Regulatory Impact Statement

Changes to tax credits

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The question in this statement is whether the following three tax credits should be repealed:

1. the income under $9,880 tax credit;
2. the tax credit for housekeeper and childcare expenditure; and
3. the tax credit for the active income of children.

The limitation of this question to the repeal of these tax credits is due to:

1. the need for consistency with the general broad-based, low-rate approach that the Government has taken to taxation;
2. the aim of Inland Revenue to improve the efficiency of returns filing; and
3. time constraints (which also meant that this Regulatory Impact Statement was not prepared and tabled with the original Cabinet paper. As such the purpose of this RIS is not to inform Cabinet decision making, but to inform consideration of the budget tax bill).

The changes recommended will allow for the redirection of Government spending into higher valued areas; however, it is not the purpose of this statement to assess where this spending will be redirected to.

Generally speaking, the proposed option should not impose any new compliance costs on businesses. However, businesses that employ only school children on very low wages (below $2,340 p.a.) may have to begin withholding PAYE from these employees from 1 April 2013. We expect that very few employers would be in this situation, but due to the inability to consult we have not been able to quantify this. Also, Inland Revenue data does not allow us to estimate the number of affected employers. In any case, we expect this change will not represent a significant increase in compliance costs given the other laws that employers must already comply with and the ability of employers to integrate collection of PAYE across all their employees.

We also believe that software developers who provide software to employers that automate PAYE processes will have sufficient time to respond to the changes. This is because no changes to payroll systems would be required until 1 April 2013. We also expect that any changes required would be relatively minor.

Reforming these tax credits means that some people who currently receive tax refunds will no longer do so. The repeal of the tax credits could also indirectly affect the business of Personal Tax Summary Intermediaries since the tax credits are a major driver of tax refunds, so their repeal should reduce the number of taxpayers who have overpaid tax.

Due to the need for Budget secrecy and the short timeframes involved, there was no ability to consult in the usual manner with affected parties. The Treasury and Inland Revenue were the only agencies involved in developing the proposals and carrying out the analysis.

There are no other significant gaps, dependencies, constraints, caveats or uncertainties concerning the regulatory analysis undertaken. The proposed option does not impair private property rights, reduce market competition, provide disincentives to innovate and invest, or override common law principles.

Dr Craig Latham
Group Manager, Policy
Inland Revenue

16 May 2012

STATUS QUO AND PROBLEM DEFINITION

1. There are a number of tax credits that sit alongside the core tax system. Three of these tax credits – the income under $9,880 tax credit, the tax credit for housekeeper and childcare expenditure, and the tax credit for the active income of children – were introduced a number of decades ago in response to issues raised at the time. They are considered to be outdated; they are fiscally expensive yet are poorly targeted and do not serve any strong policy objective.

Income under $9,880 tax credit

2. The income under $9,880 tax credit provides a credit of $11.76 for a person with an annual income below $6,241 for every week they work more than 20 hours. The weekly amount of the credit is reduced by $0.0032 for every dollar over $6,240 they earn, meaning it will be fully abated at an income of $9,880. The credit is not available when a household is eligible for Working for Families tax credits. The credit is received by approximately 49,000 people, averaging $168. It was introduced as part of a 1986 tax reform, which included the introduction of GST and an early version of Working for Families.

3. The tax credit was designed to compensate a small group of workers who would otherwise have been worse off in the 1986 tax reform package – those without children working full-time and on low incomes. Most workers gained more from the tax credits than they lost in spending power due to the introduction of GST. Those with children gained from the new family tax credit system. However, there was a small group of workers that would have been worse off. It was to compensate this group of workers that the income under $9,880 tax credit was introduced.

4. The tax credit was designed as a temporary measure to allow time for this group of workers to adjust to the new tax settings (for example by increasing their hours worked or seeking a better paying job). Even ignoring that the credit was intended to be temporary, none of this original group now qualify for the credit. It is now, in practice, only available to those without children and who work in low paying jobs full time (i.e. working more than 20 hours a week) for part of a year, the self-employed with low incomes or who can offset their income with business losses. There is no clear rationale why this specific set of people (such as those who work full time for a small part of a year) should pay less tax than others with the same income but who earn it in a different way (such as someone who works part-time for the whole year, who would not be eligible for the credit).

