POLICY ADVICE DIVISION

Tax policy report: Working for Families – integrity issues and removing indexation of the abatement threshold

Date:	26 February 2010	Priority:	High
Security Level:		Report No:	T2010/300 PAD2010/36

Action sought

	Action Sought	Deadline
Minister of Finance	**Agree** to recommendations	5 March 2010
Minister of Revenue	**Agree** to recommendations	5 March 2010

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26 February 2010

Minister of Finance
Minister of Revenue

Working for Families – integrity issues and removing indexation of the abatement threshold

Executive summary

Ministers have indicated that they have an interest in addressing issues around the integrity of Working for Families (WFF) tax credits entitlements.

In addition, the Minister of Finance has previously agreed to remove the automatic indexation of the abatement threshold of the WFF tax credits.[1]

Working for Families – integrity

The income tax definition of "taxable income" is used as the basis for determining eligibility for social assistance programmes delivered through the tax system. Some adjustments are made to taxable income for WFF tax credits purposes. For example, business losses and loss attributing qualifying company (LAQC) losses are not taken into account for determining WFF tax credits (thereby reducing the credits).

Some families have structured their financial affairs with an effect that they receive more WFF tax credits than they would in the absence of these arrangements and beyond what their true economic circumstances justify. This has a fiscal cost and reduces equity because families in similar economic circumstances are treated differently.

There are a number of possible approaches to determine the level of a household's entitlement to WFF tax credits, including using the income tax definition of taxable income, a cash flow approach based on a household's ability to pay for day-to-day expenses, asset testing, or adjusted taxable income.

[1] Treasury report T2009/2549 refers.

Officials recommend that a review be undertaken to address integrity concerns. The objective of the review would be to determine the appropriate measure of income for determining WFF tax credits. Issues to be addressed could include: whether rental and other investment losses should be recognised for WFF purposes; how to deal with non-taxable payments from a trust which were previously taxed as trustee income; whether to treat certain fringe benefits as income for the purposes of calculating WFF entitlements; and whether portfolio investment entity (PIE) distributions, in particular from non locked-in cash PIEs, should also be taken into account.

Officials consider that this review should be announced as part of Budget 2010, with a view to making legislative changes as early as possible (potentially as early as 2011). Officials do not consider that it is feasible to progress solutions to most issues in time for Budget night legislation. There are a number of complex issues to work through in handling some of these matters.

However, Treasury considers that amendments excluding investment losses for the purposes of calculating WFF tax credit entitlements should be enacted as part of Budget night legislation. Investment losses would include losses from rental properties and losses from shares purchased for the purpose of resale. Inland Revenue considers that the issue could be considered as part of the proposed wider review instead. Inland Revenue calculates that disregarding investment losses for WFF purposes could reduce expenditure by at least $15 million per annum. This estimate is based on Inland Revenue data showing that 9,720 families with rental losses also received WFF tax credits in 2008. This estimate is a minimum figure only as it does not include other types of investment losses for which data is not yet available. However, the estimate does not take into account any other potential Budget tax package changes – such as the removal of depreciation deductions.

Note that the proposed review could have wider implications than WFF tax credits, because similar integrity issues arise with other types of social assistance, for example, income-tested student allowances.

Some other Budget measures, such as removing depreciation on rental houses and aligning the top personal tax rate and the trustee rate, would help improve the integrity of WFF. However, because of the much higher effective marginal tax rates that individuals face when they receive WFF tax credits, income tax rate alignment on its own would only partially address WFF integrity concerns.

Removal of indexation of the WFF tax credits abatement threshold

Existing law requires that both the amount of the Family Tax Credit and the income threshold at which WFF tax credits begin to abate be adjusted for inflation. This ensures that the real value of assistance is maintained over time and that wage inflation does not exclude genuinely low-income families from receiving assistance.

While this "double indexation" maintains the status quo in real terms for those receiving full unabated WFF tax credits, double indexation increases the net real benefit of WFF for those families with incomes above the abatement threshold. This is because indexation of the amount of the family tax credit increases the gross amount of this payment they receive, while indexation of the abatement threshold of WFF tax credits increases the amount kept before it begins to abate.

Double indexation therefore benefits those with incomes above the abatement threshold more than those with incomes below the abatement threshold. This result is inequitable and an inefficient targeting of Government support.

