Regulatory Impact Statement

Social assistance integrity: defining family income

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

Budget 2010 announced the reform of the definition of income used for Working for Families (WFF) tax credits, the parental test for student allowances and the community services card (where the applicants have dependent children). These were previously dealt with in the 2010 Budget tax reform Regulatory Impact Statement.

The purpose of this Regulatory Impact Statement is to consider ways to improve the integrity of social assistance programmes by, for example, countering arrangements that have the effect of inflating entitlements beyond what people's true economic circumstances justify. As part of the move to greater integrity, different types of economic income that have previously not been counted as family income, such as fringe benefits, would be included.

The principal constraint was the availability of data on the size of the problem. This is because Inland Revenue does not necessarily collect information on a family's income if that income has already been taxed elsewhere. Where information is available, the evidence suggests that families are receiving income from substantial investments that are currently not included as family income. For example, there are approximately 11,400 families receiving WFF tax credits that have one or more children earning more than $500 each in passive income (interest, dividends, beneficiary income). This is equivalent to a $10,000 investment earning 5% per annum. Discussions with Inland Revenue investigators have also confirmed that families with substantial and available income are receiving WFF tax credits.

A second constraint was the proposal to introduce the reforms from 1 April 2011. This time constraint meant that the preferred proposals were developed within the existing framework and targeted the more obvious integrity concerns where families had the ability to control the nature or type of income they received for social assistance purposes.

Treasury, the Ministry of Social Development, the Ministry of Education and the Ministry of Health all participated in the development of these proposals. An officials' issues paper *Social assistance integrity: defining family income* was released in August 2010 for public comment. The submissions received on consultation were taken into account and amendments were made to the proposals. Further work will be done on the most effective and efficient way to collect and verify the parental income information for student allowances in order to move from the current parental income test to the proposed income definition. StudyLink and Inland Revenue officials are to report back to Ministers on this.

The preferred initiative and other approaches considered in this statement do not impose additional costs on businesses, impair private property rights, restrict market competition, or reduce the incentives on businesses to innovate and invest or override fundamental common law principles.

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STATUS QUO AND PROBLEM DEFINITION

1. The 2010 Budget tax reform Regulatory Impact Statement (Tax Reform package for Budget 2010) highlighted a number of problems with New Zealand's tax system. In particular, a key concern was the ability of families to artificially lower their taxable income in order to qualify for social assistance. This reflected the concerns expressed by the Tax Working Group in its report *A Tax System for New Zealand's Future* about the lack of coherence, integrity and fairness in the current tax system in that different entities (such as trusts and companies) could be used to shelter income from various social taxes or enable people to receive social support.

2. Maintaining the integrity of social assistance programmes is important for New Zealand to continue to have an effectively targeted social assistance system for those in genuine need. People should not receive different levels of assistance according to how they structure their affairs or the manner in which they receive income to live on – this is inequitable and inconsistent with social assistance objectives. Providing undue social assistance also costs money which must be found through taxes and government borrowing or reduced expenditure elsewhere. How family income is defined is crucial to the proper targeting of these social assistance programmes.

3. As part of Budget 2010, as a first step to addressing integrity concerns regarding social assistance programmes, the Government excluded investment losses (such as rental losses) for the purpose of determining Working for Families (WFF) tax credit entitlements. The Government also announced further reform of the definition of family income used for WFF tax credits, the parental income test for student allowances and the community services card (only for applicants with dependent children).

4. The current definition of family income for these social assistance programmes is based broadly on "taxable income" as defined in the Income Tax Act 2007. In some circumstances, taxable income is a reasonable approximation of the economic income of the family, which is the total income available for day-to-day spending and to support family members. However in some instances it is not, notably when:

- Income is not taxed in the hands of the family, rather it is taxed elsewhere. Two relevant examples are distributions from trusts and fringe benefits. The income of a trust may be taxed as trustee income and then distributed to families tax-free and not included as family income. The employer pays fringe benefit tax on fringe benefits received by employees which are also not included in employee's family income.
- Income is explicitly exempt from taxation. For example, a salary from certain international organisations, such as the United Nations.

