REGULATORY IMPACT STATEMENT
An income-sharing tax credit

AGENCY DISCLOSURE STATEMENT

This regulatory impact statement has been prepared by Inland Revenue.

It provides an analysis of the detailed design options for an "income-sharing tax credit" for couples with dependent children in New Zealand, including key gaps, assumptions and dependencies. The proposed income-sharing tax credit delivers on the commitment made in the 2008 confidence and supply agreement between National and United**Future** in which National agreed "to support appropriate income splitting legislation to First Reading in Parliament".

The analysis has been undertaken within the objectives indicated in United**Future**'s income splitting policy. The policy is premised on the assumption that couples with a dependent child are financially co-dependent ("income-sharing"). Its objectives are to:

- give parents greater choice in their work and caring roles;
- give families with children additional financial support; and
- acknowledge the contributions of those who forgo income to care for their children.

While meeting these policy objectives, the design of the proposed rules has also taken into account the tax policy criteria of fairness, efficiency, simplicity and administrative costs. Fiscal cost is also a relevant consideration. These criteria are taken into account by government as part of the development of tax policy.

Consistent with the confidence and supply agreement commitment, Inland Revenue focussed its policy resources and efforts on designing an appropriate form of income-splitting that best serves the policy objectives. We did not assess the merits of alternative ways of achieving those objectives, such as a "caregivers' allowance" or a universally-applied child benefit. These options were raised in consultation, as possible feasible alternatives to income splitting.

Designing an appropriate form of income splitting that best serves the desired objectives requires consideration of several policy options for determining:

- who should be eligible for the tax credit;
- how the tax credit should be administered; and
- how the tax credit should be paid out.

Our analysis was informed by feedback from consultation on the April 2008 discussion document *Income splitting for families with children*, and the December 2009 issues paper *An income splitting tax credit for families with children.* As a result of this feedback and consultation with other government departments, we have recommended changes to the proposal set out in the issues paper. The changes will make it simpler for those that are eligible to receive the credit and for Inland Revenue to administer it.

As far as possible and where appropriate the income-sharing tax credit rules have been aligned with those rules for delivering the Working for Families (WFF) tax credits. Again, this helps to keep both administrative and compliance costs down and reduce overall complexity. In some cases, however, it has been necessary to consider different rules to reflect the different objectives of the income-sharing tax credit. These differences and their implications are discussed in this statement.

The policy options would not impose additional costs on business. However, couples wishing to receive the tax credit may incur additional compliance obligations should they choose to claim it. None of the policy options impair private property rights, market competition, or the incentives on businesses to innovate and invest.

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STATUS QUO AND PROBLEM

1. This statement considers detailed design options for implementing legislation to provide for an "income-sharing tax credit" for couples with dependent children in New Zealand.

2. Couples are currently taxed as individuals, rather than on a family basis. There are a number of social assistance measures for families, such as Working for Families (WFF) tax credits, childcare assistance, and paid parental leave. WFF tax credits and income-tested benefits are calculated on the basis of the couples combined income. Further information on current support for families with children in New Zealand is set out in Chapter 2 of the April 2008 discussion document *Income splitting for families with children*.

3. Couples with children often face a choice between both parents working full-time, employing others to care for their children, and one parent working full-time and the other staying at home to care for the children, possibly on a part-time basis. For most people, financial considerations play a large role in the decision.

4. Introducing some form of income-splitting for tax purposes would enable some parents to have a greater choice in their work and caring roles. It may also help to alleviate the financial constraints on parents being able to stay at home, and give parents more choice around their work and home life balance.

Decisions already taken and process to date

5. Two current forms of financial assistance – paid parental leave and the parental tax credit – have similar objectives to the proposal. However, these are only available for the first few months of a child's life.

