The summer Budget – tax credits, the living wage and effect on household incomes

General Features

01 September 2015

LITRG review the changes taking effect in April 2016

In the summer Budget delivered in July, the Chancellor announced sweeping cuts to the tax credits system. Many tax credit claimants will face decreases in their awards from April 2016; and those having children after April 2017 may be affected by new rules set out in the Welfare Reform and Work Bill now before Parliament. This article explains the changes taking effect in April 2016 and an article in a later issue will consider those taking effect the following year.

Taper rate increased and income threshold reduced

Together, these two changes will result in significant cuts in tax credits for many existing claimants.

Two thresholds feature in the calculation set out in Tax Credits Act 2002 (TCA 2002) sections 7 and 13 and the Tax Credits (Income Thresholds and Determination of Rates) Regulations, SI 2002/2008. Currently, working tax credit (WTC) and child tax credit (CTC) elements are reduced by 41% of the amount by which income exceeds these thresholds:

- £6,420 for claims to WTC only, and claims to both WTC and CTC; and
- £16,105 for claims to CTC only.

The taper rate will increase to 48% and the threshold for WTC only and WTC/CTC cases will decrease to £3,850. Although not directly announced, these two changes, combined with the freeze on some elements of tax credits, as a consequence reduce the CTC-only threshold to £12,125.

Broadly, people with incomes above the new thresholds will have their tax credits reduced lower down the income scale and at a much faster rate.

Example 1

Krysten is a lone parent with two children. She works 30 hours a week and claims tax credits including the WTC childcare element for costs of £150 a week. Her salary is £18,000. Her 2015/16 tax credits award is around £11,600. That will reduce by £2,050 in 2016/17.

The significant reduction in the WTC threshold, together with the new National Living Wage (NLW), will result in many low-income workers losing WTC support.

Example 2

Alex is single. He is over 25, has no children and earns the national minimum wage for a 35-hour week. His income for 2015/16 is expected to be around £12,012 and for 2016/17 around £13,104 based on the NLW of £7.20 an hour announced in the summer Budget. Given the income disregard his income rise is less than £2,500 so his award for 2016/17 will be based on his 2015/16 income. The WTC elements of £1,960 + £810 = £2,770 are reduced by (£12,012-£3,850) x 48% = £3,917. That is to say, the award is reduced to nil. By comparison, his 2015/16 award would have given a reduction of (£12,012-£6,420) x 41% = £2,292, leaving a WTC award of £478.

Anyone who has income below the new thresholds or who receives income support, income based-jobseeker’s allowance, income-related employment and support allowance or pension credit will continue to receive maximum tax credits based on their circumstances by virtue of TCA 2002 s 7(2) (although they will be affected by the freeze to some elements explained below).

Example 3

Jason is a lone parent who is looking for work. He has one child and receives income-based jobseeker’s allowance (IBJSA). His child tax credits for 2015/16 are £3,325 and they will not change in 2016/17 as long as he continues to receive IBJSA.

Freeze on WTC and CTC elements

Before 2011, tax credit elements were increased each year using the retail prices index (RPI). From April 2011, this changed to the consumer prices index (CPI). At the same time the basic element of WTC and the 30-hour element were frozen for three years.

Since April 2014, most tax credit elements have increased by 1%, with the exception of the disabled adult and child elements, which have increased by the higher CPI.

It was announced in the summer Budget that all elements of WTC and CTC would be frozen for four years except the adult and child disability elements, which will continue to increase by CPI. Therefore, many people will not have any further increase in tax credits before they are replaced by universal credit.

Decrease in income disregard to £2,500

Tax credits are initially paid based on current circumstances and household income from the previous tax year. After the tax year ends, HMRC compare actual income for the year just ended with income for the previous year. Currently, as long as the income for the year just ended is no more than £5,000 higher than in the previous year, the award will be unaffected and there will be no overpayment. Hence the term 'disregard' because the first £5,000 of any income increase is disregarded when calculating the award.

When tax credits began, this disregard was set at £2,500. It was increased to a very generous £25,000 from 6 April 2006 to reduce overpayments. It was reduced to £10,000 from 6 April 2011 and then again to £5,000 from 6 April 2013.

The summer Budget announced that the disregard, set out in the Tax Credits (Income Thresholds and Determination of Rates) Regulations, SI 2002/2008, would again be reduced to £2,500 from 6 April 2016.

Example 4

Bridget has been working in the same job for two years and her earnings for 2015/16 were £15,000. Bridget is promoted to a supervisor role from April 2016 and her salary for 2016/17 will be £19,000. Under the current rules, Bridget's 2016/17 tax credits award would not be affected by her pay rise because the increase of £4,000 is less than the £5,000 disregard. Bridget would not see a fall in her tax credits until April 2017. However, under the new disregard, Bridget’s 2016/17 tax credits award will be based on income of £16,500 so she will face a fall in tax credits from April 2016 rather than April 2017.

A future article will examine the new two-child limit and removal of the family element of child tax credit from April 2017 and the phasing out of tax credits, to be replaced by universal credit.