5. Therefore, to improve integrity, adjustments need to be made to taxable income when it differs from the concept of the family's economic income available for day-to-day living needs. The key issue is what additional types of income should be included for determining eligibility to WFF tax credits, student allowances and the community services card.

OBJECTIVES

6. The objectives of these proposals is to consider options to extend the definition of income used for the purposes of WFF tax credits, the parental income test for student allowances and the community services card (for those applicants with dependent children).

Extending the definition of family income is expected to improve integrity by reducing the ability of people to structure their affairs to inflate their social assistance and address gaps in the current definition of income.

7. As the integrity concerns are proposed to be addressed with effect from 1 April 2011, there were time constraints. This meant that the preferred proposals were developed within the existing framework and targeted the more obvious integrity concerns where families had the ability to control the nature or type of income they received for social assistance purposes.

8. This Statement considers a number of specific sources of income that are currently not included as family income. The Statement presents the reasoning behind the proposed options to include these types of income, including the implications for taxpayer compliance.

REGULATORY IMPACT ANALYSIS

9. The current definition of income used for WFF tax credits, the parental income test for student allowances and the community services card is based broadly on taxable income. However, taxable income aims to reflect a family's "ability to pay" for income tax purposes. But a more comprehensive definition of income may be thought desirable to ensure social assistance is more effectively targeted to low and middle income families. If entitlements were based on day-to-day living needs, taxable income would be a reliable proxy for those families that, for example, rely predominantly on a salary or wages. However, for families receiving other types of income, using the definition of taxable income may not fully reflect their available financial resources.

Conceptual approach to defining income

10. There are a number of possible conceptual approaches that could be taken to determine a household's entitlement to social assistance. These approaches included: a cashflow approach based on a household's ability to pay for day-to-day expenses, using the income tax definition of taxable income, and taxable income with adjustments.

11. A cashflow approach is similar to that used in the Social Security Act 1964 for welfare benefit purposes. Eligibility would be based on the proportion of a family's economic income that is actually received and spent on day-to-day living needs. However, adopting a cashflow concept for WFF purposes would introduce an entirely new concept of income and involve significant administrative costs for Inland Revenue. Much of the information required to measure cash receipts is not currently collected by Inland Revenue. It would also impose additional compliance costs on all recipients. Moreover, the cash flow approach is likely to be an inadequate measure when substantial business or investment income is involved.

12. The taxable income approach would involve using taxable income as calculated under the income tax legislation to be the sole basis of determining income. This approach would be a reliable basis for those families that rely solely on taxable income received by them such as salary or wages. However, it would not be a reliable basis for those families that are able to structure their affairs or the manner in which they receive income to live on. This would perpetuate the integrity concerns that these proposals are intended to address. The adjusted taxable income approach starts with taxable income and then makes a number of limited adjustments so that the adjusted taxable income amount better reflects the income available to meet day-today living needs. It assumes that taxable income is a reliable proxy for the income that is available for day-today living needs in the majority of circumstances, but

allows other types of income to be included to better reflect income for social assistance purposes where taxable income is not a reliable proxy.

13. The adjusted taxable income approach is used currently to determine income for WFF tax credit purposes, the parental income test for student allowances and the community services card (where the applicant has dependent children and not in receipt of a main benefit). The same test applies for WFF tax credits and the community services card. Given this, the preferred approach to deal with these integrity issues is to broaden the adjustments made to taxable income. This would ensure that the existing administrative frameworks and processes are used and therefore would allow for the timely implementation of the preferred proposals.

Modifying the existing adjusted income approach

14. Rejecting the cashflow and taxable income approaches, the remaining otions are provided below.

1. Retain the status quo and do not add any additional income sources to the definition of family income; or

2. Add those types of income that are either (a) currently taxable income that is not taxed in the hands of the family or (b) income that is specifically exempt for tax purposes but which is nevertheless available for the day-to-day living expenses of the family *(recommended option).* This option would include the following types of income:

    a) Trustee income;

    b) Fringe benefits;

    c) Income of children;

    d) Portfolio investment entity (PIE) income;

    e) The income of non-resident spouses;

    f) Tax exempt salary and wages of people who work for international organisations;

    g) Deposits in the main income equalisation scheme; and

    h) Periodical payments (i.e. regular cash payments that are not caught under any of the other categories).