Officials recommend removing the indexation of the WFF tax credits abatement threshold only. This would not affect families with incomes below the current $36,827 threshold, and would increasingly target WFF towards families lower down the income distribution.

Officials consider that the removal of indexation of the abatement threshold for WFF could be enacted on Budget night. Doing so is estimated to reduce expenditure by $95 million per annum once savings are fully realised in 2012-13.

Recommended action

We recommend that you:

Working for Families – integrity

(a) **Note** that entitlements to Working for Families tax credits are based, with some modifications, on the income tax definition of "taxable income".

Noted Noted

(b) **Agree** to announce as part of Budget 2010 a review of what, from an integrity perspective, should be the measure of income for determining Working for Families entitlements.

Agreed / Not agreed Agreed / Not agreed

(c) **Agree** to enact as part of Budget night legislation an amendment so that investment losses (including those from residential rental properties) will be excluded from the calculation of income for Working for Families tax credits purposes, with application from 1 April 2011 (Treasury's preference).

Agreed / Not agreed Agreed / Not agreed

(d) If (c) is agreed to by Cabinet, **note** the following reduction in expenditure, and that the estimates are minimum figures because they are based on 2008 data for rental losses only and do not take into account other types of investment losses.

	$m increase/(decrease)				
Vote Revenue Minister of Revenue	2009/10	2010/11	2011/12	2012/13	2013/14& outyears
Benefits and other unrequited expenses: Working for Families tax credits	-	(5)	(15.000)	(15.000)	(15.000)

Note: amounts are rounded to nearest $5 million. The estimate does not take into account any other potential Budget tax package changes – such as the removal of depreciation deductions.

Noted Noted

Removal of indexation of the WFF tax credits abatement threshold

(e) **Agree** to remove indexation of the abatement threshold of WFF tax credits.

Agreed / Not agreed Agreed / Not agreed

(f) If (e) is agreed to, a**gree** to remove the provision requiring indexation from the Income Tax Act 2007 in Budget night legislation with effect from the date of enactment.

Noted Noted

(g) If (e) and (f) are agreed to by Cabinet, **note** that current forecasts indicate fiscal savings would occur from 1 April 2012, and expenditure is estimated to reduce by:

	$m increase/(decrease)				
Vote Revenue Minister of Revenue	2009/10	2010/11	2011/12	2012/13	2013/14& outyears
Benefits and other unrequited expenses: Working for Families tax credits	-	-	(25.000)	(95.000)	(95.000)

Note figures are estimated, have an estimated error margin of ± 10 percent, and have been rounded to the nearest $5 million.

Noted Noted

(h) **Note** that the reduction in expenditure referred to above in (g) may change before final decisions, depending on preliminary Budget 2010 forecasts. If the revised forecasts indicate that cumulative inflation since the last WFF indexation (October 2008) is higher than indicated in HYEFU 2009, the 5 percent cumulative threshold may be breached. In this case savings would be realised from 1 April 2011 rather than 2012.

Noted

Noted

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Working for Families – integrity

Background

1. The Victoria University Tax Working Group raised concerns about the integrity of the Working for Families (WFF) package of tax credits, in particular, relating to arrangements that have the effect of increasing WFF entitlements. A number of these arrangements date from the early 2000s and are by-products of taxpayers' planning in order to minimise the effect of the 39 percent tax rate. The increase in the abatement threshold and reduction in the rate of abatement which applied from the 2006-07 tax year also increased the incentives to make these arrangements.

2. Ministers have indicated an interest in addressing the issue of taxpayers receiving more WFF tax credits than what their true economic circumstances justify.

3. The objectives of the WFF scheme are to: ensure income adequacy, with a focus on low and middle income families with dependent children; make work pay by supporting families with children, so that they are rewarded for their work effort; and to achieve a social assistance system that supports people into work (CAB Min (04) 13/4). By targeting assistance in this way, WFF has the effect of redistributing income to those on lower incomes.

4. When the first tax credits were introduced in 1986, the definition of "taxable income" in income tax legislation was adopted as the basis of the measure of income to determine eligibility for social assistance programmes delivered through the tax system, because that information was already held for individuals by Inland Revenue.

5. A number of limited adjustments (known as "add-backs") were made to taxable income for family assistance (now WFF tax credits) purposes, to attempt to align taxable income more closely with a family's available financial resources. For example, LAQC losses and business losses are not taken into account for determining WFF tax credits entitlements, but the tax-paid retained income of a closely-held company is attributed to the shareholders for WFF purposes.

