The Treasury

Budget 2012 Information Release

Release Document

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Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Joint Tax policy report: Reform of outdated tax credits

Date:	15 March 2012	**Priority:**	**High**
Security Level:	Budget sensitive	**Report No:**	T2012/451 PAD2012/49

Action sought

	Action Sought	Deadline
Minister of Finance	**Agree** to the recommendations	20 March 2012
Minister of Revenue	**Agree** to the recommendations	20 March 2012

Contact for telephone discussion (if required)

Name	Position	Telephone	
Peter Frawley	Policy Manager, Inland Revenue	[3]	
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15 March 2012

Minister of Finance
Minister of Revenue

Reform of outdated tax credits

Executive summary

This report discusses a number of tax credits within the tax system that are anachronistic or poorly targeted. Removing these features of the system would provide a reasonable amount of fiscal savings and is in line with the Government's objective of improving the operation of the tax system. The changes will help Inland Revenue to achieve its strategic priorities by freeing up administrative resources used to process low value, often paper based, tax credits to focus on improving compliance and efficiently delivering the services taxpayers require of us in the future.

In aggregate the potential fiscal savings are sizeable – we estimate enacting all the changes would raise $35 million per year. Reforming these credits would therefore be consistent with the Government's fiscal consolidation objective; however, some of the reforms involve sensitivities and trade-offs.

We are recommending that two, the transitional tax credit and the housekeepers tax credit, be repealed. These have ceased to have a policy justification and do not fit with current government priorities as they are poorly targeted and fiscally expensive.

For the third tax credit, the children's active income tax credit, we are recommending it be replaced with an income-exemption threshold. The credit ensures that children do not need to file if they have earned small amounts of labour income not taxed at source (for example, from mowing the neighbour's lawns). This was intended to remove the requirement to file and interact with Inland Revenue. However, the credit also allows children that have earned active income taxed at source to have some of their tax payments refunded through year end filing. This is expensive yet is of little benefit. Replacing the tax credit with an income-exemption threshold will ensure children earning small amounts of labour income not taxed at source continue to have no filing obligations, but in a much more targeted way.

Reforming these outdated tax credits would be in line with the Government's objective of reducing administration and compliance costs and, in particular, reducing the need for individuals to interact with Inland Revenue (the credits are a driver of peak period contacts with Inland Revenue).

Under the rules of the tax policy work programme scorecard, because these tax credits are not appropriated expenditure, the fiscal savings from these changes could be counted towards the scorecard, meaning the fiscal savings could be used to fund future tax policy changes. Alternatively, the fiscal savings could be used to fund aspects of the Welfare Reform programme or other general Budget pressure. The savings could also be used to offset administrative costs involved in the implementation of other policy changes, such as child support. We recommend that Ministers discuss at their scheduled meeting on 20 March how to best allocate the savings, before a meeting of Budget Ministers on 22 March.

Reforming these tax credits would involve administrative costs for Inland Revenue of $1.4 million which will be absorbed within the departments existing baselines. Importantly, these reforms would not affect Inland Revenue's ability to deliver other priority programmes.

It is likely that these reforms could apply from the beginning of the 2012-13 tax year given the credits are normally claimed at year-end. This application date would require the reforms to be delivered in Budget night legislation. A complication of this approach is that although unusual, it is possible to claim the transitional tax credit and the children's active income tax credit during the year. The fiscal savings from the reforms with a 2012-13 tax year application would be:

Fiscal year	2011-12	2012-13	2013-14	2014-15	2015-16
Savings($m)	0.0	12.1	35.0	35.0	35.0

If, on the other hand, the reforms have a 2013-14 tax year application, Budget night legislation would not be required, nor would any special transitional rules. The fiscal savings of this approach would be:

Fiscal year	2011-12	2012-13	2013-14	2014-15	2015-16
Savings($m)	0.0	0.1	12.3	35.0	35.0

[6]

[6]

Recommended action

We recommend that you:

a. **Agree** to repeal the transitional circumstances tax credit.

Agreed/Not agreed Agreed/Not agreed

b. **Agree** to replace the children's active income tax credit with an exemption for active income received by a child that is not taxed at source, up to a yearly maximum of $2,340.

Agreed/Not agreed Agreed/Not agreed

c. **Agree** to repeal the housekeepers tax credit.