Housekeeper and childcare tax credit

5. The housekeeper and childcare tax credit, in general terms, is available to:

- a working couple to offset childcare costs that arise because of employment; or,
- a family where a family member has a disability, to offset either childcare or housekeeping costs.

6. The credit covers 33 percent of expenditure up to a maximum of $310 per year. People are required to send in invoices to prove their expenditure, which involves compliance and administrative costs. The credit is received by approximately 55,300 households and is worth on average $263.

7. The credit seems to have little justification from a policy perspective. It could be argued that for working couples with children, the credit helps offset the cost of childcare. However, there are no deductions or tax credits available for other personal costs of employment. This reflects New Zealand’s broad-based, low-rate approach to taxation. The housekeeper and childcare tax credit is inconsistent with this approach. The primary way that the Government funds childcare costs has also changed over time, reducing the importance of this credit. For example, the Government now provides 20 hours free childcare for children over 3 by funding early childhood education providers directly. In total, the Government spends approximately $1.4 billion dollars on early childhood education.

8. The credit is poorly targeted. According to a 2006 taxpayer survey, only 27 percent of working households qualify for the credit. In addition, the credit does not abate with income and is generally only available to those in work. It is predominantly paid to working and reasonably well-off households. The bottom 30 percent of households make up only around 11 percent of the claimants of the credit. It also raises questions of fairness. The credit is only available if both partners in a couple are working; it is not available if one partner is not working. However, sole parents can claim the credit without a work requirement.

9. A small number of the recipients of this credit are families of the disabled, for whom the credit is provided to assist with additional costs (such as housekeeping). As a result of this change, these families will receive smaller (or possibly no) tax refunds. The Government still provides assistance to such families through direct measures, such as Home and Community support provided by the Ministry of Health. For example, as part of Budget 2011, the Government increased funding to disability support services by $130 million over four years to support people to live independently in the community. Total Government funding for national disability support services, as provided by the Ministry of Health, was $1.035 billion in the 2011/12 year.

10. The Ministry of Social Development also provides financial assistance to people with disabilities such as the Disability Allowance and the Child Disability Allowance.

Tax credit for the active income of children

11. The tax credit for the active income of children allows a child[1] to earn up to $2,340 of “active” income without being liable to tax. If a child earns more than this, they are entitled to a tax credit of $245.70. The credit is received by approximately 68,600 children, averaging $240. The tax credit does not apply to income from interest or dividends, meaning a child must pay tax on the first dollar of income from these sources.

12. The children’s active income tax credit was introduced in 1978 to partly offset the repeal of another tax credit that effectively provided a tax-free income band income band for all taxpayers. Without the children’s active income tax credit, businesses that employed only school children working part time would be required to begin deducting PAYE. At the time, this was a significant compliance cost. In addition, without the credit, school children engaged in part-time domestic work would have been required to pay their own tax to Inland Revenue.

13. Since the credit’s introduction, the environment has changed, meaning the credit now serves its original purpose rarely. With the advent of electronic payroll systems, we expect

[1] The credit is available to a child who is attending secondary or primary school.

that most employers apply their normal payroll processes, including deducting PAYE, to all their employees. The credit is now mostly claimed via a child filing a tax return at the end of the year. This means the credit, originally designed to decrease compliance costs, no longer achieves this goal as it drives people to file who otherwise would not need to.

Question

14. The question in this statement is whether these three tax credits - the income under $9,880 tax credit, the tax credit for housekeeper and childcare expenditure, and the tax credit for the active income of children - should be repealed.

15. The limitation of this question to whether the credits should be repealed is based on the assumption that any options need to be consistent with the general broad-based, low-rate approach that the Government has taken to taxation, and the aim of Inland Revenue to improve the efficiency of returns filing. Reforming the credits, such as widening their scope or tightening the criteria would not change the credits' apparent inconsistency with this broad-based approach.

16. Time was also a constraining factor on the question. There was a need for the analysis to be delivered in time for Budget 2012, which limited the breadth of question that could be asked.

OBJECTIVES

17. The key objectives are:

- to deliver fiscal savings from low-value programmes – such as programmes that provide untargeted assistance - allowing the Government to redirect its spending into higher value areas;

- reduce the need for taxpayers to interact with Inland Revenue; and

- ensure that the changes are able to be implemented as part of Budget 2012.

