Income tax charge and rates
Finance (No 2) Bill 2017, clauses 1-5
Briefing from the Low Incomes Tax Reform Group (LITRG)

1 Introduction

1.1 The early clauses of the Bill re-impose income tax for the new tax year and specify the rates at which it is to be charged. In this briefing we try to set this in context from the perspective of a household on a low income who may also be subject to the National Minimum Wage (NMW) and in receipt of tax credits and means-tested benefits, and we illustrate the complexity that can result from setting rates and allowances in one part of the tax and welfare system without attempting to align them with their equivalents in other parts.

2 General comments

2.1 Clauses 1 to 5:

- re-impose income tax for the year 2017/18, setting the basic rate at 20%, the higher rate at 40% and the additional rate at 45%;
- set the basic, higher and additional savings rates also at 20%, 40% and 45% respectively;
- specify the 0% starting rate savings band at £5,000 for 2017/18 and subsequent years; and
- reduce the dividend nil rate band from £5,000 to £2,000 for 2018/19 and subsequent years.

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2.2 These ostensibly simple measures mask a whole mass of unnecessary complexity at the lower end of the income scale when the total financial position of a low-income household – tax, National Insurance, benefits, minimum wage, etc. – is taken into account.

2.3 Just looking at the tax measures, clauses 1 to 5 ensure that in 2017/18 nobody will pay income tax until their income exceeds £11,500 (the personal allowance), then they pay at the basic rate of 20% on the excess until their income reaches £45,000 (the personal allowance plus the basic rate band of £33,500) – or £43,000 in terms of the non-savings, non-dividend income of a Scottish taxpayer – above which they pay at the higher rate of 40%, unless income exceeds £150,000 a year. Thus, the objective of a progressive tax system is broadly met, but there are five significant factors that detract from this overall objective:

- the value of any tax saving is diminished for those on the lowest incomes by receipt of means-tested benefits;
- raising one threshold without considering the impact on others can lead to unexpected, and sometimes unwelcome, consequences;
- while tax allowances go up, the National Insurance threshold remains where it is in real terms (para 2.14);
- the cost of the income tax threshold approach is relatively high because most of the benefit goes higher up the income scale;
- and in any case, even the income tax aspects on their own are exceedingly complex.

2.4 We consider each of these points in turn.

2.5 ***Any tax saving is further diminished by receipt of means-tested benefits***

2.5.1 The position of low-income taxpayers who also claim benefits is seriously complicated. To anyone on most means-tested benefits, any tax saving from the raising of the tax threshold will be offset by a diminution in their entitlement to benefit. This is because means-tested benefits are based on net, after-tax, income – accordingly any reduction in the tax bill results in an increase in net income, hence the reduction in benefit entitlement.

2.5.2 Take for example universal credit which is gradually being phased in during the period up to 2022. Any increase in net income in 2017/18 of £1 over the work allowance[1] will result in 63p less by way of benefit entitlement, a net gain of only 37p. Thus, a £500 increase in the personal allowance for tax resulting in a 20% tax saving of £200 gross would yield a net gain

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[1] The 'work allowance' in universal credit is the amount a claimant can earn and still receive the maximum award to which they are entitled. Above the work allowance, their universal credit award is tapered away at the rate of 63p in the £. The work allowance varies according to a claimant's circumstances – for a claimant with responsibility for one or more children, or who has limited capability for work, it is £397 a month if there is no housing element in the award, otherwise £192 a month (see http://revenuebenefits.org.uk/universal-credit/guidance/entitlement-to-uc/calculating-universal-credit).

of £74 to a low-income taxpayer who claims universal credit. The same applies for other means-tested benefits which are calculated on net, after-tax income.

2.5.3 But where the basic rate taxpayer claims tax credits instead of universal credit, they will benefit from the whole saving of £200, because tax credits entitlement is based on gross, before-tax, income, not net.

2.5.4 Either way, cuts in welfare when combined with the reduced benefit from the increase in the personal allowance probably mean that the overall position of the low-paid has improved very little, if anything at all. A better way of improving the position of low-income households than simply raising the tax allowance would be to increase the work allowance in universal credit, or further reduce the taper.[1]

2.6 ***Raising one threshold without considering the impact on others can lead to unexpected consequences***

2.6.1 A very welcome development from the perspective of the low-income worker is the phased increase in the NMW for those aged 25 or over (the 'national living wage' or NLW). However, if other thresholds which interact with it are not aligned, the consequences, doubtless unforeseen and unintended, can leave the worker worse off than before.

