Tax Working Group
Te Awheawhe Tāke

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This paper has been prepared by the Secretariat to the Tax Working Group for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the whole Group or the Government.

Some papers contain draft suggested text for the Final Report. This text does not constitute the considered views of the Group. Please see the Final Report for the agreed position of the Group.

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Coversheet: **ETCI: implications for social policy**

Position Paper for Session 20 of the Tax Working Group
October 12, 2018

Purpose of discussion

This purpose of this paper is to provide further information to assist the Group to understand the implications of extending the taxation of capital income on social assistance regimes such as Working for Families tax credits, child supports and student loans.

It:

- briefly describes each regime and notes the importance of "income" for the purposes of establishing obligations and entitlements under each;
- outlines how "income" is defined for social policy purposes, and the rationale behind the definitions;
- concludes that extending the taxation of capital income should result in:
  - capital gains being counted as "income" for the purposes of each scheme; and
  - capital losses being excluded from the calculations.
- illustrates the effect of including capital gains and ignoring capital losses on each scheme; and
- proposes draft text to include in the Final Report in Appendix A.

Recommended actions

We recommend that you:

a **note** that for child support, extending the taxation of capital income will naturally flow through as income for both the receiving carer and the liable parent, as the child support regime uses the income tax definition of "taxable income"

b **note** that the Government is currently considering more closely aligning the definition of income for child support purposes to the definitions used for Working for Families tax credits and student loan purposes

c **agree** that capital gains should be counted as income for the purposes of Working for Families tax credits, student loans and child support d **note** that, in the year of realisation, this would likely have the effect of reducing the amount of Working for Families tax credits a person is eligible to receive, and increasing the amount of a student loan borrower's student loan repayment obligation

e **agree** that capital losses should be treated as nil in the calculations for determining entitlement to Working for Families tax credits and repayment obligations for student loans, which is consistent with the current treatment of losses for these schemes, and should also be treated as nil for child support

ETCI: implications for social policy

Position Paper for Session 20
of the Tax Working Group

October 2018

Prepared by Inland Revenue Department and the Treasury

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1. Introduction

1.1 Purpose and background

1. The purpose of this paper is to provide further information to assist in the Group's analysis as to whether, if the Group recommends extending the taxation from capital income:

    - **capital gains** should be counted as income, and/or
    - **capital losses** should be taken into account

    for the purposes of the Working for Families tax credits, child support and student loan schemes.

2. The Government provides a range of programmes to ensure that people have adequate income and a minimum standard of living, and access to health and education. Income is one of the key ways of identifying those people in genuine need. How income is defined is crucial to the proper targeting of these social assistance programmes.

3. This paper discusses social policy schemes that use a definition of "income" from the Income Tax Act 2007. The paper notes that there are a number of other social policy schemes that do not use an Income Tax Act 2007 definition of "income", and to that end, the paper only makes note of some of those schemes. Those schemes use their own definition of "income", such as the case of main benefits paid by the Ministry of Social Development under the Social Security Act 1964.

4. The definitions of "income" for Working for Families tax credits and student loan purposes have been broadened in recent times. The modifications were made to improve the integrity and equity of social assistance programmes. This is discussed further in Chapter 3.

5. Child support is still currently calculated using "taxable income" and has not been adjusted like the definitions for Working for Families tax credits and student loans purposes. Other sources of income can be considered for inclusion in child support calculations if they are recognised through a review process. This is discussed further in Chapter 5.

6. In the Issues Paper on *Social assistance integrity: defining family income* in 2010, the Government noted three conceptual approaches that could be taken to determine a household's entitlement to social assistance:

    - a cash-flow approach based on a household's ability to pay for day-to-day expenses;
    - using the income tax definition of "net income"; or
    - using the income tax definition of "net income" with adjustments.

7. It was noted at the time that using a cash-flow approach would introduce an entirely new concept of income which would involve significant administrative costs for Inland Revenue, and would impose additional compliance costs on recipients of Working for Families tax credits. It was also noted that the cash-flow approach is likely to be an inadequate measure when substantial business or investment income is involved.

8. An issue with using "taxable income" calculated under the Income Tax Act 2007 alone is that it does not always closely reflect a family's true economic circumstances. For example, it does not include income in closely held companies or the value of fringe benefits received. This could enable larger entitlements to Working for Families tax credits than the family's circumstances justified.

9. Using the "net income with adjustments" approach was considered to more accurately reflect an "economic" definition of income. It was used for the purposes of Working for Families tax credits (and then later, to a large extent for the purposes of determining a person's obligations in terms of their repayments under the student loan scheme).

