EXPLANATORY MEMORANDUM TO THE

TAX CREDITS UP-RATING REGULATIONS 2006

2006 No 963

1. This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs and is laid before Parliament by Command of Her Majesty.

2. Description

These regulations increase, from 6 April 2006, various monetary elements and thresholds within the Child and Working Tax Credits, as set out in the Pre-Budget Report on 5th December 2005.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 These draft regulations implement the change in the disregard for income rises between one tax year and the next, announced as part of a package of changes in tax credits in the Pre-Budget Report. The package of changes was designed to make the tax credits system work better for families, providing more certainty over their tax credit award and reducing overpayments while maintaining flexibility to respond to falls in income and changes in circumstances. It may be helpful to provide some background to the very significant increase in the level of the income disregard.

3.2 The tax credit system currently provides for the income on which tax credits are based, to rise by £2,500 in the current tax year, without affecting tax credit entitlement for that year. The aim of this “income disregard” was to prevent many of the overpayments of tax credits otherwise to be expected as a result of rising income from one year to the next, or to reduce the amount of tax credits overpaid, so as to maintain incentives to enter work or increase working hours. The level of the disregard was set drawing upon the best information available at the time. The first two years’ experience of the tax credits system has shown some unexpected trends, however. Of particular relevance here, it shows that people’s incomes have been more volatile than the available research suggested, with more big rises from one year to the next, and more short term fluctuation making it hard for people to give an accurate estimate of annual income. This meant that there were more, and higher, overpayments within the tax credit system as a result of rising income than anticipated. Statistics for 2003-04 show that 313,000 families who were overpaid saw their income rise by more than £ 10,000 between 2001-02 and 2003-04.

3.3 In the light of this experience, it is therefore proposed to increase the level of the disregard to £25,000 from 2006/07. This will mean that, for instance, a family where a non-working partner moves into work on average earnings will not see their increased income lead to a fall in their tax credit entitlement during that year. This will maintain the incentives for people to move into work, while removing a major cause of the overpayments seen in the first two years of the system's operation. This will also give greater certainty to families about their awards, since their payments will not be adjusted in-year if they see a rise in their income. Analysis based on data from the first two years of the system's operation indicates that about two-thirds of beneficiaries from the increased disregard will be in the bottom 30% of the income distribution.

3.4 It was made clear during the passage of the tax credits legislation that the operation of the system in practice would be monitored so that adjustments could be made where necessary, and that the legislative framework was intended to enable such adjustments. In particular, the powers provided in S.7(3), which establish how tax credits entitlement reflects changes in income between tax years, were extensively debated. In the course of that debate, Ministers made clear that the powers were intended to allow a range of approaches to income changes, including the ability effectively to base entitlement on income of the previous tax year, and said that they would expect to use the powers to make changes, should experience prove them necessary. For example, the then Financial Secretary to the Treasury said in Standing Committee A (Hansard ref. Thursday 17 January 2002, Tax Credits Bill, Column No 75 *)*: "One reason for taking such a flexible approach is to enable the system to be refined in the light of experience and we shall monitor it closely."_

3.5 The package of measures announced in the Pre-Budget report, of which the change in the disregard forms a key part, meets the commitment to adjust the way that tax credits work to respond to difficulties that claimants have encountered. It is intended to provide more certainty about the levels of payment that families will receive. For that reason, the proposed change in the disregard has been widely welcomed by representative groups. For example, John Whiting, Chairman of the CIOT's Tax Policy Sub-Committee, said: "This effectively means that most tax credit claimants, whose income increases from one year to the next, will have their final awards based on their previous year's income. This was a common suggestion for simplification made by our members when we surveyed them in December 2003 just after tax credits were introduced." Citizens Advice also welcomed the decision that increases in income up to £25,000 would be disregarded in the calculation of tax credits, saying it would significantly reduce the number of overpayments occurring.

4 Legislative Background

4.1 A draft of these Regulations is laid before Parliament in accordance with the provisions of Section 66(1) and(2) of the Tax Credits Act 2002 for approval by resolution of each House of Parliament. These Regulations are made by the Treasury, in exercise of the powers conferred upon them by sections 7, 9, 11,13 and 65(1) of that Act.

4.2 Section 7 of the Tax Credits Act 2002, allows regulations to be made for an income test on claimants for both tax credits. Section 13 of the Act allows for regulations setting out the income thresholds and supplements the powers conferred in section 7 of the Act. These powers have been used to increase the first income threshold for Child Tax Credit and the income rise disregard found in the Tax Credits (Income Thresholds and Determination of Rates) Regulations 2002. Section 9 of the Act allows for regulations to be made setting out the elements making up the Child Tax Credit. This power has been used to increase elements of the Child Tax Credit found in the Child Tax

Credit Regulations 2002. Section 11 of the Act allows for regulations setting out the elements for the Working Tax Credit. This power has been used to increase elements of the Working Tax Credit, found in the Working Tax Credit (Entitlement and Maximum Rate) Regulations 2002.

5. Extent

This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Paymaster General, Dawn Primarolo has made the following statement under section 19(1)(a) of the Human Rights Act 1998:

In my view the provisions of the Tax Credits Up-rating Regulations 2006 are compatible with Convention rights.

7. Policy background

Section 41 of the Tax Credits Act 2002 requires the Treasury, in each tax year, to review certain elements of tax credits. In consequence of that review the Treasury have made these Regulations, which amend the rates of certain elements and thresholds within tax credits.

8. Impact

8.1 A Regulatory Impact Assessment has not been prepared for this instrument as it has no impact on business, charities or voluntary bodies.

8.2 The estimated cost of the increases to rates and thresholds, which was included in the Budget 2005 forecast, is £940 million. The estimated cost of the increased disregard for income rises is included in the estimate of the Pre-Budget Report tax credits package.

9. Contact

Anne Berriman at HM Revenue and Customs [tel: 020 7147 2470 or e-mail: Anne.Berriman@hmrc.gsi.gov.uk] can answer any queries regarding the instrument.