2.6.2 Carer's allowance is paid at a rate of £62.70 a week to carers who help look after someone with substantial caring needs for at least 35 hours a week. One of the conditions to be met in order to get carer's allowance is that the carer's earnings after allowable deductions must not exceed £116 a week. From April 2017, someone aged 25 or over earning the NMW for a 16 hour week will have earnings of £120 a week (before any allowable deductions). As this is above the carer's allowance earnings threshold of £116, they will not receive any carer's allowance unless they have any deductions that can reduce their earnings figure to below the £116 threshold in which case they would receive the full amount of carer's allowance. An alternative would be to reduce their hours to 15, but if they are claiming working tax credit (WTC), any reduction below 16 hours a week would risk forfeiting their WTC entitlement altogether.

2.6.3 This example focuses not so much on any tax threshold as on the interaction between the NMW/NLW, the earnings limit for carer's allowance and the working hours requirement for WTC. But it does illustrate very clearly what can happen when adjustments are made to one threshold or limit without corresponding adjustments being made to other thresholds or limits, elsewhere in the tax and welfare system, that interact with it.

2.7 ***And while the tax-free threshold goes up and up, the National Insurance threshold remains where it is in real terms***

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[1] The universal credit taper, now 63p in the £, was 65p prior to 6 April 2017.

2.7.1 The policy of raising the personal allowance for tax each year at a rate higher than inflation, and adding tax breaks in addition for lower-income earners and savers, is not matched by similar increases in the point at which National Insurance contributions (NICs) start to be payable (the primary threshold, or lower profits limit). Without commenting on the merits or demerits of this from a policy perspective, it has the potential – judging from our postbag – to cause confusion, particularly among the self-employed who are of course responsible for their own NIC. There is certainly a simplification advantage in aligning the point at which earners begin to pay both income tax and NIC, as was done for much of the early 2000s. If this were considered worth pursuing, care would have to be taken not to compromise the NIC credit to which those whose earnings are between the lower earnings limit and the primary threshold are entitled.

2.8 ***The cost of the income tax threshold approach is relatively high because most of the benefit goes higher up the income scale***

2.8.1 With a progressive income tax system, under which people pay more tax as their income increases, any rise in the threshold at which people start to pay tax will have an inverse effect, benefiting those who pay the most tax more than those who pay least, while non-taxpayers experience no benefit at all. For example, a higher-rate taxpayer living in England, Wales or Northern Ireland, earning £47,000 and with dividend income of (say) £3,000 will pay £500 less tax in 2017/18 than in 2016/17 as a result of the £500 increase in the personal allowance and £1,500 increase in the higher rate threshold. But a basic rate taxpayer earning (say) £16,000 will gain only £100 reduction in tax payable as a result of the increase in the personal allowance.

2.9 ***And even the income tax rates on their own can be complex***

2.9.1 Apart from the different basic rate bands in different parts of the UK, the rates of income tax on their own look straightforward enough. But then – staying for a while with tax – there are many variations on the basic theme. If you have savings income, you may be entitled to the zero per cent starting rate on savings income if your total income is low enough – that could extend your tax-free band of income from £11,500 to as much as £16,500. On top of that you might be entitled to a tax-free savings allowance on £1,000 of savings if a basic rate taxpayer, or £500 if you pay tax at the higher rate. There is also the nil rate on dividend income up to a £5,000 limit (or £2,000 from next tax year), plus – new this year – trading income and property income allowances of £1,000 each.

2.9.2 All these income tax breaks are hugely helpful to low earners, provided they can find their way around the complex rules that govern their interaction (extremely difficult if they cannot afford access to professional advice, or cannot access GOV.UK because they are among the many who do not have a computer at home). But if the overall objective is to improve the financial position of low-income households, taking them out of tax by increasing the income tax personal allowance and adding a suite of nil-rate bands may not be the most effective way of doing that.

2.9.3 A simple solution which is also cost neutral seems elusive. But if we were to propose a blueprint for a future policy on rates and thresholds in the lower income range in both tax and benefits, it would be that the income tax personal allowance, the NIC primary threshold, the NMW and the universal credit work allowance would be set with reference to each other rather than in isolation. Ideally, the income tax personal allowance and NIC threshold would be aligned with each other, even if this meant relinquishing any further rises in the personal allowance for the time being. We would also propose increasing the universal credit work allowance to a point where every claimant benefits from being in work, and aligning it with the NMW so that a claimant who works a given number of hours each week can take home what they earn without suffering any diminution in their benefit entitlement because of their earnings. It would also make for greater simplicity if additional income tax reliefs and allowances, such as the personal savings allowance and property or trading income allowance, were also disregarded for universal credit purposes. Any extra costs involved would in our view be compensated for by increased simplicity – if people understood the system better, they would be less likely to fall foul of the rules inadvertently and thereby compliance costs might be saved.

3 About Us

3.1 The LITRG is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low income workers, pensioners, migrants, students, disabled people and carers.

3.2 LITRG works extensively with HM Revenue & Customs (HMRC) and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.

3.3 The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

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