Contractor guide to the tax treatment of child benefit and the January 2013 changes

Contractors with a gross personal income in excess of £50,000 a year face losing thousands of pounds worth of child benefits – £1,752 for two children – and could suffer a marginal tax rate of 54.02% after means testing is introduced on 7 January 2013.

However, according to James Abbott, tax partner at contractor accountant Abbott Moore, contractors can adopt strategies to mitigate the impact of the changes by sharing income with a spouse or varying dividend payments from year to year. He urges contractors to prepare now to have a strategy in place well before the January start date.

"The new rules mean child benefit will be incrementally withdrawn once a contractor is earning over £50,000 a year," he explains. "And because of a quirk in how the benefit is paid, in some cases contractors could end up paying up to 54.02% in income tax and corporation tax combined if their earnings are in the £50,000 - £60,000 income band.

Means testing child benefit rules effective from 7 January 2013

Child benefit has traditionally not been means tested, which has meant that parents claiming the benefit have been paid regardless of how much they earn or the overall level of their household income.

"From 7 January 2013, if there is an earner in a household with an income over £60,000, then no child benefit is paid by the state," continues Abbott. "The income on which the benefit is based is measured using gross personal income, less gross charitable donations and gross personal pension contributions. It is not the income of a contractor's limited company."

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> James Abbott, Abbott Moore

If there are two earners in the household each with a gross income of less than £50,000 but which may be greater than £50,000 when combined, child benefit is still paid, even though the total household income may be well over the £60,000 top threshold.

£50,000 plus earners face income tax charge

A further quirk is that the benefit continues to be paid to the benefit claimant, but is then deducted by income tax directly from the earnings of the member of the household earning above £50,000 a year.

When coupled with income tax and corporation tax, this can result in higher earning taxpayers claiming child benefit paying a marginal rate of up to 54.02% on earnings between £50,000 and £60,000. Abbott explains: "For a family with two children, on each £100 earned above £50,000 a contractor will be taxed £17.52; so a contractor with a gross personal income of £58,000 will face an income tax charge of £1,401.60."

According to Abbott, the 54.02% marginal tax rate is based on a contractor taking most of their income as dividends. Contractors receiving the majority of their income as salary, those working through an Umbrella for example, will be even worse off because of the effects of National Insurance Contributions (NICs).

A contractor earning £60,000 or more with two children will face a charge of £1,752, which is exactly how much child benefit a family would normally receive for two children.

Mitigation strategies

First and foremost, Abbott says that contractors claiming child benefit need to know that the rule change is coming, as any family with children and an earner who has a gross personal income above £50,000 will be facing an unexpected tax bill for the 2012-2013 tax year.

He continues: "There are a number of strategies contractors can adopt that can take them out of the £50-£60,000 earnings band, enabling them to retain their child benefit and avoid the 54.02% marginal rate." These include:

Income splitting by awarding a non-earning spouse shares, or a greater proportion of shares, to split the dividends and thus reduce both spouse's gross income to below £50,000 (note that income splitting between non-spouses/civil partners may be subject to the settlements legislation/Section 626, formerly Section 660)

Diverting income above £50,000 into a private pension and/or making a charitable donation, to take gross personal income below the limit

Increasing and decreasing dividend payments substantially in alternating years. For example, if a contractor would normally pay a £60,000 dividend, in year 1 they would pay £50,000 to stay below the limit and secure child benefit. Then in year 2 they would pay themselves a dividend of £70,000, losing the benefit but taking gross personal income beyond the 54.02% marginal rate band. Paying £60,000 in both years would mean no benefit in either year.

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James Abbott is the owner of Abbott Moore LLP and often speaks on freelancer / contractor tax matters. He has his own growing portfolio of contractor clients.

Abbott Moore LLP are PCG Accredited Accountants and specialise in providing tax advice to freelancers as well as dealing with their year end accounts and tax returns. **Read Full Profile...**

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Abbott concludes: “The vast majority of contractors with children and who don’t currently income split are likely to be affected by the rule change. Ideally they should have a strategy in place before means testing takes effect on 7 January 2013.”

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