Agreed/Not agreed Agreed/Not agreed

d. (i) **Decide** that the reforms should apply from the beginning of the 2012-13 tax year and be delivered through Budget night legislation, which would require transitional rules for those claiming during the 2012-13 tax year. This option has fiscal savings of:

Fiscal year	2011-12	2012-13	2013-14	2014-15	2015-16
Savings($m)	0.0	12.1	35.0	35.0	35.0

Decided Decided

OR

(ii) **Decide** that the reforms should apply from the beginning of the 2013-14 tax year, delivered in the next available tax bill. This option does not require transitional rules and has fiscal savings of:

Fiscal year	2011-12	2012-13	2013-14	2014-15	2015-16
Savings($m)	0.0	0.1	12.3	35.0	35.0

Decided Decided

e. **Discuss** how the fiscal savings from reforming these tax credits should be allocated.

Discussed

Discussed

Peter Martin
Director, Tax Strategy
The Treasury

Struan Little
Deputy Commissioner
Policy
Inland Revenue

Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Purpose

1. This report discusses a number of tax credits within the tax system that sit alongside the core structure and are anachronistic or poorly targeted. Removing those features of the system would provide a reasonable amount of fiscal saving and is in line with the Government's objective of improving the operation of the tax system.

2. In aggregate the potential savings are sizeable – we estimate enacting all the changes would raise $35 million per year. Reforming these credits would therefore be consistent with the Government's fiscal consolidation objective; however, some of the reforms involve sensitivities and trade-offs.

3. The changes will help Inland Revenue to achieve its strategic priorities by freeing up resources on low value, often paper based, tax credits to focus on efficiently delivering the services taxpayer require of us in the future. The changes would also reduce the need for people to interact with Inland Revenue; these tax credits are a major driver of taxpayer contacts.

4. Under the rules of the tax policy work programme scorecard, because these tax credits are not appropriated expenditure, the fiscal savings from these changes could be counted towards the scorecard, meaning the fiscal savings could be used to fund future tax policy changes. Alternatively, the fiscal savings could be used to fund aspects of the Welfare Reform programme or other general Budget pressure. The savings could also be used to offset administrative costs involved in the implementation of other policy changes, such as child support. We recommend that Ministers discuss at their scheduled meeting on 20 March how to best allocate the savings, before a meeting of Budget Ministers on 22 March.

Outdated tax credit reforms

5. We have identified three tax credits that are outdated and should be reformed. These are poorly targeted, do not serve any strong policy objective, yet are fiscally expensive, costing a total of $35 million per year. The credits are also a driver of peak-period contacts with Inland Revenue.

6. We are recommending that two of these credits, the transitional circumstances tax credit and the housekeepers tax credit, be repealed. We are recommending that the third tax credit, the children's active income tax credit, be replaced with an income-exemption threshold, which better aligns with the credit's policy objective.

7. Reforming these outdated tax credits would be in line with the Government's objective of reducing administration and compliance costs and, in particular, reducing the need for

individuals to interact with Inland Revenue. The reforms would align with the aim of delivering a better and more efficient tax system.

Transitional circumstances tax credit

8. The transitional circumstances tax credit is available to a person with a taxable income of less than $9,880, provided they work 20 hours or more in the weeks that they do work. Because the credit, by definition, is paid to people earning less than $9,880 it is not received by full-time low wage earners because such people, even on the minimum wage, would earn over the $9,880 limit. This means the credit is most often paid to people who have worked part of a year, such as a tertiary student. Approximately 48,700 people claimed the credit in the 2009-10 income year.

9. The transitional circumstances tax credit is no longer serving any useful purpose, yet has a fiscal cost of $7 million per year. It also imposes administrative costs on Inland Revenue as it complicates the tax system and is a driver of tax refunds and taxpayer contacts. For example, the credit can be claimed on a pay-period basis by selecting a special tax code; however, due to the credit's particular settings and low income limit, the majority of taxpayers who select this special code are not actually eligible for the credit. Not only is this confusing, but these people must also file a tax return as they would have underpaid tax throughout the year. It is unlikely these people would have otherwise been required to file. We recommend that the transitional circumstances tax credit be repealed.

10. The credit was introduced as part of a set of tax reforms in 1986. This reform included the introduction of GST, tax cuts and an early version of Working for Families. This package left the majority of people better off, but a small group of low income, full-time workers without children would have been made worse off. It was to compensate this group of people that the transitional circumstances tax credit was introduced; this group would no longer be in receipt of the credit due to rising incomes. Therefore, removing the credit would not affect its original target group.