15. With respect to option 2 (the recommended option), the issue to resolve is how and to what extent to include additional income sources in the definition of income. This is covered in the table below. When determining whether a particular type of income should be included as family income, the key question is whether the income is available for the day-to-day living expenses of the family.

Income type currently not included as family income	Proposal and recommendation	Comment and analysis
Trustee income	If a person is a settlor of a trust, include the trustee income and the net income of a company controlled by the trust as family income.	- Counts trustee income as family income for social assistance purposes. - The objective is to attribute income from a closely-held family trust to the family member that ultimately controls the distribution of income. The settlor of the trust is the most appropriate proxy for the person controlling the income of the trust. An alternative approach was considered that would only count distributions of trustee income made by closely held trusts. The attribution rule was preferred because, compared to amounts actually received, it more accurately reflects the resources available to meet a family's living expenses. Also, it avoids the issue of how to account for trust loans. - Uses the existing definition of settlor in the Income Tax Act 2007 with minor modification to deal with potential overreach, limiting additional compliance cost. - Adds some complexity to the application for social assistance for settlors of family trusts. - Note that the current definition of income already includes an attribution rule for the income of a closely-held company directly owned by individuals.

Fringe benefits	Include major fringe benefits of shareholder/employees as family income. A shareholder/employee is a person who is an employee in a company in which, together with associates, hold more than 50% of the voting interests or market value interests (if a market circumstance exists).	- Including all fringe benefits as family income would impose significant compliance costs on employers and employees. It would require a valuation and attribution to each employee of any benefit they receive as part of their employment. To mitigate these concerns, the proposal only includes those fringe benefits that are attributed to individual employees under the fringe benefit tax rules. - Including only major or “attributable” benefits captures those benefits that are substitutable for cash or a major household expenditure (e.g. a motor vehicle). However, requiring all employees to include attributable fringe benefits could create inequities where an employee is granted private use of a motor vehicle. The value of the attributed vehicle may not reflect the actual benefit to the employee. Furthermore, not all fringe benefits are subject to the fringe benefit tax rules. - Limiting the inclusion of benefits in family income to only shareholder/employees targets closely held situations where the employee is in a position to determine the make-up of their remuneration. Employees who enter into salary sacrifice arrangements with employers also have control over the make-up of their total remuneration package. This would be considered as part of a wider review of salary sacrifice arrangements. - Limiting the proposal to shareholder/employees creates an inequity in relation to other employees who are not required to include benefits as family income. - There may be increased compliance costs for shareholder/employees who apply for WFF tax credits; however the necessary information should be readily available given that the employee is effectively the employer as well.

Income of children	Include only passive income of children (e.g. interest, dividends, beneficiary income) as family income above a threshold of $500 per child per annum.	- Prevents parents divesting income to their children to increase entitlements to social assistance. - The definition of passive income applied would use existing definitions in the Income Tax Act 2007 to minimise compliance and administrative costs. - A $500 threshold would allow children to be entitled to some income that may not contribute towards a family's day-to-day expenses. - Wages are not included as income because such income may not contribute towards a family's day-to-day expenses and the existing tax rules protect against excessive wages being paid to children. - Increased compliance costs if families are required to report the income of children.
PIE income	Include income from PIEs that are not registered superannuation schemes or retirement savings schemes as family income.	- Income from cash PIEs is analogous to interest income from bank deposits. This income is clearly available to support the family. - Minimal compliance costs for PIEs that may have to alter their investment statements to investors.
Income of non-resident spouses	Include the worldwide income of non-resident spouses as family income	- Creates equity relative to resident families where the income of both spouses is included as family income. - Minimal compliance costs as it requires a statement of income to be provided by the non-resident spouse.
Tax exempt salary and wages	Include tax exempt income in the nature of salary and wages as family income	- Income that is clearly available for day-to-day expenses is counted as family income.