Current concerns

6. Entitlement to WFF tax credits is subject to an income-based test contained in the Income Tax Act 2007. However, some families are able to structure their financial affairs in ways that divert the incidence of tax away from the individual to other entities, such as trusts, while still receiving economic benefits. While the purpose of such restructuring may have other drivers, an effect is to increase their entitlement to WFF tax credits.

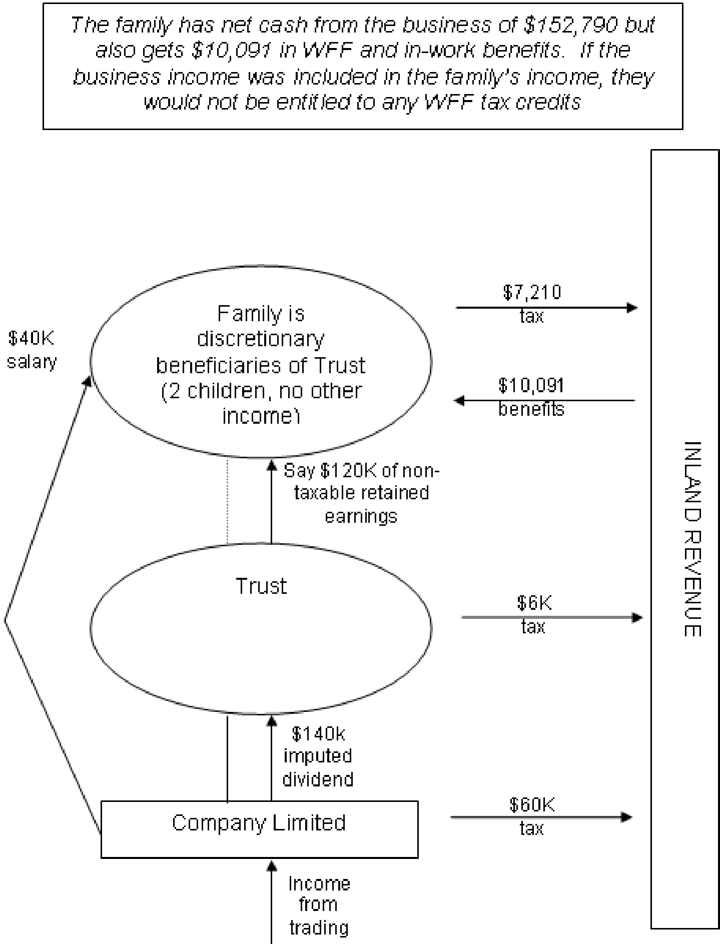
7. Some payments are not taxed in the hands of the individual, which may be appropriate from an income tax perspective but may not be from a WFF perspective. For instance, if the income of a trust is taxed as trustee income, instead of as beneficiary income, it can be later distributed to beneficiaries tax-free because income tax has already been paid at the trustee

level. Similarly, because fringe benefit tax is imposed on employers, fringe benefits are not subject to income tax in the hands of employees who derive the benefit of them.

Trustee income

8. Currently, the income of a trust can be taxed to the trustee at a final tax rate of 33 percent and later distributed to beneficiaries tax-free. As the distribution has already been taxed at the trustee level, further distributions are not included in the taxable income of the beneficiaries – and so are not included in their calculation for WFF purposes. Consequently, this feature of the income tax treatment of trusts can have the effect of increasing entitlements to WFF tax credits. The income of a trust can also be paid to dependent children as beneficiary income; even though such income is taxed at 33 percent, it does not count for WFF calculation purposes as children's passive income is not counted.

9. Inland Revenue has identified a number of structures that have the effect of inappropriately increasing WFF entitlements. These arrangements often involve the use of a company (which owns the family business) owned by a trust. The family member(s) who work for the company draw a lower salary than what might be expected, and most of the company's income is subject to company tax and then paid as a dividend to the trust, where it is retained and taxed at trustee rate. Tax-free distributions from the trust are subsequently made to beneficiaries that are not counted for WFF purposes. An example of this arrangement is set out in a diagram below. Similar results can also be obtained where the family business is owned directly by a trust.



