CLIENT BULLETIN

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A G Kelly Ltd - Accountants

TAX CREDITS FOR CHILDREN

Many people are thoroughly confused about the proposed changes in tax reliefs and Social Security benefits for families with children. Partly this is because the Government uses the term 'tax credit' to mean in some cases a tax allowance, but in others a Social Security benefit; partly because the Treasury Press Releases, on which the newspapers base their articles, give examples of the benefits payable to 'typical families' rather than explaining the underlying principles; and partly simply because there have already been so many changes in recent years.

To begin at the beginning, at present a family with children may be entitled to:

- Child Benefit, which is a Social Security benefit payable (usually) to the child's mother, generally at the rate of £15.75 a week for the first child and £10.55 for each additional child.
- Children's Tax Credit, which is a tax allowance worth just over £10 a week, doubled to £20 if a new baby is born between 6 April 2002 and 5 April 2003. There is only one Credit per family, irrespective of the number of children. The allowance is progressively withdrawn if either parent is a higher-rate taxpayer.
- Working Families' Tax Credit, which is really an income-related Social Security benefit paid to families with children, though as employees usually receive it with their wages, it appears to be a kind of 'negative income tax'.

From April 2003 there will be:

- Child Benefit, as now, but increased in line with inflation.
- Child Tax Credit (sometimes called 'integrated Child Credit') which will be a Social Security benefit paid (usually) to the child's mother. Unlike the current Children's Tax Credit, it will *not* be a tax allowance. Another important difference is that a separate Credit will be payable for each child.
- Working Tax Credit, which will, like the current Working Families' Tax Credit, be an income-related Social Security benefit which employees will usually receive with their wages. But unlike WFTC, it will also be payable to people without children.

Both the Working Tax Credit and the Child Tax Credit will be reduced as the family's income rises. The detailed rules are complex, but in outline:

Working Tax Credit

The amount of Working Tax Credit payable will depend on whether the benefit is claimed by a single person, a lone parent or a couple. There will also be additional allowances for childcare.

For example, the maximum entitlement for a couple, with or without children but not paying any childcare costs, will be £69.90 a week. However, this maximum entitlement will be reduced by 37 per cent of the amount by which the family's income exceeds £97 a week. Thus if the couple's income is £250 a week, their reduced Working Tax Credit entitlement will be only £13.29.

The maximum entitlement for a couple paying childcare costs for two or more children will be £209.90 a week. The same 37 per cent clawback applies, so that if the couple's weekly income is £500, their reduced Working Tax Credit entitlement will be £60.79. (Child Tax Credit will be payable in addition, as explained below.) While Working Tax Credit will usually be payable 'in the wage packet', the childcare costs element will generally be paid direct to the mother.

One very important difference between the current Working Families' Tax Credit and the proposed Working Tax Credit and Child Tax Credit is that, while WFTC is based on income after deducting tax and National Insurance contributions, both the new Credits will be based on gross earnings.

Child Tax Credit

The maximum Child Tax Credit will be £10.45 a week plus £27.75 for each child. It will be reduced by 37 per cent of the amount by which the family's income exceeds the amount at which Working Tax Credit is reduced to nil (that amount will itself vary according to the family's circumstances especially, the amount of childcare costs paid). However, there will be a minimum Child Tax Credit irrespective of the number of children of £10.45 a week where the family's income does not exceed £50,000 a year (payable in addition to Child Benefit), tapering to nil at an income of £58,000. The £10.45 basic amount (called the 'family element') will be doubled to £20.90 for the year in which a new baby is born.

Practical points

Everyone with children will be entitled to some Tax Credit from April 2003, unless the family's income exceeds £58,000. Where childcare costs are paid, the Tax Credit entitlement can be worthwhile, even on quite high earnings: for example, a couple with joint earnings of £35,000 a year, paying childcare costs for two children, may be entitled to Tax Credits of £62.71 a week.

The Tax Credits scheme will be administered by the Inland Revenue, who will be issuing claim forms for 2003/04 in the late summer or autumn of this year.

Two final points are worth emphasising. Firstly all kinds of Tax Credit can be claimed by self-employed people and company directors, on equal terms with employees. Secondly, while the current Working Families' Tax Credit cannot be claimed by families with savings of more than £8,000, there will be no such restriction on Child Tax Credit and Working Tax Credit.