6. The proposal reflects a key part of United**Future**'s tax policy, which is intended to assist couples with dependent children. National agreed "to support appropriate income splitting legislation to First Reading in Parliament" in the confidence and supply agreement between National and United**Future**. Therefore, this statement focuses on the design and delivery of an appropriate form of income splitting that best achieves the desired objectives, having regard to principles of good tax policy.

7. The final design of the income-sharing tax credit closely mirrors the proposal in the December 2009 issues paper *An income splitting tax credit for families with children*. Submissions received on the issues paper helped to inform our final recommendations on the design of the tax credit. The issues paper was informed by submissions on the April 2008 discussion document. The discussion document considered the extent to which income splitting would provide choice to families with children. It also assessed income splitting against generally accepted tax policy criteria.

8. There are four key design choices to be made and this statement addresses each of these in turn.

OBJECTIVES

9. The objectives of the proposed income-sharing tax credit, indicated in United**Future**'s income splitting policy, are to:

- give parents greater choice in their work and caring roles;
- acknowledge the contributions of those who forego paid work to care for children; and
- give families with children additional financial support.

10. The income-sharing tax credit is not intended to duplicate other social assistance measures which focus on ensuring the adequacy of family income from week to week.

11. While meeting the specified objectives, appropriate legislation should, as far as possible, take account of the tax policy design criteria of fairness, efficiency, simplicity and administrative costs. The April 2008 discussion document provides a detailed assessment of income splitting against these criteria.

12. In order to achieve the desired objectives of the tax credit we have drawn heavily on the rules for delivering the WFF tax credits. This would help to keep administrative and compliance costs down and reduce overall complexity.

REGULATORY IMPACT ANALYSIS

13. The final design of the income-sharing tax credit closely reflects the proposal in the December 2009 issues paper. The amount of the tax credit would be the difference between the tax that is payable by the couple and the tax they would pay if each partner derived half of the couple's combined income (50:50 income-sharing).

14. The income-sharing tax credit would give some couples greater freedom to make decisions to work fewer or more flexible hours of paid work in order to care for children, by increasing their combined after-tax income. For eligible couples, the credit would provide up to $9,080 per year. Approximately half of the credits paid would exceed $1,000, while the mean credit value would be nearer to $2,000. The moderate size of the credit limits any incentives for unwanted behaviour, such as "gaming". A table showing the value of the credit for various combinations of incomes is shown in the Appendix. The number of couples who would benefit is shown in the analysis of the options for the age limit for eligibility, below.

15. The credit would not be available to all families with children and in particular would not assist sole parents. The most significant gains would go to higher single income households with the lowest gains going to low-income families. We estimate that 78% of the value of credits paid will go to couples with joint income of $70,000 or more. No credit would be payable to partners with the same marginal tax rate. For these reasons, a number of agencies have questioned whether it is the best-targeted method of achieving the policy objectives.

16. The likely effects on labour participation and gender equity have also raised concern. Secondary earners, who are mostly women, would have weaker incentives to participate in the labour market, and to invest in their careers. The credit could encourage partners to take specialised roles and increase the pay gap between men and women.

17. The proposed legislation may result in discrimination on the grounds of marital status that may be inconsistent with the New Zealand Bill of Rights Act 1990. It may be difficult to justify some of the discrimination identified.

18. The four key design choices and their impacts are outlined below.

Age limit for eligibility of the "dependent child"

19. We considered two options with respect to the age limit for eligibility of a couple's dependent child: under six years of age, or under 18 years of age.

Option 1: Age limit for eligibility of six years

20. Parents of pre-school children are more likely to sacrifice paid work to care for children, and to need additional financial support. The lower age limit would also be consistent with the Future Focus policy of work-testing domestic purposes benefit recipients whose youngest child has turned six.

Option 2: Age limit for eligibility of 18 years

21. Setting the age limit at 18 is consistent with the eligibility rules for WFF tax credits and with parents' legal responsibilities under the Care of Children Act 2004. The majority of submissions in response to the issues paper supported this option.