REGULATORY IMPACT ANALYSIS

18. There were three broad stages of analysis in which options arose. The first was the shape of the reforms themselves – if the status quo should be retained, the credits repealed, or if they should be replaced by something else. The second was the timing of the reforms. The third was what transitional rules should be developed (necessitated by the decision made on reform timing).

Shape of the reforms

Income under $9,880 tax credit and the tax credit for housekeeper and childcare expenses

19. For the income under $9,880 tax credit and the tax credit for housekeeper and childcare expenses, the options considered were repealing the credits or keeping the status quo.

20. Our preferred option is that these credits be repealed because, as described above, they are outdated. The credits were designed to serve a specific purpose which, due to changing

Government policies and economic conditions, they no longer serve. The credits are also inconsistent with the broad-based, low-rate framework. Their repeal would broaden the tax base and so deliver full-year fiscal savings of $21 million. Further, the credits are a driver of peak-period contacts with Inland Revenue. Repealing the credits removes the need for these contacts, freeing up resources for more highly valued services. The repeal of these credits would be able to be implemented as part of Budget 2012.

Tax credit for the active income of children

21. For the tax credit for the active income of children, a wider range of options were identified. While not directly required to answer the question asked in this statement, these other options are consistent with a broad-based, low rate approach and so could usefully be considered. These other options would also be able to be implemented in time for inclusion in Budget 2012.

22. The options that were identified were:

- replace the tax credit with a limited tax exemption with the same eligibility criteria, ensuring that children will not need to file a return if they have small amounts of income not taxed at source, but would be fully taxed on income that has tax withheld *(preferred)*;

- repeal the tax credit with no replacement; or

- retain the tax credit, and expand the types of income which are considered passive.

23. Our preferred option is to replace the tax credit with a limited tax exemption as it accords with its original policy intent. The option means that children are not able to file to claim a refund of tax that has been correctly withheld, reducing compliance and administration costs. At the same time, the replacement tax exemption means a child is able to earn small amounts of income where there is no withholding obligation (for example, income from mowing their neighbours' lawns), without being required to pay tax on that income, and thus keeping them out of the tax system.

24. The estimated $14 million per year savings come from children who derive income that has a withholding obligation (such as salary and wages) or from children who earn more than $2,340 in income where this is no withholding obligation. The current tax credit generally applies to such income but the new exemption will not.

25. The second option, repealing the credit with no replacement, would mean large numbers of children earning small amounts of income would be pulled into the tax system. This would increase both administration and compliance costs without creating any real benefit.

26. Retaining the tax credit and expanding the types of income that are considered passive is also not preferred. For example, beneficiary income from a trust or income from a welfare benefit could be added to the definition of passive income. Currently the Government provides roughly $14 million per year in tax refunds that have been correctly withheld. There is no strong rationale for this. While restricting the types of income to which the tax credit would apply would help, it does not address the problem directly. As with the other tax credits, it is also a driver of peak period contacts.

Timing of reforms

27. Two possible timings were identified for these reforms: they could apply from the 2012-13 tax year or from the 2013-14 tax year.

28. This is a finely balanced decision and we do not have a preferred option. Obviously, the earlier application date would bring forward the measure and, as a consequence, the fiscal savings of the reforms by one year. This is the key advantage of a 2012-13 application. The reasonably quick application is possible because, by and large, the credits are claimed at year-end, rather than during the year.

29. However, a complication is that it is possible for the income under $9,880 tax credit and the credit for the active income of children to be claimed during the year through the PAYE system. The option requires developing transitional rules and increases the possibility that people may face a tax bill at the end of the year if they do file. These transitional rules will ensure that any transitional compliance costs for businesses are small.

30. A 2013-14 application would not require any transitional rules, as the reforms would have been fully enacted before the beginning of that year. However, it would delay the measure and the consequent fiscal savings by one year.

31. Ministers decided upon the earlier application for these reforms, meaning that the reforms would apply from the 2012-13 tax year.

Transitional rules

32. As described above, a 2012-13 application requires transitional rules to guide the treatment of the relatively small number of people claiming tax credits through the PAYE system during the 2012-13 tax year. For the active income of children tax credit, the only real transitional rule option was:

- for employers: allow the employers to continue to take account of the tax credit in determining whether to withhold PAYE from a child employee, up until 1 April 2013; and

- for child employees: if an employer has been taking the credit into account, not require the child to file a tax return (and therefore not be required to pay any resulting top-up tax) <u>if</u> they would not have otherwise been required to file.

