EXPLANATORY MEMORANDUM TO

THE TAX CREDITS (DEFINITION AND CALCULATION OF INCOME) (AMENDMENT) REGULATIONS 2017

2017 No. 396

1. Introduction

1.1 This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs (HMRC) on behalf of Her Majesty's Treasury (HMT) and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 These regulations make changes to how income is calculated for the purposes of setting claimants' tax credits payments. The rules for calculating income for tax credits generally mirror those for income tax. These regulations therefore make changes in three areas where the income tax rules will change in 2017-18.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

Other matters of interest to the House of Commons

3.2 As this instrument is subject to negative resolution procedure and has not been prayed against, consideration as to whether there are other matters of interest to the House of Commons does not arise at this stage.

4. Legislative Context

4.1 Section 7 of the Tax Credits Act 2002 (c. 21) sets out that the entitlement of a person (a claimant) to tax credits is dependent on the relevant income. The Tax Credits (Definition and Calculation of Income) Regulations 2002 (S.I.2002/2006) (the Income Regulations) set out how a claimant's relevant income is to be calculated.

4.2 Regulation 4 of the Income Regulations sets out how to calculate a claimant's employment income. Regulation 3 of this instrument makes amendments to regulation 4 so that where a benefit is provided pursuant to an optional remuneration arrangement, the amount of a claimant's earnings to be taken into account for tax credit purposes will include the value of the earnings that have been given up as a consequence of the arrangement.

4.3 Regulation 10 of the Income Regulations sets out how to calculate a claimant's investment income. Table 4 identifies amounts of investment income which a claimant can disregard in calculating income. Regulation 4 of this instrument inserts a new entry into that Table (entry 15) which disregards the whole amount of the government bonus paid in respect of a Lifetime Individual Savings Account (ISA).

4.4 Regulation 11 of the Income Regulations sets out how to calculate a claimant's property income by reference to a claimant's annual taxable profits arising from a business carried on for the exploitation, as source of rents or other receipts of any interest etc. in or over land in the United Kingdom. Regulation 5 of this instrument provides that the restrictions in section 272A of the Income Tax (Trading and Other Income) Act ("ITTOIA") 2005 (c. 5) and in section 399A of the Income Tax Act ("ITA") 2007 (c. 3) on the deduction of finance costs related to residential properties are disregarded for the purposes of calculating a claimant's property income.

5. Extent and Territorial Application

5.1 The extent of this instrument is the United Kingdom.

5.2 The territorial application of this instrument is the United Kingdom.

6. European Convention on Human Rights

6.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

What is being done and why

7.1 Tax credits are a means-tested form of support which provides help to millions of families with a wide variety of differing circumstances. Child Tax Credit supports families with children. Working Tax Credit provides support for working people on a low income. It tops up the earnings of workers on low to moderate incomes, targeting support to those in work at the lowest income levels.

7.2 Tax credits awards are calculated on the basis of claimants' income. The rules for calculating income for tax credits generally mirror those for income tax, which means that claimants do not have to carry out a separate calculation of their income but can use figures calculated for tax purposes.

7.3 These Regulations follow three changes to income tax rules. Changes to the Income Regulations 2002 are needed to maintain the link for the tax year 2017-18 onwards.

7.4 At the Autumn Statement 2016, the Chancellor of the Exchequer announced changes to income tax rules around optional remuneration arrangements, which was referred to as salary sacrifice.

7.5 The aim is to limit the income tax and employer National Insurance Contributions advantages where an employee can choose between cash and benefits in kind. These arrangements include cash allowances, flexible benefit packages with a cash option, and salary sacrifice. The changes value the benefit in kind at the higher of the cash given up and the normal taxable value.

7.6 For the purposes of these regulations, this change applies to: cars with emissions exceeding 75 g CO_2 / km; cash vouchers and credit tokens; and non-cash vouchers and credit tokens, including if they are currently tax exempt.