Impacts

	Option 1 **Under 6 years**	**Option 2** **Under 18 years**
Impact: how many couples are expected to benefit?	150,000	310,000
Revenue cost: (for the 2012-13 tax year)	$240 million	$460 million
Administrative costs for Inland Revenue for the first 5 years: Capital cost Annual operating costs	 $2 to $3 million $2 to $3 million	 $2 to $3 million $3 to $4 million

22. In relation to option 2, the WFF definition of a "child" excludes a person in a marriage, civil union or de facto relationship. This exclusion is likely to be seen as discriminatory against younger teenagers who are legally married (possibly at a young age in another country) but remain dependent on a parent or guardian.

23. On balance, and particularly given the difference in revenue cost, our preferred option is to limit the credit to couples with a dependent child's age limit for eligibility of six years.

Principal caregiver

24. Rules are needed to identify whether a couple is in fact responsible for the care of that dependent child. To achieve this, it is proposed that a partner in the couple must be the "principal caregiver" of the dependent child. Two options are considered for determining who that person is.

Option 1: WFF definition of "principal caregiver"

25. For WFF purposes a principal caregiver is the person, whether or not a parent of the child, with the primary responsibility for the day-to-day care of a dependent child, other than on a temporary basis.

Option 2: restrictive definition of "principal caregiver"

26. This option would restrict the definition of "principal caregiver" to more-narrowly target those persons who personally care for the child – for example, the child could be required to live in the same household throughout the year and couples where both partners work fulltime could be excluded. This definition would exclude those arrangements where the person is not personally caring for the child – for example, when the child is at boarding school.

Impacts

27. The fiscal cost of option 2 would be lower than that calculated for option 1, as fewer couples would be eligible for the tax credit, and it may be better targeted in terms of the objectives that relate to parents balancing their work and caring roles. However, option 2 would also be more complex, inconsistent with WFF, and might be seen as unfair, particularly when compared with the proposed shared care rules. It would also disadvantage some couples, such as those whose children attend boarding school, compared to other couples in otherwise similar circumstances.

28. We support option 1 for reasons of fairness, administrative ease and simplicity.

Administration of the income-sharing tax credit

29. We considered two options for when the tax credit could be paid out.

Option 1: interim payments

30. This option involves estimating a couple's taxable incomes in advance in order to pay interim instalments during the year.

Option 2: annual tax credit

31. This option involves the calculation and payment of the credit at the end of the year, based on the couple's assessed taxable incomes for the tax year.

Impacts

32. WFF tax credit rules provide for both of these payment options, with most recipients preferring interim instalments. Option 1 would give families a cashflow benefit by providing a payment during their first year of eligibility, but it would increase administration and compliance costs by requiring estimates of income, many more individual payments, an end-of-year square-up, and recovery of any overpaid amounts.

33. The administrative and compliance costs of option 2 would be much lower. We support option 2.

Departures from WFF

34. The income-sharing tax credit rules have drawn heavily from the WFF rules in order to keep administrative and compliance costs down. We expect that approximately 60% of recipients would be WFF customers, already providing the information needed to determine their eligibility for the tax credit at the end of each year. In some cases, however, it has been necessary to consider different rules to reflect the different objectives underpinning the different types of assistance. The three key areas where we have recommended departing from the WFF rules are:

- the principal caregiver test in "share care" situations;
- whether the tax credit should be apportioned in certain circumstances; and
- the residency rules for couples.

Principal caregiver test in "shared care" situations

35. We considered two options for determining an appropriate test for "principal caregiver" in shared care situations.

36. The first option is to use the WFF "principal caregiver" test for determining a couple's eligibility for the credit in shared care situations (when a child has, on the face of it, two or more principal caregivers, living apart). This test treats a person as a principal caregiver if a dependent child is in their exclusive care for at least one-third of a four-month period, the tax year, or an "entitlement period". Adopting this option would add significant complexity particularly for people that do not currently receive WFF tax credits. We are not convinced that this complexity is justified given the relatively low value of the tax credit and the fact that its objectives do not include WFF's strong focus on the "adequacy" of family income in the short-term.