11. The tax credit was designed to provide temporary assistance to this small group of workers, allowing them time to adjust their income in response to the GST (e.g. by working slightly more or negotiating a slight pay increase). It was not designed to be a permanent wage subsidy. Indeed, the original advice was to repeal the tax credit after 12 to 24 months. Given this, there seems to be a strong case for its repeal.

Fiscal impact

12. We estimate that repealing the transitional circumstances tax credit would provide fiscal savings of $7 million per annum.

Children's active income tax credit

13. The children's active income tax credit provides a credit up to $245.70. It allows a child to earn up to $2,340 tax free or, if the child earns more than this, provides for reasonably large discount on their tax bill. It does not apply to passive income such as bank interest, which is taxed at source from the first dollar through Resident Withholding Tax.

14. The children's active income tax credit was introduced in 1978 to partly offset the effect of repealing another tax credit that provided an effective tax-free 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, school children engaged in part-time domestic work would be required to pay their own tax to Inland Revenue.

15. This tax credit, in its current form, is outdated. Instead of decreasing compliance costs, as it was originally intended, it now increases compliance costs owing to children filing tax returns in order to claim the credit. In 2010 roughly 67,600 children claimed the children's active income tax credit through an end-of-year square up. These children would likely otherwise be non-filers, but the credit is driving them to file. Businesses also often find it easier to deduct PAYE from all staff rather than separating out school children employees.

16. Nevertheless, we consider it appropriate that some kind of exemption be available so that children engaged in part-time domestic work are not required to file tax returns and pay tax directly to Inland Revenue.

17. We recommend that the children's active income tax credit be replaced with an exemption for active income received by a child that is not taxed at source, up to a yearly maximum of $2340 (the amount of active income a child can earn tax-free currently under the children's active income tax credit). This would ensure that children deriving small amounts of income from which tax is not deducted at source (e.g. mowing the neighbour's lawn) are kept out of the tax system. At the same time, compliance and administrative costs would be reduced as children could not file for a refund of tax withheld at source.

18. It should be noted that this new tax exemption would have a "cliff-edge" effect: a child earning $2340 from active income not taxed at source would not be required to pay any tax on that income, but a child earning $2,341 would be required to pay tax on the full amount. This approach is appropriate given the exemption is designed to reduce compliance and administration costs. In practice this should not be overly problematic as the vast majority of children are likely to be earning either well under, or well over, this $2,340 threshold.

Fiscal impact

19. We estimate that repealing the children's active income tax credit and replacing it with a select tax exemption as described above would provide fiscal savings of $14 million a year.

Housekeepers tax credit

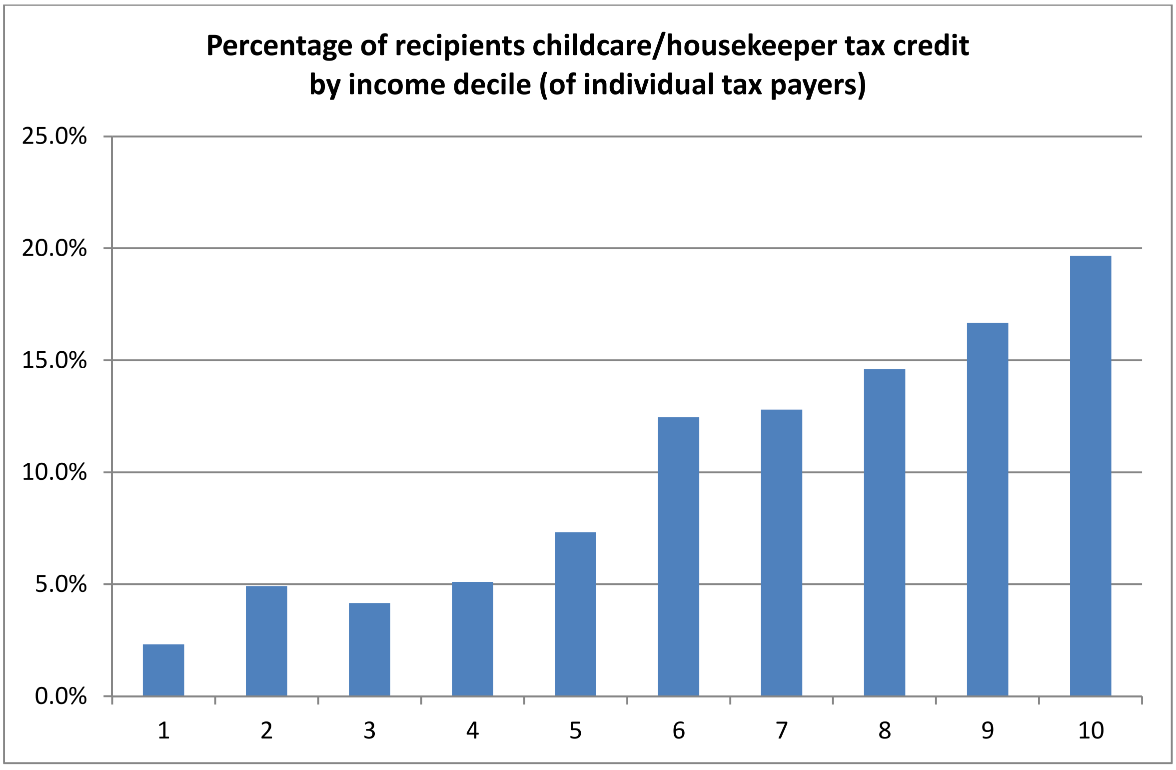
20. The housekeepers tax credit, in general terms, is available to:

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

21. The credit covers 33 percent of expenditure up to a maximum of $310 per year. People are required to send in invoices to prove expenditure. Processing this involves some administrative costs.

22. 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 – a significant cost of employment. However, there are many other costs of employment, yet no other credits or deductions are available. Moreover, childcare is subsidised by the government in other ways (such as by providing 20 hours free child care a week, and more generally by providing the IWTC through Working for Families).

23. The credit is also poorly targeted. According to a 2006 taxpayer survey, only 27 percent of working households with children qualify for the credit. Further, it does not abate with income, and as it is generally only available to those in work, is predominately paid to working and reasonably well-off households This is shown in the graph below; those that claim the credit are clearly skewed towards the top end of the income distribution. The bottom 30 of income earners made up only around 11 percent of claimants in the 2009-10 year. The credit is also not well accessed – according to the 2006 survey, only half of those eligible for the housekeepers credit claimed the credit.



24. Given these factors we recommend that the housekeepers tax credit be repealed.

25. We note that some of the benefit of the housekeepers tax credit goes to families of the disabled. However, there are already direct measures in place to provide assistance to such families, such as Home and Community Support provided by the Ministry of Health. Providing assistance through these channels seems more appropriate than through this low-value tax credit.

Fiscal impact

26. Repealing the housekeepers tax credit would provide fiscal savings of $14 million.

Administrative costs

27. The reforms of these tax credits would involve administrative costs for Inland Revenue of approximately $1.4 million. Inland Revenue will absorb these costs within its existing baseline. Importantly, implementing these reforms will not affect Inland Revenue's ability to deliver other priority programmes.

Process and fiscal impacts

28. There are two broad options for enacting these reforms. One option is for the reforms to apply from the beginning of the 2012-13 tax year (the tax year that begins on 1 April 2012). This would require the reforms being delivered through Budget night legislation to ensure the legislative is settled in time for Inland Revenue to make the required systems changes.

29. This reasonably fast application is possible as these tax credits are generally claimed in tax returns at year-end, rather than during the year.

A complication with this approach is that, while unusual, it is possible for the transitional tax credit and the children's active income tax credit to be claimed during the year. If you decide on a 2012-13 tax year application date, we will develop transitional rules for the few taxpayers claiming these credits during the year.

30. If the reforms have a 2012-13 tax year application and are enacted in Budget night legislation, the fiscal savings over the forecast period would be:

Fiscal year	2011-12	2012-13	2013-14	2014-15	2015-16
Savings($m)	0.0	12.1	35.0	35.0	35.0

31. The other option is for the reforms to apply from the beginning of the 2013-14 tax year. This means that Budget night legislation would not be required. The reform could be enacted through the next tax Bill (scheduled to be introduced in July), which would allow for submissions of the reforms. This approach also removes the need for transitional rules for the few that claim the tax credits during the year.

32. If the reforms have a 2013-14 tax year application, the fiscal savings over the forecast period would be:

Fiscal year	2011-12	2012-13	2013-14	2014-15	2015-16
Savings($m)	0.0	0.1	12.3	35.0	35.0

[6]