7.7 Where a tax credits claimant uses a salary sacrifice arrangement in respect of a benefit that is included as income for tax credits purposes, the policy aim is to ensure that the value of the benefit is the same for both income tax and tax credits purposes. This means that the claimant will not need to calculate separate values for income tax and tax credits.

7.8 Under the Savings (Government Contributions) Act 2017 (c. 2), Lifetime Individual Savings Accounts (ISAs) government bonuses are exempt from income tax.

7.9 Tax credits follow the same approach as income tax for payments of interest or bonuses into an ISA, disregarding them as income. The policy aim is to maintain this consistency for government bonus payments into Lifetime ISAs, which are exempt from income tax. As a result, claimants will not have to follow different rules for income tax and tax credits.

7.10 At Summer Budget 2015, it was announced that the government will restrict the amount of income tax relief landlords receive on residential property finance costs to the basic rate of tax. The change is to be introduced gradually from April 2017 over 4 years. This was legislated for in the Finance (No. 2) Act 2015 (c. 33), with further legislation in the Finance Act 2016 (c. 24).

7.11 Tax credits follow the same approach as income tax when calculating property income. It does this by reference to Part 3 of ITTOIA, which sets out how property income is calculated for income tax purposes. As a result, the changes to tax legislation that disallow deduction of property finance costs from income would also apply to all tax credits claimants when calculating their tax credits award, regardless of the rate of income tax they pay.

7.12 These regulations prevent the restrictions from applying for the purposes of tax credits income calculation. This ensures that tax credits claimants who do not pay income tax or pay it at basic rate levels will not receive a lower award of tax credits as a result of how Part 3 of ITTOIA and Part 8 of ITA now calculate taxable profits from property rental.

7.13 Section 24 Finance (No.2) Act 2015 as amended by section 26 Finance Act 2016 added new provision to Part 3 of ITTOIA, with the aim of reducing tax relief for residential landlords. Section 272A applies the restriction by limiting the extent to which finance costs can be deducted from income in arriving at taxable profit. Section 274A then applies the basic rate of income tax to the amount not deducted, and reduces taxpayer's income tax liability by that amount. This means that basic-rate taxpayers mostly do not see a change to their overall income tax, although there will be some who move from basic rate to higher rates as a result.

7.14 Section 24 Finance (No.2) Act 2015 as amended by section 26 Finance Act 2016 also added similar provision to ITA 2007. Section 399A limits the extent to which finance costs can be deducted from income where someone has invested in a property partnership. Section 399B then applies the basic rate of income tax to the amount not deducted, and reduces taxpayer's income tax liability by that amount.

7.15 The restriction is being phased in over a period of 4 years, with the full impact taking effect from tax year 2020-21.

7.16 These regulations add to the Income Regulations a reference that sections 272A and 399A of ITTOIA do not apply for tax credits purposes, so that claimants can continue to deduct their finance costs.

Consolidation

7.17 There are no plans to consolidate the Income Regulations

8. Consultation outcome

8.1 No separate consultation exercise was conducted as this instrument makes consequential changes required in relation to changes to income tax legislation

8.2 HMRC consulted on the proposed income tax and National Insurance changes on salary sacrifice arrangements between 10 August and 19 October 2016[1]. HMRC received 259 responses from employers, representative bodies and accounting firms and 77 from individuals. The feedback was mixed with some strongly in favour of reform. HMRC made several changes to the policy including protecting the majority of those already in arrangements and extending exemptions to Ultra Low Emission Cars. At Autumn Statement 2016 the Chancellor announced the government's intent to legislate these changes, and draft legislation[2] was published on 5 December with accompanying Tax Information and Impact Note[3]. This legislation was subject to a technical consultation until 1 February 2017[4]. HMRC has worked closely with the DWP on these changes.