37. The second option, which we prefer, is to use a modified version of the WFF "principal caregiver" test. This option simply requires exclusive care for at least one-third of the relevant tax year.

Full or partial entitlement in shared care situations

38. The tax credit could be apportioned based on the proportion of the tax year when a couple has a dependent child in their exclusive care. For example, if a couple cares for a child for 40% of the year they would be eligible for 40% of the credit they would receive if they had exclusive care of the child throughout the tax year. This is the rule that applies for the purposes of the WFF family tax credit. Alternatively, if two couples satisfy the one-third of the tax year test both couples could be given the full entitlement.

39. Apportioning the tax credit would reflect the amount of time a parent is likely to be caring for a child in the home. However, the impact of shared care arrangements on a parent's capacity for paid work may exceed the period of exclusive care. By one measure, apportionment could reduce the annual revenue cost of the proposal by up to $12 million, with an age limit for eligibility of 18, or up to $6 million with an age limit for eligibility of six. However, these estimates are likely to significantly overstate the potential saving because they do not take into account, for example, other children in the couple's care.

40. On balance, we do not favour apportionment. This approach would be difficult to administer and would lead to complexity and uncertainty for those seeking to obtain a tax credit. It could also encourage couples to seek or report a higher percentage of shared care to obtain a greater credit. While the apportionment approach is used for WFF's "family tax credit", it is not used for the "in-work tax credit". In this regard, the in-work tax credit and income-sharing tax credit are both focussed more on questions of work-home choices rather than income adequacy.

Residency of the couple

41. The issues paper proposed a multi-layered residency test for both partners, as used for principal caregivers in WFF in situations where the dependent child is not resident and present in New Zealand. These WFF tests cover specific policy concerns in the WFF area and are more complex than the residency tests for income tax purposes. Consequently, for the income-sharing tax credit we now favour using a simpler test – that is, both partners must be resident in New Zealand for income tax purposes for the whole of the relevant tax year. Again, the "whole year" requirement reduces the potential for manipulation and would minimise compliance and administrative costs. It would also be straightforward to apply at the end of the tax year when the couple's claim for the tax credit is assessed.

CONSULTATION

42. There were 205 submissions in response to the April 2008 discussion document. Of these, 90%, mostly from individuals, supported some form of income splitting for tax purposes on the grounds that it recognises the contribution of full-time parents in their homes and communities, strengthens the family unit, balances assistance to parents in the workforce, reduces emigration incentives, or reduces the impact of fiscal drag. Most submissions supported limiting eligibility to married couples, civil union partners and de facto couples with a dependent child up to 18 years of age. The majority of submitters also considered that income splitting should be optional and based on a 50/50 split.

43. There were 55 submissions received in response to the December 2009 issues paper. Sixty-nine percent supported the annual tax credit proposal, with 20% opposing it and the remainder neither supporting nor opposing. Supporters argued that parents taking a greater role in the care of their children would be beneficial for children and society, or that the tax credit would provide financial relief for the family. Opponents believed the scheme was not well targeted, would have a high revenue cost and could discourage secondary earners from taking paid work. Comments on the specific design features of the proposal were mostly supportive of the proposed approach.

44. In addition to considering public submissions on the issues paper, a number of other agencies have been consulted on the proposal. Their comments are summarised below.

45. The Department of Labour highlighted the policy's potential to reduce the incentives for secondary earners, in particular, to participate in the labour force and to invest in their own training and development. In some cases, primary earners' labour market incentives could also be reduced by the income effect of receiving a "windfall" tax credit.

