The Treasury

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Release Document

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Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Reform of outdated tax credits: transitional rules

Date:	2 May 2012	**Priority:**	**High**
Security Level:	Budget Sensitive	**Report No:**	T2012/731 PAD2012/90

Action sought

	Action Sought	Deadline
Minister of Finance	**Agree** to the recommendations	10 May 2012
Minister of Revenue	**Agree** to the recommendations	10 May 2012

Contact for telephone discussion (if required)

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2 May 2012

Minister of Finance
Minister of Revenue

Reform of outdated tax credits: transitional rules

Executive summary

Earlier we reported to you on the reform of three outdated tax credits (PAD 2012/49, T2012/451 refers). You agreed to these reforms and decided they should apply from the 2012-13 and later tax years. This quick application is possible because, by and large, these tax credits are claimed only at year-end. It is possible, however, for two of these credits – the transitional circumstances tax credit and the children's active income tax credit - to be claimed by employees during the year through reduced Pay As You Earn (PAYE) deductions. Transitional rules are required to deal with these taxpayers.

You have delegated authority from Cabinet to decide on these transitional rules (Cab Min (12) 13/3(28) refers).

For employers, we recommend that they be allowed to continue taking these two tax credits into account when determining the PAYE deductions for their employees until 1 April 2013. This is to minimise the impact of these changes on employers and allow time for payroll systems to be updated.

For employees, we recommend that they not be required to file a tax return (and therefore not be required to pay any resulting top-up tax) if they would not otherwise have been required to file a return. However, all taxpayers who do file a return will be treated in the same manner. This means that an employee who has been claiming one of these tax credits during the year and files a return will pay the same amount of total tax as an employee who has not claimed these credits during the year. This seems appropriate, although the former will have a tax bill to pay while the latter will not. Inland Revenue will put information on its website and, in some cases, write to taxpayers directly explaining the impact of these tax credit reforms on those that file.

The forecasted fiscal impact of the tax credit reforms, detailed in our earlier report, took into account that these transitional rules would apply to taxpayers claiming the tax credits through the PAYE system during the 2012-13 year. As noted in our earlier report, this reform has administrative costs that Inland Revenue will absorb within its existing baseline.

Recommended action

We recommend that you:

(a) **Agree** that employers be able to continue to take account of the children's active income tax credit and the transitional circumstances tax credit when determining the PAYE deductions for their employees until 1 April 2013.

Agreed/Not agreed Agreed/Not agreed

(b) **Agree** that employees receiving the children's active income tax credit and the transitional circumstances tax credit during the 2012-13 tax year not be required to file a tax return (and pay resulting top-up tax) if they otherwise would not have been required to file.

Agreed/Not agreed Agreed/Not agreed

(c) **Note** that an employee that received either of these credits during the 2012-13 tax year and filed a tax return would be required to pay the same amount of tax in total as a person that did not claim these credits during the year and filed a return.

Noted Noted

(d) **Note** that Inland Revenue will include information on its website about the consequences of filing for those receiving these tax credits during the 2012-13 tax year, and in some cases, Inland Revenue will also write informing them of these consequences.

Noted Noted

Andrea Black
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Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Purpose

1. Earlier we reported to you on the reform of three outdated tax credits: the transitional circumstances tax credit; the children's active income tax credit; and the housekeepers tax credit (PAD 2012/49, T2012/451 refers). You agreed to these reforms and decided they should apply for the 2012-13 and later tax years. Transitional rules are required to deal with the small number of taxpayers who claim two of these credits during the year through the PAYE system. This report details those rules.

2. The forecasted fiscal impact of the tax credit reforms, detailed in our earlier report, took into account that these transitional rules would apply to taxpayers claiming the tax credits during the 2012-13 year. As noted in our earlier report, this reform has administrative costs that Inland Revenue will absorb within its existing baseline.

3. You have delegated authority from Cabinet to decide on the details of these transitional rules (Cab Min (12) 13/3(28) refers).

Transitional rules for tax credit reforms

4. While the reforms to these tax credits apply from the beginning of the 2012-13 tax year, they will be announced on Budget day – part way through the tax year. This application date is possible because the tax credits are generally claimed only at year end. However, while unusual, it is possible for two of these credits – the transitional circumstances tax credit and the children's active income tax credit - to be claimed during the year through the PAYE system.