8.3 In July 2015 the Government launched a consultation on reforming pension tax relief with the aim of strengthening the incentive to save. There were 450 respondents to this consultation[5]. The consultation found that young people in particular wanted more choice and flexibility in how they saved for the long term. The Lifetime ISA was therefore announced at Budget 2016. The Government subsequently informally consulted with industry and interested parties on the detailed policy design, and publicly consulted on draft regulations in October 2016[6].

8.4 The draft legislation on residential landlords' relief was published in July 2015 as part of the Summer Finance Bill. None of the responses received regarding that legislation related to tax credits.

9. Guidance

9.1 Guidance is provided for tax credits claimants online through the gov.uk website and through the tax credits helpline. Where claimants need more detail on how to calculate their income for tax credits purposes, they are referred to income tax guidance, which is also available on the gov.uk website.

9.2 Guidance will be prepared by HMRC on the limiting of the income tax and employer National Insurance Contributions advantages where benefits in kind are provided through salary sacrifice arrangements. This guidance will also apply to tax credits claimants as they calculate their income for tax credits purposes.

9.3 Tax credits guidance already sets out that claimants do not need to include as income any income arising from Individual Savings Accounts.

9.4 Tax credits guidance will be updated to make it clear to claimants that they can continue to deduct property finance costs in arriving at the figure for property income for tax credit purposes, in the same way that they do now.

10. Impact

10.1 The provisions relating to salary sacrifice schemes will minimise the impact on businesses, charities and voluntary organisations who employ tax credits claimants

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[1] https://www.gov.uk/government/consultations/salary-sacrifice-for-the-provision-of-benefits-in-kind
[2] https://www.gov.uk/government/publications/finance-bill-2017-draft-legislation-overview-documents
[3] https://www.gov.uk/government/publications/income-tax-limitation-of-salary-sacrifice/income-tax-limitation-of-salary-sacrifice
[4] Finalised legislation with accompanying Explanatory Note will be published after Spring Budget 2017
[5] https://www.gov.uk/government/consultations/strengthening-the-incentive-to-save-a-consultation-on-pensions-tax-relief
[6] https://www.gov.uk/government/consultations/draft-legislation-lifetime-isa

who use salary sacrifice schemes by ensuring that they will only need to provide one valuation of certain employee benefits, rather than the two that would be required if income tax and tax credits rules were to give different outcomes.

10.2 There is no impact on business, charities or voluntary bodies from the provisions relating to Lifetime ISA bonuses.

10.3 The impact on businesses, charities or voluntary bodies from the provisions relating to landlords' property finance costs will ensure they can continue to calculate their income in the same way, without reducing their tax credits award.

10.4 There is no impact on the public sector.

10.5 An Impact Assessment has not been prepared for this instrument.

11. Regulating small business

11.1 The legislation applies to activities that are undertaken by small businesses.

11.2 The provisions relating to salary sacrifice schemes will minimise the impact on businesses who employ tax credits claimants who use salary sacrifice schemes by ensuring that they will only need to provide one valuation of certain employee benefits, rather than the two that would be required if income tax and tax credits rules were to give different outcomes.

11.3 There is no impact on small business from the provisions relating to Lifetime ISA bonuses.

11.4 The provisions relating to landlords' property finance costs will ensure that claimants who are also landlords can continue to calculate their income in the same way as they currently do for tax credits purposes, without the changes to the income tax provisions reducing their tax credits award.

12. Monitoring & review

12.1 HMRC will monitor the effect of the new salary sacrifice provisions in line with the Tax Consultation Framework[7].

12.2 HMRC will monitor the impact of Lifetime ISAs on an ongoing basis using the information provided by Lifetime ISA providers.

12.3 HMRC will monitor the effect of the restrictions on landlords' property finance costs through tax returns and other data.

13. Contact

13.1 Martin Stribblehill at HMRC Telephone: 03000 526626 or email: benefitsandcreditspolicyinbox@hmrc.gsi.gov.uk can answer any queries regarding the instrument.

[7] https://www.gov.uk/government/publications/tax-consultation-framework