46. The Ministry of Women's Affairs pointed out that women and the economy benefit from women being in the labour force through higher lifetime earnings, protection against poverty, and provision of a much-needed resource given New Zealand's aging population and shortage of skilled workers. By increasing effective marginal tax rates for secondary earners, who are mostly women, the proposal would encourage partners to have specialised roles, discouraging women's participation in the workforce and increasing their share of unpaid work. This, the Ministry says, appears inconsistent with the government's policy on labour force participation and the growing desire among younger people to more equally share work and the care of children. The Ministry also considered the proposal to be unfair to sole parent families, because they cannot receive the tax credit, and to low income families where there are two earners with similar income levels. The Ministry preferred other ways of supporting the ability of families to choose to stay at home and look after their children, such as extending paid parental leave.

47. The Ministry of Social Development commented that the income splitting proposal would provide additional income for a limited population, with the most significant gains being for higher single-income households and lowest gains for low-income families. Couples who have similar working hours (and arguably therefore are likely to share child minding responsibilities) would receive minimal, if any, gains, given that couples on the same marginal tax rate would not gain from the proposal. The proposal would be unlikely to greatly improve incentives to enter work for low-income unemployed families. Further, it would not target assistance to those who most need it.

48. The Treasury has not been involved with the detailed policy design of the proposed income-sharing tax credit. This is largely due to their other commitments and priorities in delivering the government's tax policy work programme. However, the Treasury has provided the following comment:

> *The Treasury considers that the credit is poorly targeted and has negative distributional impacts, as 78 percent of the benefits are expected to accrue to families earning over $70,000 per annum. In addition, the fiscal cost of the proposal, estimated to be $502 million per annum by the end of the Budget 2011 forecast period, will be more than 45% of new spending in Budget 2011 if progressed. Given the substantial fiscal cost, and the minor economic benefits, Treasury does not recommend introducing an income-sharing tax credit.*

49. The Ministry of Justice was consulted on the human rights implications of the proposal.

CONCLUSIONS AND RECOMMENDATIONS

50. Our preferred approach to implementation of United**Future**'s income splitting policy involves an annual "income-sharing tax credit" payable to eligible families with dependent children up to 6 years of age.

51. A couple would be eligible to apply for a tax credit if they satisfy all the following criteria for the relevant year:

- the couple must be married or in a de facto or civil union relationship for the whole of the relevant tax year;
- both partners must be tax-resident for the whole of the relevant tax year; and
- at least one of the partners must be a "principal caregiver" of a dependent child.

52. In a shared care situation, a person may be a "principal caregiver" if they have exclusive care of a dependent child for at least one-third of the tax year and may receive a full tax credit.

53. The credit would be calculated as the difference between the tax that is payable by the couple and the tax they would pay if each partner derived half of the couple's combined income.

54. In keeping with WFF rules, there would be a pro rata adjustment to the full year credit when a couple's dependent child is eligible for less than a full tax year.

55. The credit would be administered by Inland Revenue and paid through the WFF system at the end of the relevant tax year.

56. The value of the credit would be unaffected by other entitlements or obligations of the partners.

57. To be consistent with the treatment of other social policy payments, a partner in a couple receiving the credit would not be eligible to receive the independent earner tax credit.

IMPLEMENTATION

Legislation

58. Implementing the income-sharing tax credit rules would require amendments to the Income Tax Act 2007 and the Tax Administration Act 1994. These amendments will be included in a tax bill planned for introduction in July 2010. In addition, if the legislation is passed, amendments will be needed to take account of the effect of the credit on after-tax income for certain social assistance purposes.

59. Eligible couples would be able to apply for the tax credit for the tax year starting from 1 April 2012.

Implementation risks

60. The proposed rules would add a new task for Inland Revenue, but taking an end-of-year credit approach and aligning much of the design with WFF, where appropriate, would help to keep administration and compliance costs down.

Interactions with existing legislation

61. The assumption of income sharing between partners would not be used as the basis for determining other tax obligations or for determining child support liabilities or student loan repayments. Social assistance benefits are already income-tested based on a couple's joint income. However, some changes to the rules for other assistance payments are needed to take account of the income-sharing tax credit.