Fringe benefits

10. Employees and employers can arrange for a significant proportion of employee remuneration to be paid as fringe benefits (for example, the use of motor vehicles and the provision of free or discounted goods and services) which are not included in an employee's taxable income (and therefore not counted for calculating WFF tax credits entitlements), instead of wages and salary which are counted. This is particularly easy to arrange in the case of closely-held companies. Especially where there is a corresponding salary sacrifice, these benefits represent a form of income or an increase in means and should, in principle, be incorporated for WFF tax credits purposes.

Foreign-sourced income of non-resident parents

11. The foreign-sourced income of non-residents is also not taken into account in the calculation of WFF entitlements. Inland Revenue is aware of cases where a non-working spouse and dependent children are in New Zealand receiving taxpayer-funded benefits such as education while the main income-earning spouse, who pays for most household expenses, is a non-resident for income tax purposes. The family qualifies for WFF tax credits because the offshore income of the non-resident spouse is not included in taxable income.

Application of anti-avoidance provision

12. Officials note that there is a specific WFF anti-avoidance provision to counter arrangements which have the effect of increasing entitlements to WFF tax credits beyond the amount justified by a household's true economic circumstances.

13. This provision has been successfully applied by Inland Revenue in a number of cases. However, relying on such an anti-avoidance provision is not an ideal long-term solution. One of the drawbacks of this approach is that it is only effective against cases identified in an audit process, which would not be all cases. This approach may also lead to court action, which is not an efficient way of administering entitlements to WFF tax credits. Relying on audits and/or prosecutions to reverse these types of arrangements also incurs high administration costs.

Need for review

14. As indicated above, there can be a tension between the taxable income of a person and what should be treated as the person's income for WFF tax credits purposes. WFF integrity is jeopardised when people receive more assistance than what their true economic circumstances justify. There are also fiscal costs involved in providing undue WFF assistance in these situations, as well as being inequitable that families with similar economic means are unable to access the same levels of taxpayer-funded assistance.

15. Consequently, officials consider that there needs to be a review of the basis for determining entitlement to WFF tax credits. This review could be announced as part of Budget 2010 and could consider how the WFF tax credits can best meet the objective of supporting low and middle income families with dependent children. Some possible options for reform are discussed later in this report.

16. Note that this review could have wider implications than WFF tax credits, because similar integrity issues arise with other types of social assistance, for example, income-tested student allowances.

17. Officials consider that it is not feasible to progress solutions to most of these WFF integrity issues in time for Budget night legislation. There are a number of complex issues to work through in handling some of these matters. The WFF integrity issues identified in this report require thorough solutions which by their nature will take time to develop. In particular, some solutions may raise significant administrative and compliance issues which have to be properly worked through. It is also necessary to ensure that any solutions are comprehensive to prevent people from readily structuring around them.

18. However, Treasury considers that excluding investment losses for calculating entitlement to WFF tax credits is a principled change that should be included in Budget night legislation, with application from 1 April 2011. Investment losses would include losses from rental properties and losses from shares purchased for the purpose of resale. Inland Revenue considers that the issue could be considered as part of the proposed wider review instead.

19. Should Ministers agree to a review, officials will report back after the Budget on potential options for scope and timing, with a view to developing solutions for legislation potentially as early as 2011.

Appropriate measure of income

20. There are a number of possible conceptual approaches as to how to determine a household's entitlement to WFF tax credits. The approaches include: using the income tax definition of taxable income; a cash flow approach based on a household's ability to pay for day-to-day expenses; taxable income with adjustments; and asset testing. Any review would consider the implications of these approaches in detail.

Taxable income approach

21. This approach would involve using taxable income calculated under the Income Tax Act 2007 for determining WFF entitlements delivered through the tax system. The definition of taxable income includes salary and wage income, dividends, beneficiary income, and other benefit income (such as New Zealand superannuation). It does not include certain distributions from a trust, fringe benefits or PIE income. If income has already been taxed to another entity, it is generally excluded for WFF purposes unless it is explicitly added back.

22. Taxable income is aimed at reflecting 'ability to pay' for income tax purposes. But a more comprehensive definition of income may be thought desirable to ensure that WFF tax credits are more effectively targeted to low and middle income families. Suppose instead that WFF entitlements were to be based on day-to-day living needs. For families that rely solely on a salary or wage, taxable income would be a reliable proxy for the amount that is available

to meet their day-to-day living needs. However, for families receiving other benefits, using the definition of taxable income may not fully reflect their available financial resources.