Deposits in main income equalisation schemes	Include as income deposits in main income equalisation schemes and refunds (excluding interest) would be deducted from family income.	- Currently deposits in such schemes reduce family income and increase social assistance entitlements. However, the purpose of the scheme is to smooth income for tax purposes. The income is available to the family before being deposited into the scheme. - The proposal is consistent with the treatment before the 2002-03 income year when a deduction was not allowed for family assistance purposes for deposits into such schemes and refunds (excluding interest) were not counted.
Periodic payments	Include as family income regular payments above a threshold of $5,000 per annum per family that contribute to their day-today living expenses.	- Periodic payments would include regular cash gifts, payments of expenses or distributions from trusts (that are not included as income under any other proposal). - Regular or periodic would mean an expectation that the payment is more than a one-off and could include annual payments. - A $5,000 threshold limits the proposal to significant payments. If cash payments exceed $5,000 per annum, the whole amount will be counted in family income. A $5,000 threshold is equivalent to the amount of income a person on the domestic purpose benefit can earn before the benefit abates. This means that people can still provide some support to each other without affecting their social assistance but any significant regular payments will be captured. - Without such a rule, trustee income that is not captured under the settlor attribution rule above could be distributed from trusts without being counted as family income.

Further cost/benefit analysis

16. In terms of the net impact of the Government's operating balance, the proposals are expected to reduce WFF expenditure by $1 million in 2010/11 and $17 million per annum thereafter.

	$ millions increase / (decrease)				
Vote Revenue **Minister of Revenue**	2010/11	2011/12	2012/13	2013/14	2014/15 & out years
Passive income from children	(1.000)	(6.000)	(6.000)	(6.000)	(6.000)
Unlocked PIE income	–	(1.000)	(1.000)	(1.000)	(1.000)
Trustee income	–	(10.000)	(10.000)	(10.000)	(10.000)
Benefits and other unrequited expenses; Family tax credit and In-work tax credit	(1.000)	(17.000)	(17.000)	(17.000)	(17.000)

17. The fiscal savings from including deposits in income equalisation schemes is expected to be negligible, but positive (less than $500,000).

18. The Ministry of Health expects that a small but unquantified reduction in community services card numbers is likely to result in some modest savings to District Health Boards, for example, through fewer subsidised after hours doctors visits.

19. It is difficult to estimate the number of current student allowance recipients who would no longer be eligible under the proposed new taxable income definition. Indicative estimates of the impact are as follows:[1]

Percentage of current recipients (parental income tested) who are likely to be no longer eligible	Number of current recipients (parental income tested) who are likely to be no longer eligible	Potential net savings per year, including flow on increase in student loan borrowing ($m)	
		2011/12 (half year)	2012/13 & outyears
10%	4,600 (in 2012)	11.600 (high scenario) 6.000 (low scenario)	22.000 (high scenario) 11.400 (low scenario)

[1] The high savings scenario assumes that current recipients will no longer be eligible for any level of student allowance. The low savings scenario assumes that recipients will still be eligible for half of the average parental income tested allowance. There are flow on implications that will increase student loan costs, as some affected recipients will choose to borrow living costs through the loan scheme instead.

20. Officials will include further details on the fiscal impacts of the change in the parental income test definition as part of their report back on the implementation and timing issues associated with student allowances.

21. Given that the objective of the proposals is to increase the integrity of social assistance, the proposals are expected to have an overall net social benefit. Additional types of income that are available for the family's day-to-day living expenses would be counted when determining the level of social assistance. This would increase the equity of the WFF programme and improve its targeting to those in need. There may be a perceived inequity by those families whose entitlements decrease as a result of the proposals. However, this decrease would be due to counting income that is available to the family to live on.

CONSULTATION

22. Inland Revenue and Treasury released an officials' issues paper *Social assistance integrity: defining family income* in August 2010 for public comment. The paper contained a set of proposals to extend the definition of family income. The proposals were developed in consultation with the Ministry of Education, the Ministry of Social Development (including StudyLink). Officials also consulted with the Australian Treasury, the Australian Tax Office and CentreLink.

