs as evidence to support their claim, which the Revenue may ask to check;

.– requiring childcare users to get confirmation of their arrangements in writing from childcare providers;

– the Revenue checking the details provided about childcare use with the provider in a sample of cases.

5 A targeted means of support (Chapter 5)

- We think there are three main approaches we could use for dealing with benefits in kind, on which we would welcome views. These are:

– ignore all benefits in kind, and so keep the rules simple at the expense of some inequity and poor targeting;

– take all benefits in kind into account, ensuring fairness and better targeting, and accept that the price paid for that is a certain increase in complexity for employees receiving benefits in kind; or

– take into account only the most common benefits in kind of a significant value (the most obvious examples being company cars and fuel).

- We propose to look at each social security benefit in turn and consider what approach should be taken for the purposes of new tax credits. We would welcome views about the appropriate treatment of particular benefits in new tax credits

- We propose to take other forms of income into account only where, in aggregate, they exceed a certain level, although we need to consider carefully what that level should be. We would welcome views.

- We would be interested in views on whether the full disregard of child maintenance payments in Working Families' Tax Credit and Disabled Person's Tax Credit achieved its objectives, and whether maintenance payments should similarly be disregarded for the purposes of new tax credits.
- We would welcome views on what treatment should be given to student loans in new tax credits.

6 How the system might work (Chapter 6)

- We would welcome views on the level of an appropriate threshold for changes in income to which the new tax credit should respond.

7 Bringing the tax and benefits systems closer (Chapter 7)

- We are committed to bringing the tax and benefits systems more closely into line and would welcome views on:
  - How we could simplify the Housing Benefit and Council Tax Benefit means tests in cases where tax credits are paid;
  - How to handle cases where a household is eligible for both the Pension Credit and the employment tax credit.

Glossary

Within this consultation document, we have referred to a number of tax credits and benefits and, where these could not be avoided, used some technical terms. For clarity, brief descriptions are given here.

Name	***Full title and meaning where appropriate***
Income-based Jobseeker's Allowance	This is the means-tested element of Jobseeker's Allowance. Premia are awarded on the same basis as in Income Support. It is only this element of Jobseeker's Allowance that will be affected by the new tax credits.
Children's Tax Credit	An income tax relief, introduced in April 2001. It is available through the tax system to taxpaying families and is gradually withdrawn where the individual claiming it pays tax at the higher rate.
Working Families' Tax Credit	A payable tax credit, introduced in October 1999. It is available to working families with children and is gradually withdrawn as family income increases.
Disabled Person's Tax Credit	A payable tax credit, introduced in October 1999. It is available to working people with a disability whether or not they have children. It is gradually withdrawn as income rises.
Child Dependency Increases	Child Dependency Increases are paid as part of the support available to families with children who receive some types of benefits.
Pension Credit	The new credit for pensioners to be introduced from 2003. It will provide a minimum income guarantee to all pensioners and will also reward those with modest income of their own above the level of basic state pension.
Benefits in kind	The tax term for non-cash benefits paid by employers instead of cash wages. Examples of benefits in kind are the personal use of a company car and free petrol.
Individual Savings Account (ISA)	The tax-free savings vehicle which replaced Personal Equity Plans (PEPs) and Tax Exempt Special Savings Accounts (TESSAs) in 1999.
Pay As You Earn	System by which tax and National Insurance are deducted from earnings before they are paid.
Jobcentre Plus	This is the new agency within the Department for Work and Pensions that provides services to people of working age. Similar work was formerly carried out by the Employment Service within Department for Education and Employment and the parts of Benefits Agency within the Department of Social Security.
Employment Credit 50+	Payment under New Deal 50+ for 52 weeks made to anyone aged 50 or over returning to work after at least six months' unemployment or inactivity, whose income is no more than £15,000 a year.

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