Cash flow approach

23. Another approach would be to generally adopt a cash concept of income for social assistance purposes, similar to that used in the Social Security Act 1964. Eligibility for WFF tax credits would be based on the proportion of a family's economic income that is readily available for spending on day-to-day living needs (that is, the family's ability to pay for regular outgoings). In this sense, it is a family's access to cash that is important.

24. This approach would include as income for WFF tax credits amounts which are not currently counted – for example, company drawings, regular gifts, regular distributions from trusts, and fringe benefits. Therefore, even amounts that are not taxed in the hands of the recipient may be taken into account for calculating WFF entitlements. For families which receive significant non-taxable benefits in addition to salary or wage income (for example, distributions from a trust), this approach may better reflect their available financial resources.

25. However, adopting a cash concept of income for WFF purposes would involve significant administrative costs for Inland Revenue because much of this information is not currently held by Inland Revenue. It would also impose additional compliance costs on the recipients of the tax credits.

Asset test

26. As there is currently no asset testing for WFF tax credits (or other primary social security benefits), it would be a fundamental change to introduce such a test. If not properly designed, an asset test would be vulnerable to being circumvented by structures such as trusts. An asset test would also involve significant administrative costs as Inland Revenue does not have extensive information about a household's assets. Further, it would impose additional compliance costs on the recipients of the credits.

Adjusted taxable income approach

27. This approach starts with taxable income (as defined in the Income Tax Act) and then makes a number of limited adjustments for the purposes of determining WFF entitlements. Adjusted taxable income may more clearly reflect a family's available financial resources. For example, business losses which are allowed for income tax purposes would be disregarded for the purpose of determining WFF entitlements. This is the current approach to defining income for WFF tax credits purposes.

Possible further adjustments to taxable income

28. At this preliminary stage, an approach based on adjustments to the taxable income definition appears to be the most viable reform option. Without prejudicing the direction or outcome of any future review, this part of the report outlines potential adjustments to taxable income that could be considered as part of the review.

29. There are a number of possible solutions to counter the problem of people entering inappropriately receiving more WFF tax credit entitlements than their economic circumstances should allow. The options described below are broadly based on widening the definition of taxable income for the purpose of determining WFF tax credit entitlements. Possible adjustments to the income definition used for determining a household's entitlement to WFF tax credits could, for example:

- Treat investment losses (such as rental property losses) the same as business losses; that is, the losses cannot be offset against other income for WFF purposes.
- Treat payments from trusts as income of the beneficiaries for WFF tax credits purposes. Alternatively, the income of the trust, and of any company controlled by the trust could be attributed, with adjustments to prevent double counting, to the household.
- Treat fringe benefits which are closely substitutable with cash (for example, use of an employer's credit card), and possibly other fringe benefits, as income for WFF tax credits purposes.
- Count the foreign-sourced income of a non-resident spouse for WFF purposes.
- Count income from PIEs that are not locked-in, such as cash PIES, for the purposes of determining entitlement to WFF tax credits.

30. These are discussed in more detail below. As part of any review of WFF integrity, officials would analyse how other countries address this issue.

Investment losses (generally associated with residential rental property)

31. For the purposes of calculating income for WFF assistance, income and losses from investment assets (often residential rental properties) that are held directly by one or both spouses, rather than being held in a company, are treated as follows:

- Income less expenses is included.
- Losses can be offset against other family income.
- Any capital gain or loss from sale is excluded.

32. Any investment loss effectively reduces family income and increases entitlements to WFF tax credits. This treatment follows that of assessable income for tax purposes. If investment losses were not offset against salary and wage income, the household would be entitled to less WFF assistance.

33. The treatment of investment losses could be compared to the treatment of carried forward losses and business losses, neither of which are taken into account when determining entitlement for WFF tax credits. One objective of any reform or review, therefore, could be to adopt a more consistent treatment of losses with regard to WFF entitlements. In principle, the treatment of business and investment losses should be the same.

34. Owning an investment property is arguably a matter of choice that should not have the effect of giving a family access to taxpayer-funded assistance that is intended to support families with inadequate income. The investment property also represents resources the family has at its disposal.

Trustee income

35. Income that has been taxed as trustee income of a trust is not currently counted for WFF tax credits purposes when distributed tax-free to beneficiaries. To the extent that a distribution from a trust has already been taxed as trustee income, the amount could be treated as income for the calculation of WFF entitlements.