VALUE ADDED TAX

In his Budget Statement last month, the Chancellor confirmed three VAT changes for small traders. He promised a simpler, flat-rate method of accounting for VAT; more straightforward bad debt relief; and an end to automatic surcharges for late payment. But as yet, only the first of these changes is in force:

Flat-rate VAT accounting for small traders

Flat-rate VAT accounting is available now it is open to VAT-registered traders whose taxable turnover (standard-rate, zero-rate and reduced-rate sales) does not exceed £100,000 a year, and whose total turnover (taxable turnover plus any exempt or 'outside the scope' supplies) does not exceed £125,000. Some trade sectors are excluded - notably tour operators and traders using the margin scheme for the sale of second-hand goods (including motor cars, etc).

Under the flat-rate scheme, the trader does not have to calculate his input tax (the VAT paid on his purchases) and deduct the total from his output tax (the VAT charged on his sales), to arrive at the net VAT payable to HM Customs & Excise. Instead, the payment to Customs is calculated as a flat percentage of his total sales. Different percentages have been set by Customs for different trade sectors. For example, the flat rate for hairdressers is 13 per cent, so a hairdresser with gross sales of £20,000 for a quarter would have to pay VAT of £2,600.

The Chancellor emphasised that flat-rate accounting will be simpler to operate and so save time and money in administration. However, overall, the new scheme will not benefit everyone. This is because the flat rates have been set as averages, but even within the same trade sector, some essentially similar businesses pay far more input tax than others. To return to the example of hairdressers, some will be paying VAT on their shop rent, while others will not.

Accordingly, before deciding to join the scheme, every trader should compare the projected payments under flat-rate accounting with the net tax payable under regular VAT accounting.

There are also other decisions to be made: for example, there are three different ways of calculating total turnover for flat-rate accounting. We shall of course be happy to advise clients on their own individual circumstances.

Relief for bad debts

Bad debt relief will be simplified: a trader will no longer be required to write to his customer before claiming bad debt relief on his VAT Return. Conversely, a customer who has not paid his bill within six months of the due date will be required to cancel out his input tax relief claim by adjusting his next VAT Return. However, these changes are not yet in force: the implementation date has not yet been announced, but is likely to be in the late summer or early autumn of this year.

'Default surcharge' for late payment of VAT

Although the abolition of the automatic 'default surcharge' when VAT is paid late was first announced last year, it will not come into force until sometime next year. Even then, the relaxation will apply only to businesses with an annual turnover of £150,000 or less. So it is still important to ensure that VAT Returns and payments are sent in on time.

AND FINALLY - IT'S NOT THAT SIMPLE!

The world is full of people offering seemingly simple solutions to important and complex questions. For example, the newspapers have recently carried reports of people selling 'pension liberation schemes' which, it was claimed, allowed their clients to cash in the full value of their pension funds, before retirement age. This was very tempting to people in their 40s and 50s who had been made redundant and thought they could use the money to repay their mortgages or set up in business.

The scheme involved taking a sham job with a company run for the purpose, transferring accumulated pension rights to that company, and then withdrawing the fund in cash. The catch is that there is a 40 per cent tax charge on fund withdrawals, in addition to the fees - typically 20 or 30 per cent of the pension fund charged by the people organising the scheme.

Can an offshore company save you tax?

People often hear that they can save tax by running part of their business through a company registered on the Isle of Man, or from an accommodation address in Jersey, or through a bank account in Guernsey. The truth of the matter is, that if you are resident in the United Kingdom, then any company or business you control is subject to United Kingdom tax.

There are offshore company registration agents who will tell you that you can 'establish fiscal domicile' in Ruritania by subscribing to their mail forwarding service. This may even be accepted by the Ruritanian tax authorities but it will cut no ice with the people who matter to you, the United Kingdom Inland Revenue.

Well-meaning friends can wreak havoc

But the saddest cases are where someone listens to the advice of a well-meaning, but ill-informed, friend. For example, an elderly lady was told that she could save inheritance tax by putting her house into the names of her children. That sounded simple and straightforward enough, so she did it. But in fact, the house will continue to count as her property for inheritance tax purposes, as long as she continues to live in it.

Far worse, because the house is now owned by the children, who do not live there, the amount by which it has increased in value since the date of the transfer will, eventually, be subject to capital gains tax.

And the sting in the tail is that, because the lady has few assets other than the house, no inheritance tax would have been payable in any case. So the family has swopped a non-existent inheritance tax liability for a real capital gains tax charge.

Before taking important financial decisions, it really is essential to take independent, expert advice. We know that professional advice can seem expensive, but the benefit will be enjoyed long after the bill is forgotten and free advice is usually worth what you pay for it.

This newsletter deals with a number of topics which, it is hoped, will be of general interest to clients. However, in the space available it is impossible to mention all the points which may be relevant in individual cases, so please contact us for personal advice on your own affairs.