United Kingdom Treasury

January 2005

Response to

CRITERIA FOR TAX CREDITS

Definition proposed in July 2004 paper:

Definition: a tax credit is a reduction of tax offered to households or other entities – most often of tax on income – which is embedded in the tax system. To be recorded as such, this reduction should be part of the tax system, calculated on the same basis and over the same time period like taxes.

Proposed Definition:

We suggest a shorter definition with illustrative criteria (see further below)

Definition: a tax credit is a reduction of tax offered to households or other entities which is embedded in the tax system.

Treatment of Tax Credits

We agree with the July paper that if a tax credit is payable in excess of the amount of that tax due from the individual taxpayer then the payable amount should be treated as positive expenditure.

Wastable and Non-Wastable Tax Credits

We agree with the July paper that the distinction between wastable and non-wastable tax credits is a useful one. We find the names confusing. We suggest:

- *Payable* tax credits, for those that may be paid in excess of the amount of tax due or to non tax payers
- *Non-payable* tax credits, for those that may not be paid in excess of the amount of tax due.

Proposed Criteria for Assessing Whether a Transaction is a tax credit

We agree that criteria are needed. We regard the criteria set out in the July paper as too prescriptive – judgement is needed and the criteria should be seen as indicators. Further, we regard most of the suggested criteria as mistaken. For example, we see no reason why a flat rate amount should not be a tax credit – after all the basic personal Income Tax allowance is not treated as expenditure. We suggest instead the following:

Not all transactions that may be netted from the amounts of taxes due to be paid should be treated as tax credits. Some should be treated as positive payments of grants or subsidies.

Tax credits should be part of the tax system, calculated on a similar basis and over the same time period as the related taxes. The following should be used, in declining order of significance, as indicators that a transaction is a tax credit.

- *That a transaction is "non-payable" ("wastable") is a strong indication that it is a tax credit. More questions need to be asked about "payable" ("non-wastable") transactions.*
- *The amount scored as a reduction against tax falls naturally out of the normal rules for calculating tax payable. By contrast, if the amount can be calculated independently of the procedure for calculating the tax payable then it is unlikely to be a tax credit* based on ONS CS&M 21.70 *DN alternative would be to drop this and the next bullet – if in original form they're meaningless in this context (same argument as for income tax PA above) and they don't add that much in my suggested revamp – I'd certainly move them below the 4th one here.*
- *That the value of the reduction in tax depends on the marginal rate of tax* based on ONS CS&M 21.70
- *That the calculation of value is based on the same definition of time periods and income or allowable expenditure as the tax*
- *That the legal and administrative framework for the transaction is connected with that of the tax – for example, in those countries which have a unified tax code, the tax credit legislation is in the tax code, the assessment is made by the authority that collects taxes and as part of the tax assessment process, information on the transaction is given to recipients along with information about their liability to tax. In those cases where separate tax and tax credit notifications are issued, usually for operational reasons, there would need to be links between the underlying operational tax credit and tax systems.*

Examples

The criteria above are similar to those that have been applied in the UK by the Office for National Statistics. Some examples of real cases from the UK illustrate how the criteria could be applied in practice.

Child benefit

This is paid to parents of all children under 16 or under 19 and still in full time education. It is paid by the tax authority but there is no connection to the tax system and is clearly not a tax credit. All of it scores as net social benefits expenditure.

New Tax Credits

The Child and Working Tax Credits were introduced in April 2003. Child Tax Credit is payable to households with dependent children, Working Tax Credit to households with at least one working adult. Both tax credits are payable.

The UK Government has classified the part of the tax credits which is less than or equal to the household's tax liability as negative tax and the part which exceeds tax liability as net social benefit expenditure.

Applying the criteria suggested above for defining a tax credit to the Child and Working Tax Credit:

- although both tax credits are payable only the part of them which is less than or equal to the household's tax liability is classified as negative tax.

- in general the reduction in tax liability can only be determined with reference to the amount of tax payable.

- given that tax payable is a function of the marginal rate of tax, it follows that the reduction will also in general be a function of the marginal rate.

- The value of the Child and Working Tax Credits is calculated using taxable income received over the tax year and the credits are paid out over a tax year. (Awards of tax credits are initially based on income in the previous tax year and are reconciled after the end of the tax year to take account of actual income in the year during which they are paid).

- The definition of income used to calculate tax credits is very similar to that used for income tax, although household income is used, so that tax credits for a dual earner couple will reflect both partners' incomes.

The assessment of the value of tax credits awarded is made by Her Majesty's Revenue and Customs, which also collects income tax. The administrative framework for tax credits is linked to the income tax system but for logistical reasons the two are separate. For example, information on individuals income tax paid is used to cross-check against income data used to assess the value of tax credit awards.

Graham Watkins
United Kingdom Treasury