36. An alternative would be to consider whether an attribution rule could be made to work for closely-held companies and trusts. Current rules attribute income from closely-held companies to families if income is retained in the company and if the family owns the shares directly. If a trust is placed between the family and the company the attribution rules cannot apply, which allows the retention of income in the company or the trust. The retained funds are not included in the calculation of WFF entitlements. However, attribution rules are not straightforward and appropriate income attribution when a trust is interposed between a company and the effective owners would need to be carefully considered in the proposed review.

37. Officials consider that these options should be explored further in the proposed review of WFF integrity.

Foreign-sourced income of non-resident parents

38. The foreign-sourced income of a non-resident parent of dependent children in New Zealand is not taxed in New Zealand and, therefore, is not counted for WFF tax credits purposes. Given that WFF tax credits are provided on the basis of family income, there is an argument for including the worldwide income of both spouses in the definition of income. However, this may involve greater administrative and compliance challenges.

Fringe benefits

39. Fringe benefits are currently not included in the WFF definition of income. Since such benefits have a positive effect on the economic situation of a family, there is a strong case for taking these into account when assessing entitlements for WFF. The strongest case may arise when the fringe benefits are close substitutes for cash. An obvious example is the provision of an employer's credit cards to employees. A key issue would be whether other fringe benefits should be included. For example, the provision of an automobile, which is available for private use and which cannot be sold, may not be converted to cash yet it still provides a benefit to the family (for example, it frees up cash for expenditure on other items).

PIEs

40. Income from PIEs is currently not included in income for WFF tax credits purposes. This is probably an appropriate treatment for PIEs that are KiwiSaver funds because they are locked in until retirement age. However, in the case of PIEs that are not locked in – for example, so-called cash PIEs – which are often substitutable for other types of investments

(such as term deposits) the income from which is counted for WFF purposes, there would seem to be a strong argument to include income from non-locked in PIEs for the purposes of determining WFF tax credit entitlements.

Other issues for inclusion in proposed review

Children's income

41. Any income earned directly by children is currently not included for WFF purposes. Given that the WFF tax credits are provided for the support of a family with dependent children, there is a case for considering the income of those dependent children as family income, particularly where that income is derived from family sources. To exclude low levels of earnings by children from occasional part-time work, a threshold could be introduced on compliance cost grounds.

Superannuation contributions

42. Employer contributions to an individual's superannuation scheme may not be counted for WFF purposes. The key issue is whether income from superannuation schemes that is not locked-in, and is therefore available for living expenses, should be included as income.

Entitlement to in-work tax credits

43. There is an issue where a family member works full time for the family's business which is in a company or a trust. In good years that business distributes income to the family and there would be an in-work entitlement, but if the business has a bad year there may be no income to distribute and the entitlement to the in-work tax credit would be lost. Officials are not sure that this is appropriate, and consider it should be included in the proposed wider review.

Fiscal implications of excluding investment losses for WFF purposes

44. If Cabinet agrees to excluding investment losses from the calculation of WFF tax credit entitlements, the policy is estimated to reduce expenditure by the following amounts:

	$m increase/(decrease)				
Vote Revenue Minister of Revenue	2009/10	2010/11	2011/12	2012/13	2013/14& outyears
Benefits and other unrequited expenses: Working for Families tax credits	-	(5)	(15.000)	(15.000)	(15.000)

Note amounts are rounded to nearest $5m.

45. This estimate is based on data from the 2008 tax year which identified 9,720 families with rental losses which also received WFF tax credits. The $15 million revenue estimate is a minimum figure only because it does not include other types of investment losses for which

data is not yet available. However, the estimate does not take into account any other potential Budget 2010 tax package changes, such as the removal of depreciation deductions.

Implications of other Budget measures

46. Other proposals being considered as part of Budget 2010 would have implications for WFF integrity.

47. Measures to improve the integrity of the personal income tax structure, such as aligning the top personal rate with the trustee income tax rate (for example, at 33 percent), would help to improve the integrity of WFF tax credits. This is because such legislative measures reduce the total benefit of such planning (income tax saved plus an increase in social assistance payments) for people who structure their affairs to reduce their income tax and receive more WFF tax credits than they could otherwise obtain.

48. However, even if the top personal tax rate and trustee tax rates are aligned and the company tax rate is not too much lower, which would remove many integrity pressures for income tax purposes, there remains an issue for various social assistance measures which abate with income, where there can be much higher effective marginal tax rates. Rate alignment will not solve these pressures.