33. The lack of other options is due to the mechanism of claiming this credit through the PAYE system. In practice, if an employer expects a child employee to earn less than $2,340, they are able to take account of the credit by not withholding any PAYE. The employer also does not inform Inland Revenue about the child's pay. Due to this, Inland Revenue has no ability to identify children whose employers have been taking into account the credit during the year.

34. This approach means that, while such children will generally not be required to file, if they do happen to file they may face an end-of-year tax bill. Nevertheless, this will mean that the child will pay the same amount of tax in total as a child whose employer did not take into account the tax credit during the year. This seems appropriate.

35. For the income under $9,880 credit, similar transitional rules for employees and employers would also apply. Employers could continue to take account of the credit when deducting PAYE from their employees, and employees who have been claiming the credit during the year would not be required to file a tax return if they otherwise would not have been required to file.

36. In addition to these measures, Inland Revenue is able to identify taxpayers that claim this credit through the PAYE system. This provides some additional options for the treatment of employees. It allows:

- for Inland Revenue to write a letter to those claiming the credit through the PAYE system, explaining the possible impact of continuing to claim the credit and then filing a tax return *(preferred)*; or

- have a legislative rule providing that such employees do not lose the benefit of the credit if they file a return.

37. We prefer the first of these options, which is having Inland Revenue write to affected employees explaining the impact of filing. This option means that taxpayers on the same levels of income who file will pay the same amount of tax in total, regardless of whether they claimed the credit during the year or not. It is also consistent with the treatment of those claiming the tax credit through the PAYE system for the active income of children.

CONSULTATION

38. Due to the need for Budget secrecy and the short time frames involved, there was no opportunity to consult in the usual manner. The Treasury and Inland Revenue were the only agencies involved in developing the proposals and carrying out the analysis.

CONCLUSIONS AND RECOMMENDATIONS

39. The recommended option is to:

- repeal the income under $9,880 tax credit and the tax credit for housekeeper and childcare expenses;

- replace the tax credit for the active income of children with a limited tax exemption;

- have these reforms apply for the 2012-13 and later tax years; and

- have transitional rules that:
    - for employers, means they can continue to take account of the tax credits when determining the PAYE deductions for their employees until 1 April 2013; and
    - for employees who are claiming the tax credits through the PAYE system, not be required to file a tax return (and pay resulting top-up tax) if they would not have otherwise been required to file.

40. This option is base broadening and delivers substantial fiscal savings from low-value programmes. It also reduces the need for taxpayers to interact with Inland Revenue. The option is able to be implemented as part of Budget 2012.

<table>
<tr><th rowspan="3">Credit</th><th colspan="4">Impacts</th><th rowspan="3">Net Impact</th></tr>
<tr><th rowspan="2">Credit recipients</th><th colspan="2">Government</th><th rowspan="2">Employers</th></tr>
<tr><th>Fiscal</th><th>Administrative</th></tr>
<tr><td>Income under $9,880</td><td rowspan="2">($21m)</td><td rowspan="2">$21m</td><td rowspan="3">($1.4m) transition cost

Unquantified but small ongoing savings.</td><td>Minor transitional costs</td><td rowspan="3">The ongoing efficiency gains outweigh the small transitional cost for some employers.</td></tr>
<tr><td>Housekeeper and childcare</td><td>None</td></tr>
<tr><td>Childrens' active income</td><td>($14m)</td><td>$14m</td><td>Minor transitional costs</td></tr>
</table>

41. We also note that changes will result in fewer people being eligible for a tax refund, which may have an indirect impact on Personal Tax Summary Intermediaries (companies that calculate if a person has a tax refund owing and, if so, claim it on their behalf).

IMPLEMENTATION

42. The necessary legislative changes will be included in Budget night legislation.

43. Implementing this option requires minor systems changes for Inland Revenue. Implementation risks are being minimised by including the changes in Budget night legislation, which ensures the law is settled before the systems changes begin.

MONITORING, EVALUATION AND REVIEW

44. The post-implementation phase of the generic tax policy process will help to identify and address any remedial issues post-Budget. The Income Tax Act 2007 is also subject to regular review by officials.