62. A couple who receives an income-sharing tax credit for a tax year should be excluded from receiving an independent earner tax credit during that year. This is consistent with the treatment of not allowing an independent earner tax credit where a person is in receipt of other social policy payments, such as WFF tax credits, income-tested benefits and superannuation. This exclusion also reduces the overall cost of the proposal. We estimate that, if the age limit for eligibility is 18, excluding income-sharing tax credit recipients from receiving the independent earner tax credit would reduce independent earner tax credits by up to $19 million. If the age limit for eligibility is six, the savings would be up to $10 million. These revenue savings are uncertain due to behavioural factors, and are not taken into account in the revenue costings provided in this statement.

63. There are several instances where social assistance regulations may need to be amended, as a result of the income-sharing tax credit on couples' after-tax income. For example, we will be reporting to the Minister of Revenue on the level of the minimum family tax credit for the 2012–13 and later tax years. Setting this level is an annual process.

64. WFF tax credits are treated as "chargeable income" for hardship assistance (such as Temporary Additional Support). The income-sharing tax credit should be treated in the same manner as lump sum WFF tax credits for social assistance

purposes. If the proposed legislation is passed, the Ministry of Social Development will seek approval for consequential amendments to incorporate the income-sharing tax credit as chargeable income for supplementary assistance purposes, in the same manner that WFF tax credits are treated.

Enforcement strategy to ensure that the preferred option achieves its public policy objectives

65. Drawing, where appropriate, on systems developed for WFF purposes would help to achieve the desired policy objectives.

66. Information provided for one purpose under the Tax Acts would assist in verifying information provided for purposes of the income-sharing tax credit.

MONITORING, EVALUATION AND REVIEW

67. Inland Revenue monitors its administration of the tax system through a range of periodic indicators, such as a regular Customer Satisfaction Survey, and through its Complaints Management System.

68. Inland Revenue has internal processes for staff to bring policy issues to the attention of Inland Revenue's Policy Advice Division, and has regular meetings with tax professionals and specific industry groups.

69. Social policy initiatives, in particular, are subject to considerable public and academic interest and scrutiny. Inland Revenue would take note of any external evaluations of the impacts of the policy, and bring them to the attention of the Minister of Revenue when appropriate. Significant concerns identified, internally or externally, regarding the impacts of the legislation would be considered for review as part of the Tax Policy Work Programme.

Appendix

Amount of the income-sharing tax credit

The annual payment to couples with various combinations of incomes is set out in the table below. For example, if partner A's income is $40,000 and the partner B's is $10,000, the amount of the income-sharing tax credit would be $280.

The figures in the table are based on the tax rates that will apply from 1 October 2010, as a result of the recent Budget.

Table: Income-sharing tax credit per couple (per tax year)

		Partner B's income ($000)							
		$0	**$10**	**$20**	**$30**	**$40**	**$50**	**$60**	**$70**
Partner A's income ($000)	**$0**	0	0	420	980	980	1,230	2,480	3,730
	$10	0	0	280	280	280	530	1,780	3,030
	$20	420	280	0	0	0	250	1,500	2,750
	$30	980	280	0	0	0	250	1,500	2,250
	$40	980	280	0	0	0	250	1,000	1,000
	$50	1,230	530	250	250	250	0	0	0
	$60	2,480	1,780	1,500	1,500	1,000	0	0	0
	$70	3,730	3,030	2,750	2,250	1,000	0	0	0
	$80	5,280	4,580	3,800	2,550	1,300	300	300	0
	$90	6,830	5,630	4,100	2,850	1,600	600	300	0
	$100	7,880	5,930	4,400	3,150	1,900	600	300	0
	$110	8,180	6,230	4,700	3,450	1,900	600	300	0
	$120	8,480	6,530	5,000	3,450	1,900	600	300	0
	$130	8,780	6,830	5,000	3,450	1,900	600	300	0
	$140	9,080	6,830	5,000	3,450	1,900	600	300	0