49. Reducing or removing depreciation on buildings would also lessen integrity pressures. The possible removal of depreciation on rental properties would significantly reduce the amount of rental losses that can be offset against other income. Consequently, a household's taxable income would increase and its entitlement to WFF assistance would fall.

Indexation of the abatement threshold of the Working for Families tax credits

Background

50. The Family Tax Credit (FTC) is the government's main form of financial support to families with children. It is available on an income tested basis to beneficiary and working parents regardless of whether they undertake any form of paid work. Since 2005, the child component of primary benefits has been delivered through the FTC.

51. The main WFF tax credits are added together and abated when a person's income exceeds $36,827 per annum. FTC is abated first, followed by the in-work tax credit, the grand-parented child tax credit and then the parental tax credit.

52. The Income Tax Act 2007 requires that both the amount of the FTC and the income threshold at which the WFF tax credits begin to abate be adjusted for inflation (effectively a "double indexation"). Indexing the amount of the FTC ensures that the real value of

assistance is maintained over time. Indexing the abatement threshold is designed to ensure that the same group of people who receive the full (unabated) amount of WFF tax credits remains roughly the same over time, protecting this group from reductions in assistance.

53. The adjustment occurs once the cumulative increase in the Consumer Price Index (CPI) reaches 5 percent from the last adjustment (which was in October 2008). Treasury forecasts at HYEFU 2009 indicated that the next adjustment will take place in time for increases to be paid from 1 April 2012. However, there is a possibility that the 5 percent CPI accumulation may be breached before then, triggering an increase in payments from April 2011.

54. The Minister of Finance has previously agreed to remove the indexation of the abatement threshold of the WFF tax credits (T2009/2549 refers). At their meeting on 14 October 2009, the Minister of Finance and the Minister for Social Development and Employment agreed to de-index WFF income thresholds.

Issues with double indexation of Working for Families

55. While double indexation retains the real level of benefits for those receiving full unabated WFF tax credits, it results in a double benefit for those above the abatement threshold.

56. For this group, indexation of the amount of the FTC serves to increase the gross amount they receive, while indexation of the abatement threshold increases the amount kept in hand before it begins to abate. Accordingly, double indexation benefits those with incomes above the abatement threshold more than those with incomes below the threshold. This is both inequitable and ineffective targeting of public resources.

57. The 2006 extension of WFF increased the annual income threshold from $27,481 to $35,000 (increased in October 2008 to $36,827). Due to this extension, families earning over $100,000 are now eligible for WFF tax credits, and receive greater benefits from double indexation than low income families.

Removing abatement threshold indexation

58. Removing the indexation of the *amount* of the WFF tax credits would mean that, in real terms, people would receive less assistance over time. Accordingly, this report considers removing the indexation of the abatement threshold and not the amount of the tax credits.

59. In contrast, removing the indexation of the abatement threshold would not impact on families with nominal incomes below the current $36,827 threshold. However, over time the effect of inflation would mean that WFF tax credits would increasingly be targeted to lower income families.

60. Officials consider that there are sound policy reasons for removal of indexation of the income threshold and that this removal could be enacted as part of Budget night legislation, with effect from the date of enactment.

Fiscal implications

61. Not indexing the abatement threshold of the WFF tax credits on 1 April 2012, as is currently forecast, is expected to reduce expenditure by the following amounts:

	$m increase/(decrease)				
Vote Revenue Minister of Revenue	2009/10	2010/11	2011/12	2012/13	2013/14 & outyears
Benefits and other unrequited expenses: Working for Families tax credits	-	-	(25.000)	(95.000)	(95.000)

62. Note that the amounts above are estimated to have an error margin of ± 10% and have been rounded to the nearest $5m. The reduction in expenditure referred to above may change before final decisions, depending on preliminary Budget 2010 forecasts. If the revised forecasts indicate that cumulative inflation since the last WFF indexation (October 2008) is higher than indicated in HYEFU 2009, the 5% cumulative threshold may be breached. In this case savings would be realised from 1 April 2011 rather than 2012.

63. Note also that the reduction in expenditure reflects the difference between forecast aggregate WFF expenditure with and without abatement threshold indexation. Family incomes have been adjusted for each forecast year by the appropriate forecast drivers.