Tax Credits

There are two relevant tax credits - child tax credit (CTC) and working tax credit (WTC). You can claim for both if you are 25 or over and work 30 hours a week. (There are different rules for under 25s).

The system works by adding together those elements for which you qualify, then looking at your income, and reducing the amount of credit (the "abatement") accordingly. If your income is too high, the credits reduce to nil. The maximum income for CTC is c£58k (£66k if there is a child under 1).

The initial claim is based on the previous year's income and revised when the income for the actual year is known.

There are major tax planning opportunities in certain circumstances, because it may be possible to reduce your income by making pension contributions, or by investing in your business and claiming capital allowances, and thereby increase the tax credit.

In addition, an increase in income from one year to another of up to £25,000 is disregarded - ie you are considered to have the same income in year 2 as in year 1 - which means that the tax credit benefit of such an income reduction in one year can apply also to the following year.

Example[1]

David and Victoria are married with 2 children. They both work, and pay childcare of £250 per week. Their total income is £30,000.

They qualify for the following elements

WTC	
Basic	1730
Couple	1700
30 hours	702
Childcare (£250x52x80%)	10400
CTC	
Family	545
Child x2	3690
Total	18770

Abatement

[1] Rates of tax, NI and tax credit in this article are those applying in 2007-8

Income	30000	
Less threshold	(5220)	
	24780	
x37%	(9169)	
Tax Credit payable		9601

David decides to buy a new energy efficient car for his business, qualifying for 100% FYA, and costing £10,000. There will be 20% private use, which is disallowed for tax, so his taxable income is reduced by £8,000. He therefore saves tax of 22%, and class 4 NI of 8%, a total of £2,400 (£8,000x30%). It also reduces the family income to £22,000, and reduces the tax credit abatement, (increasing the tax credit payable) by £2,960.

In the following year, actual income is again £30,000. However, because of the income disregard, the amount of £22,000 is again used for tax credits. So the car counts twice!

Hence:

Cost of car		10000
Tax & NI saved	2400	
Tax credit increase	5920	
(8320)		
Cost of car after tax		1680

Tax planning point

Capital expenditure can be used to reduce income and increase tax credit claims. A similar effect can be achieved using pension contributions.

A critical point about tax credits is that they can only be backdated for 3 months before the date of the application. This means that if there is a nasty surprise on the income front more than 3 months into the tax year, the claim will be less than it might have been if a “protective” claim had been made.

Example

Bob the Builder, a single parent with 4 children, usually earns £75,000 per year, so he doesn’t make any claim for tax credits. In September one of his clients goes bust, owing him £10,000. Then on December 1st he falls off a ladder, and cannot work again that year. His final income for the year is only 8 months work instead of 12, and he earns £50,000, less his bad debt of £10,000. On January 1st he realises that he is eligible for tax credits and makes his claim, which is backdated to October 1st.

WTC			
Basic		1730	
Lone parent		1700	
30 hours		705	
Childcare (£300x52x80%)			12480
CTC			
Family			545
Child x 4		7380	
Total			24540
Abatement			
Income	40000		
Less threshold	(5220)		
34780			
x37%		(12868)	
Tax Credit full year			11672
Days claimed: 182/ 365			
Tax credit payable			5820
Tax credit unclaimed			5852

Bob would have received the amount of £11,672 if he had claimed from the beginning of the year on a precautionary basis. At first he would not receive anything. However, when he advises his change of circumstances and income, his claim is changed for the whole year.

Tax planning point

A claim for tax credits should be made as early as possible. Even if it appears that no credit will be due, circumstances may change.

Regarding childcare, there is a weekly tax free allowance of £55 for employees. If this is accepted it may reduce the amount of tax credits payable. It may therefore be better to accept normal salary, or an alternative benefit. HMRC provides a calculator at: http://ccincalculator.inlandrevenue.gov.uk/CCIN1.aspx

Finally on tax credits, it is imperative to keep renewals up to date. A renewal pack is sent out in April and must be returned by July 31st to keep the claim live. There are also certain changes in circumstances that must be reported promptly to avoid penalty.