23. The issues paper attracted 11 submissions from individuals as well as interest groups and businesses. The submissions generally supported the government's policy to improve the integrity of the social assistance programmes.

24. However, there were mixed responses to the specific proposals. Some considered that the proposals did not go far enough whereas others considered that the proposals went beyond the objectives of the reform. A number of submissions suggested that, for equity reasons, the proposal relating to the inclusion of fringe benefits should be extended to apply to all employees who receive attributed fringe benefits. Also, some considered the costs of implementing the proposals could outweigh any fiscal savings.

OFFICIALS' COMMENT ON ISSUES RAISED IN CONSULTATION

25. Officials do not consider the costs of implementing the proposals would outweigh any fiscal savings from reduced WFF tax credit entitlements. The aim of the proposals is to enhance the integrity of these social assistance programmes, rather than to simply raise revenue. The improvement in integrity is a significant benefit that is not measured as part of the fiscal savings.

26. Further, the proposals have been developed with careful consideration to both the administration and compliance costs associated with extending the types of income that would be counted for WFF purposes. For example, although in principle all fringe benefits that are substitutable for cash or a major household expenditure could be included, it was considered that the costs to both employers and employees would outweigh the benefits of including them as income. The proposal was therefore limited to including only major fringe benefits where an shareholder/employee can clearly influence the make-up of their remuneration.

27. Submissions included some specific suggestions on income types that officials considered had merit and adapted the proposals accordingly. The specific amendments made to the proposals were:

Trustee income
28. A person who provides personal services for free to a trust should not be considered a settlor of that trust and attributed income from the trust. An example would be a person who provides personal services such as repairs and maintenance of a trust property. To prevent any overreach, officials recommended excluding persons who provide personal services for free in relation to a trust's administration or the maintenance of the trust's property from the definition of settlor.

Unlocked portfolio investment entity (PIE) income
29. Retirement savings schemes that meet the requirements of the retirement savings contribution tax rules should be excluded from the definition of an unlocked PIE.[2] Officials agreed with this proposition as such schemes are effectively retirement schemes and the income is not available for a family's daily living expenses.

Periodic payments
30. To acknowledge the potential compliance and administrative concerns with this proposal, officials recommended a threshold of $5,000 per year per family to exclude small regular payments received in a year. If cash payments exceed $5,000 per annum, the whole amount would be counted in family income. A $5,000 threshold is equivalent to the amount of income a person on the domestic purpose benefit can earn before the benefit abates. This way, people can still provide some support to each other without affecting their social assistance but any significant regular payments will be captured. In addition, we also consider the receipt of non-taxable private pensions and annuities should be included on a 50 percent basis in family income. This approach is already used in the community service card rules for superannuitants. The 50 percent adjustment recognises that some portion of these receipts is the return of the original capital investment rather than income, when the capital is returned on a periodic basis rather than as a lump sum.

CONCLUSIONS AND RECOMMENDATIONS

31. The preferred framework is to continue to use the adjusted taxable income approach for determining income for the WFF tax credit, the parental income test for student allowances, and the community services card. The two broad options in relation to the definition of income for social assistance purposes is to either retain the status quo or extend the definition to those sources of income currently not included. Given the concerns with the integrity of WFF tax credits, student allowances and the community services card, the recommended approach is to extend the definition of income. Doing so unambiguously improves the equity of these social assistance schemes.

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[2] For a retirement savings scheme to be eligible for these rules, the rules governing the scheme must restrict withdrawals before a person reaches an age of retirement. Limited withdrawals can be made for first home ownership, tertiary education and financial hardship.

32. It is recommended that the specific proposals outlined in the table above be adopted. These proposals have been designed to strike a balance between improving the equity of the social assistance programmes and minimising the administration and compliance costs.