5. Strictly speaking, since the reforms apply from the beginning of the tax year, this will mean that some people will have been claiming tax credits that no longer exist. As such, unless transitional rules are developed, they may be required to file a tax return (and pay any resulting top-up tax) when they would not have otherwise had to. It is appropriate to minimise the negative impacts on those few that began claiming the credits before the reforms are announced.

6. We consider a reasonable starting point for these transitional rules is that they should ensure a person is not required to file a return after the reforms if they would have otherwise not been required to file. At the same time, someone who does file a return should be treated in the same way as other people who have filed a return.

Children's active income tax credit

7. Employers currently have the option to take account of the children's active income tax credit when withholding Pay As You Earn (PAYE) from a child's pay if they expect the child

to earn less than $2,340 that year. If an employer does this, they do not send that child's pay in the pay data sent to Inland Revenue. A consequence of this approach of applying the credit, which is likely an artefact of its outdated nature, means Inland Revenue cannot identify employees whose employer has taken into account this credit during the year.

8. We understand that this practice of omitting PAYE deductions is not common. First, many child employees will earn over the $2,340 limit for the credit and therefore have PAYE deducted as normal. Second, most employers prefer to apply their normal payroll systems, including deducting PAYE, to all their employees. Nevertheless, without any transitional rule, the few employers that do engage in this practice would have to immediately change their payroll systems and begin to fully withhold PAYE from children employees. This could be difficult. To ensure employers are not adversely impacted, we recommend employers be able to continue this practice of not withholding for the 2012-13 tax year. These employers will have to withhold PAYE from their children employees as normal from 1 April 2013.

9. A similar transitional rule should apply to children employees whose employer has taken account of the children's active income tax credit by not withholding PAYE. The rule would mean that a child would not have to file a tax return for the 2012-13 tax year if they would otherwise not have been required to file a return. This is consistent with the approach described above; it ensures that taxpayers are not driven to file for the 2012-13 tax year and pay additional tax because of reforms that occurred after the start of the tax year.

10. We note that a child may still face an end-of-year tax bill if that child files a tax return and their employer has been taking account of the credit during the year. This means the child will pay the same amount of tax in total as a child whose employer did not take account of the tax credit during the year, which seems appropriate, but, on the other hand, the former will face a tax bill while the latter may not. Nevertheless, we understand that this is an unusual circumstance and Inland Revenue will put information on its website explaining the possible impact of this reform on children that file a tax return. Inland Revenue cannot write to the employees directly as it cannot identify them. The maximum possible additional tax payment because of this reform is be $245.70.

Transitional circumstances tax credit

11. The transitional circumstances tax credit can also be claimed by employees during the year. This is done by an employee electing one of two special tax codes. We also recommend transitional rules for affected employers and employees. That is to:

- not require employers to move employees off these special tax codes until 1 April 2013. This is to minimise the impact of the reform on employers; and
- not require employees that have been using one of these tax codes to file a tax return for the 2012-13 tax year if they would otherwise not have been required to file a return. This again ensures taxpayers are not driven to file and pay additional tax because of the reforms.

12. As with the children's active income tax credit, although we are recommending a rule which would prevent a person on one of these special tax codes from being forced to file, there is a very small group of employees (approximately 680) using one of these codes correctly that have historically filed a return. As Inland Revenue can identify those that are receiving the transitional circumstances tax credit during the year, there is more flexibility in how it handles these 680 people. Broadly, there are three options:

- do nothing – if the employee files they will face a tax bill;
- write a letter to all employees that have elected one of these special tax codes explaining the possible impact of filing a return, but if an employee files they may face a tax bill; or
- develop a legislative rule providing that such employees do not lose the benefit of the credit if they filed a return; Inland Revenue would then need to manually process any tax returns from those that have elected one of these special tax codes to ensure this occurred.

13. We recommend the second of these options – for Inland Revenue to write to employees currently on these two special tax codes. 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 transitional circumstances tax credit during the year, while ensuring taxpayers are informed about the consequences of filing. The maximum additional tax payment a minimum wage employee could be required to make is $270.48.[1]

[1] In theory, the maximum additional tax payment would be $611.52. However, the tax credit is only available in weeks where a person works for 20 hours or more. Provided an employee is receiving at least the minimum wage, they can at most qualify for this tax credit for 23 weeks of the year. Only employees that hold an exemption certificate are able to be paid below the minimum wage, and these are extremely uncommon.