ACCA

technical factsheet 138

Child Tax Credit

Tax credits were introduced in order to help people on low incomes without discouraging hard work, and the idea was to allow benefits to be claimed through HM Revenue and Customs. There are two main tax credits: working tax credit which is available to working people on low incomes, and child tax credit, which is for people with children, whether they are working or not. Child tax credits are available to people on surprisingly high incomes, the basic element being available until family income exceeds £50,000 (in 2009/10 and 2010/11). At that point it is tapered away at the rate of £1 for every £15 of further income (or 6.67%), which gives a cut off point of £58,175.

Because benefits are traditionally outside of the scope of work accountants usually handle for their clients, many practitioners have disregarded tax credits. It would however be good practice to at least inform clients of tax credit deadlines, and it is important to be aware of any tax credit implications of any other tax work a practitioner may carry out for existing clients. It is possible that tax credits due could be lost if prompt action is not taken, as claims can only be backdated three months. Additionally trading losses and capital allowance claims need to be considered carefully in the light of how they may affect the level of tax credits due.

Letters of engagement

It is important that the letter of engagement sets out the position with regard to tax credits. If a practitioner makes the decision not to get involved in any tax credit work, it should be expressly excluded in the letter of engagement, after having regard to the Unfair Contract Terms Act 1977. If it is not expressly mentioned, and the engagement is of a tax compliance nature, the client could well claim that he/she had not been properly advised. As claims can only be backdated for three months, it is possible that tax credits due could be lost if prompt action is not taken.

Outline

Child tax credit is for people who are legally responsible for at least one child or qualifying young person. Although separate taxation has now been in place for some years, tax credits applications must be joint applications if a claimant is part of a couple. The basic element of child tax credit is payable until family income exceeds £50,000 p.a., and then it is tapered away at £1 per every further £15 of income, giving a cut off point of £58,175

The child tax credit is made up of several elements:

Element	Maximum annual rate 2009-10	Maximum annual rate 2010-11
Family element*	£545	£545
Family element for a child under the age of one*	£1,090	£1,090
Child or young person element	£2,235	£2,300
Disability element - where the child or young person is disabled**	£4,905	£5,015
Severe disability element - where the child or young person is severely disabled**	£5,980	£6,110

* The two amounts of family element are mutually exclusive: one amount per family.

** The child or young person elements, including the higher amounts in respect of disability or severe disability, are mutually exclusive: one element, the highest for which the child or young person qualifies, will be payable for each child or young person.

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In addition, claimants may be entitled to working tax credit if their income is low enough. Working tax credit includes a childcare element if the claimant has to pay childcare costs.

Critical dates

An initial claim for child tax credit cannot usually be backdated for more than three months. The renewal deadline is 31 July. At the start of the tax year tax credits are paid on a provisional basis based on the previous year's income but will be finalised and recalculated after the year end using actual income. If, as may often be the case, income has increased, tax credits will only be recalculated if the increase is more than £25,000 (for 2009/10 and 2010/11).

All examples consider only child tax credits, not any working tax credit that may also be due.

Example (all examples consider only child tax credit, not working tax credits.

Consider Colin and Elisabeth who both work and have two children. They have no childcare costs. In 2009/10 Colin earns £9,000 and Elisabeth earns £4,000. They will be entitled to child tax credits of £5,015. In 2010/11 Colin changes his job and his earnings for that year are £30,000, while Elisabeth's wages increase to £4,500. The increase in the family income is £21,500, which is less than the £25,000 disregard, so in 2010/11 they will receive £5,145 (2010/11 rates).

Income

To calculate entitlement to tax credits it is necessary to look at the claimant's income. Self employed income for this purpose will be the taxable profit for the tax year. In this context, "taxable profit" has the same meaning as it has in Part 2 of ITTOIA 2005.

Trading loss reliefs for tax credits

If a loss is made, then it will be set against any other income for that year, including income of any joint claimant, to reach an income figure for tax credits purposes. If a loss is carried forward, it will reduce any taxable profit in the following year, producing a lower figure for tax credit purposes.

Example

Consider Victoria and David, a couple who both work and have two children. David is self employed and he made a loss in 2009/10 of £5000. Victoria works part time and earns £10,000. The net family income is therefore £5,000. They will be entitled to £5,015 child tax credits. In 2010/11 if David makes a profit of £18,000, this means the total family income is £28,000, compared to £5,000 in the previous year. As the increase is less than £25,000, the couple's child tax credits will be £5,145 in 2010/11.

This does not mean that losses carried back against the previous year's income for real tax purposes cannot be used for tax credits; they must be used against the current year's income, then that of the following years.
Losses not used in the current year can be carried forward. The amount carried forward for real tax purposes and for tax credit purposes will often be different because:

- Losses for tax credit purposes must be set against a partner's income, whereas this is not normally done for real tax purposes;
- Losses can be carried back for real tax purposes but not for tax credit purposes.

Example

Robert makes a loss of £25,000, having made a profit of £10,000 in the previous year. He has no other income. His partner has income of £6,000.

For income tax purposes, he can carry back £10,000 against the previous year and carry forward £15,000 against the following year.

For tax credits, he must use £6,000 against his partner's income and carry forward £19,000 against the following year.

It is possible to make a protective claim where a person is not eligible for payment because their income is too high, but would otherwise meet the criteria. This gives them an 'identity' for tax credits and if their income for the year falls, e.g. they are made redundant or make a loss, they may be entitled to tax credits, recalculated from the start of the year. If they were to only claim when the income drops, the claim could only be backdated three months.

Capital allowances and tax credits

A capital allowances claim will reduce taxable profit and thus the level of income to take into account for tax credit purposes. Investment in fixed assets for capital allowances or annual investment allowance could easily impact on the £25,000 disregard. This change in threshold can lead to tax credit levels being preserved for another year, even when profits have increased substantially.

Example

To return to the example of Victoria and David (see above), a couple who both work and have two children: The net family income in 2009/10 is £5,000, made up of Victoria's employment income of £10,000 less David's trading loss of £5,000 and they are entitled to £5,015 of tax credits.

In 2010/11 David makes a profit of £21,000 while Victoria retains her £10,000 salary. David is considering investing in his business to buy new and more efficient machinery that would cost £6,000. David is unsure as to whether he can afford the new machinery

If the machinery is purchased in 2010/11 David will be able to claim capital allowance of £6,000 as annual investment allowance The total family income for tax credit purposes will therefore be £25,000 (21,000 – 6,000 + 10,000). As the income has not increased by more than £25,000 over 2009/10 (25,000 – 5,000 = £20,000) the level of tax credits will be £5,145 (2010/11 rates).

If David chooses not to purchase the machinery, the family income at £31,000 has increased by more than £25,000. The tax credit claim for 2010/11 will therefore become £545.

If David does not make the purchase, his tax credits will fall by £4600. The net cash flow position is that if he spends £6,000 on machinery he will only be £1,400 worse off.

The illustration above does not necessarily constitute an extreme case. It can be argued that small start-up businesses often incur losses in their first year of trading and struggle to find sources of funding for much needed investments in capital assets. The regulations of tax credits, in particular in this case the £25,000 disregard rule, can indeed interact with capital allowances and investment decisions and ultimately provide cash that can fund a small business' growth. Such interaction opens the door to planning opportunities for small businesses in respect of tax credits that go beyond the traditional considerations of tax planning for capital investments.

FURTHER INFORMATION

There is guidance on this topic available on the HMRC website at:
http://www.hmrc.gov.uk/manuals/tctmanual/index.htm