

Regulatory Impact Statement

Extending eligibility for the in-work tax credit to unpaid shareholder-employees in certain circumstances

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The question in this Statement is whether unpaid shareholder-employees can be eligible for the in-work tax credit where they work the required number of hours per week. Currently, the in-work tax credit is only available to a shareholder-employee who works full-time and where they derive wages, salary or a shareholder salary. It is not available if they only derive dividends or other distributions from the company.

The Statement provides an analysis of the options for extending eligibility to unpaid shareholder-employees.

As the change concerns people who are currently ineligible, there is little information to indicate the number of people affected. Estimates have been made based on current administrative data and information gathered through consultation. The number affected is expected to be very low and also likely to vary between years due to economic conditions affecting business profitability.

Other than set out in this Disclosure Statement and the broader Regulatory Impact Statement, no significant gaps, assumptions, dependencies, constraints, caveats or uncertainties have been identified.

In preparing this Statement, we have consulted with the Treasury and the Ministry of Social Development, which agreed with our analysis. We have also discussed the issue and potential options with representatives of the New Zealand Institute of Chartered Accountants. The consultation informed the problem definition, development of options and analysis summarised in this Statement.

The proposed change will not impose any significant new compliance costs on shareholder-employees seeking to apply for the in-work tax credit. The proposed change also does not impair private property rights, reduce market competition, provide disincentives to innovate and invest or override common law principles.



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STATUS QUO AND PROBLEM DEFINITION

1. Where a person meets certain criteria they will be eligible for the in-work tax credit. The criteria include being a New Zealand resident, caring for a dependent child, not receiving an income-tested benefit or student allowance, working the minimum required number of hours a week and deriving income from that work activity.
2. Section MD 9 of the Income Tax Act 2007 requires the full time worker to be receiving specified income from the work activity. This specified income is defined to include wages and salary, shareholder salary and income from a business carried on for profit, as well as weekly ACC and parental leave payments in certain circumstances.
3. This requirement is not clearly stated on the application form leading to some applicants being unaware of the requirement for income to be derived from the work activity. Additional costs can be incurred by the department and applications in correcting applications.
4. Where all the criteria are met the person can apply for the in-work tax credit, which provides up to \$60 a week where the family has up to three children, and an extra \$15 a week for each additional child. The total amount, along with any family tax credit or parental tax credit, is abated against family scheme income. Family scheme income is defined in the Income Tax Act 2007 to include wages and salary, shareholder salary and business income. It also includes income attributed to people from trusts or companies in specific circumstances.
5. These criteria are intended to encourage people to move off income-tested benefits into work. It also encourages people to remain in work.
6. When a business makes a loss in a tax year, it may decide not to make a payment to the business owner relating to the owner's work activity. If the business owner is a sole trader, partner, shareholder of a look-through company, or beneficiary of a trading trust, they may still be eligible for the in-work tax credit as the gross income of the business can be treated as the person's income from a business. However, this treatment does not apply where the business is conducted via a company. A shareholder-employee will only qualify as receiving income from a work activity if they are paid wages or salary, or a shareholder salary. The gross income of the company is not treated as the person's income from a business for the purposes of the test in section MD 9.
7. In a number of situations, companies have elected to make no payment to the shareholder-employee due to the overall net loss of the company in that year. As a result, an unpaid shareholder-employee is not eligible for the in-work tax credit, even though they normally work the required number of hours per week. The number affected is estimated to be very low.
8. The current situation creates an inequity between working business owners based on the type of structure their business operates in.
9. An alternative could be for a shareholder-employee to receive a nominal payment, meaning they would meet the criterion of receiving income from a work activity. However, as this is an artificial construct it is likely to receive additional scrutiny from Inland Revenue with associated costs for the department and applicant. It would be preferable to address the problem directly.

10. The key cause of this situation is the inability for an unpaid shareholder-employee to meet the current legislative definition of income from a work activity. While the definition is sufficient for business owners in other entities, it does not cover shareholder-employees in standard companies. A non-legislative solution of the payment of a nominal salary is artificial and could result in greater scrutiny being applied to it with increased uncertainty and compliance costs for applicants.

OBJECTIVES

11. The main objective is to ensure that the in-work tax credit operates as intended by encouraging people to move into and remain in work. It aims to support people with dependent children based on their level of work activity and their level of income. The question is whether the legislation setting out the eligibility criteria achieves the policy objectives.

12. In making changes to the eligibility rules, consideration should be given to government priorities to improve the integrity of the tax credits. Fiscal costs are also a consideration.

REGULATORY IMPACT ANALYSIS

13. The options that we have identified are to:

Option A: provide further guidance to applicants and Inland Revenue staff about the requirements for income to be derived from work and the approach taken on nominal salary payments in light of the recent broadening of the definition of income. This would only clear some confusion on the current rules and would not extend eligibility to unpaid shareholder-employees.

Option B: change the definition of “full-time earner deriving income from a work activity” to include major shareholder-employees of close companies that produce gross income, provided the person meets all other requirements. This would extend eligibility to unpaid shareholder-employees who meet all other requirements.

14. As noted, Option A does not address the inequity that has been identified, although it may reduce the uncertainty and compliance costs for some applicants.

15. The preferred option is Option B to amend the Income Tax Act 2007 to extend eligibility to major shareholder-employees of a close company, where the close company produces gross income and all other requirements are met. This addresses the inequity.

16. The preferred Option B will result in an estimated increase in expenditure on the in-work tax credit of approximately \$0.650 million per year. The 2011-12 appropriation for the in-work tax credit is approximately \$567 million. The estimated cost of the preferred option can be met within the existing appropriation.

17. Shareholder-employees affected by the proposed change will be required to confirm that they meet all the eligibility requirements when applying for the in-work tax credit. No social, environmental or cultural costs are expected to arise.

CONSULTATION

18. Officials discussed the status quo and problem definition with representatives from the New Zealand Institute of Chartered Accountants, who provided information to inform the analysis. Indicative options were also discussed and the representatives did not support the

option to issue further guidance only. Feedback from the consultation was factored into the analysis and informed the development of the preferred option.

19. Inland Revenue has also consulted with the Treasury and the Ministry of Social Development, which agreed with our analysis.

CONCLUSIONS AND RECOMMENDATIONS

20. The recommended option is to amend the Income Tax Act 2007 to change the definition of “full-time earner deriving income from a work activity” to include major shareholder-employees of close companies that produce gross income, provided the person meets all other requirements. This would ensure comparable treatment between major shareholder-employees and other working business owners.

IMPLEMENTATION

21. The definition of family scheme income has been broadened from 1 April 2011 to improve its integrity. The broadened definition of family scheme income will reduce the risks associated with potential behavioural changes. In particular, section MB 4 attributes the net undistributed income of a close company to the major shareholders in proportion to their shareholding. Furthermore, section MB 7 attributes the income earned by a trust that is not paid out as beneficiary income to the settlors of the trust. This broadened definition of family scheme income ensures that Working for Family tax credits, including the in-work tax credit, are well targeted.

22. The necessary legislative change will be included in the tax bill scheduled to be introduced in September 2011, with effect from the 2012-13 tax year.

23. As the proposed option refers to existing definitions of major shareholders and close companies, it can be implemented within existing processes for changes to Working for Families. Administrative costs will be met within the Inland Revenue’s existing baselines. No significant risks have been identified.

MONITORING, EVALUATION AND REVIEW

24. The proposed change to eligibility will be monitored as part of business as usual processes on the take-up and expenditure of the in-work tax credit.