IMPLEMENTATION

Working for Families tax credits

33. The amended definition of family income for WFF purposes would apply from 1 April 2011.

34. Inland Revenue would deliver the necessary administrative changes to support this policy in a phased approach. Phase one would focus on delivering communication messages to affected families outlining what income needs to be considered for determining WFF entitlements.

35. Phase two, which would be in the 2011/12 tax year, would involve amending the processes to collect the additional information on the income types of WFF applicants arising out of these reforms – for example, trustee income, passive income of children and fringe benefits. Inland Revenue would use this additional information to report on the outcome of the new policy, confirm family income, and assist in future compliance activity.

36. The amendments to the definition of family scheme income are expected to increase compliance costs for some families that apply for WFF tax credits because they will be required to report additional sources of income as part of their application. However, the increase in equity of the scheme is expected to significantly outweigh any compliance costs.

Community services card

37. The amended definition of family income for community services card purposes would apply from 1 April 2011.

38. For the community services card, there is already an existing authority for sharing family income information with the Ministry of Social Development. Therefore, we consider there will be very little operational impact unless there are any changes proposed to the information matching agreement with Inland Revenue to reflect these changes.

39. Most community services card holders would continue to be assessed under the old definition of family income as at 31 March 2011. Families whose applications for WFF tax credits are completed before 1 April 2011 will not be assessed for the community services card using the amended definition of income until the tax year commencing 1 April 2012.

40. It is not known exactly how many families would be affected by the proposed changes. Therefore it is difficult to assess the number of clients who may no longer be eligible for community services cards. It is anticipated that some families would have income that places them over the allowable income thresholds for community services cards as a result of the change to the definition of family income. This reduction may result in a decrease in the number of community services cards issued to families claiming WFF tax credits. There may also be an increase in call centre activity if affected cardholders query the way their income is circulated.

41. Since the majority of families in receipt of a community services card earn wages and salaries, it is expected that the number of cardholders affected by the change to the definition of family income is likely to be very low.

Student allowances

42. Cabinet, as part of Budget 2010, agreed that the changes to the family income definition would also apply to the parental income test for student allowances. A significant number of these parents would not be collecting WFF tax credits as their children are over 18 years. However, not all their family income details will be held by Inland Revenue. Further work is required on the most effective and efficient way to collect and verify the parental income information for student allowances to allow the change to be implemented. Discussions between the Ministry of Education, StudyLink and Inland Revenue continue on how to progress this work.

43. Implementing the change for student allowances could require changes by StudyLink to its information technology systems. One option to simplify administration and improve accuracy would be for Inland Revenue to provide information on family income of parents to StudyLink. There may be a need to amend the secrecy provisions in the Tax Administration Act 1994 to allow Inland Revenue to share information on parents' family income for student allowance purposes. Currently the definition of beneficiary for social welfare purposes includes the spouse of a person applying for a student allowance and allows Inland Revenue to provide income information on the student and their spouse. There may be a need to extend this to include the nominated parent(s). Any legislative change could be included in the tax bill scheduled to be introduced in November this year, which already contains a number of amendments to secrecy rules as part of the Transform Inland Revenue work.

44. For student allowances, the amended definition for parental income of a student could potentially apply to all student allowance applications received for study commencing after 1 January 2012. This will depend on further work by StudyLink and Inland Revenue on the most efficient and effective means of obtaining and assessing the additional income information. Officials will report back on the implementation issues and costs associated with student allowances.

MONITORING, EVALUATION AND REVIEW

45. Phase two of Inland Revenue's implementation includes the collection of specific data on the additional income types to be included in family income for social assistance purposes. The collection of this information would allow an analysis for auditing and compliance purposes by Inland Revenue. It would also allow an assessment of the impact of each of these proposals on WFF entitlements. This analysis is part of Inland Revenue's ongoing risk assurance relating to WFF tax credits.

46. While the proposals improve the integrity of social assistance programmes, Inland Revenue would continue to monitor other areas that are not included as part of this reform. This would include fringe benefits received as a part of salary sacrifice arrangements and the extent to which remuneration is received by children working in family businesses. If any concerns arise, they will be raised with Government in the future.