10. The concept of net income with adjustments is based on the proportion of a person's economic income that is readily available for spending on day-to-day living needs.[1] Including capital gains following any extension of the taxation of capital income fits within the current framework.

1.2 Content and scope

11. In the Interim Report, the Group noted that:

> **Effect on social policy schemes**
>
> 88. Consideration will also need to be given to how capital gains are dealt with for purposes of entitlements and obligations under social policy schemes such as *Working for Families* and child support. While the eligibility tests may use taxable income as a base, they also deal with many forms of payments that are not taxable income. It may be that changing the tax characterisation of the proceeds of sale of a particular asset makes little difference to the seller's entitlements or obligations under social policy schemes, but this will need to be understood better.
>
> The issue can be illustrated by a person receiving *Working for Families* payments through the year. At the end of the year they are entitled to a part of the gain from the sale of a rental property. If this is included as income for the purposes of the person's *Working for Families* entitlement

[1] It is worth noting that the adjusted net income approach still excludes economic income which is not readily available to meet a person's needs. Examples of this are included below.

they may be required to repay some, or all, of the payments they received.

12. The Interim Report refers to "taxable income" as amounts of income that are subject to income tax. In this regard, it is synonymous to the use of the term "net income" in this paper.[2]

13. This paper will discuss the current eligibility tests and briefly outline the current approach to determining entitlements and obligations under each scheme. It also outlines the mechanics of the scheme and the effect of including capital gains as income, and the effect of ignoring capital losses, for the purposes of determining entitlements and obligations.

[2] Net income refers to a person's annual gross income minus their annual gross deductions for that year (i.e., it is the amount that a person pays tax on). The difference between "net income" and "taxable income" as defined in the Income Tax Act 2007 is that taxable income includes losses brought forward from earlier years.

2. Background

2.1 Working for Families tax credits

14. The Working for Families tax credits scheme is an annual entitlement comprising of payments to help make it easier for people to work and raise a family. The scheme comprises of various payments with different rationales, and what payments a person qualifies for depends on their family circumstances (for example, the number of children in the family's care, hours of work, and sources of income).

15. The scheme was originally introduced in 1986, then amended in 2004, and is targeted at low and middle-income families with children, because they are often little or no better off in work than on a benefit, once work-related costs, benefit abatement rates and tax are taken into account. It aims to remove the cost of raising children as a barrier to entering the workforce and increases the returns for those wanting to work.

16. The Working for Families tax credits scheme is discussed further in Chapter 4.

2.2 Child Support

17. Child support is paid by parents who do not live with their children, or who share care of their children with someone else. How much child support a person is paid depends on:

    - what both parents earn
    - the cost of raising a child
    - whether the parents have other children, and
    - how much care each parent provides for the child.

18. The purpose of child support is to make sure that parents take financial responsibility for their children, and financial contributions from liable parents help to offset the cost of benefits that support their children.

19. Child support is discussed further in Chapter 5.

2.3 Student loans

20. New Zealand based student loan borrowers who receive income will have a repayment obligation based on the amount of income they receive for a tax year. Generally, for borrowers whose only source of income is salary or wages, the deductions made from those payments are considered "full and final" and there are no additional amounts to pay towards the borrower's loan balance for the year.

21. For borrowers who have additional sources of income which are not subject to withholding regimes where student loan deductions are made, such as self-

employment, or the proceeds under the land taxing provisions, an additional amount must be paid towards the borrower's loan balance for the year.

22. Another component of the student loan scheme is the student allowance. The parental income test for the student allowance uses a modified version of the definition of income used for Working for Families tax credits. The parental income test, and the effect extending the taxation of capital income would have on the student allowance is discussed in Chapter 4.

23. The student loan repayment obligation rules are discussed further in Chapter 6.

2.4 Other social policy programmes across government

24. The Secretariat notes that there are a number of other social policy programmes across government where the concept of "income" is important, and may be consequentially affected by any extension of the taxation of capital income. Some of these are noted in Chapter 7.

25. As noted above, the student allowance includes a parental income test for the purposes of establishing the level of a student's entitlement to the student allowance.

26. Other social assistance programmes tend to use a definition of "income" that is not aligned with the Income Tax Act definition, and instead use more of a "funds available" approach (such is the case with the Social Security Act 1964). This paper does not discuss the effect of extending the taxation of capital income on schemes that do not use a definition of "income" from the Income Tax Act 2007. However, the Secretariat notes that, if extending the taxation of capital income is recommended, further work will be required with agencies (such as the Ministry of Social Development) to ensure that other "income" tests remained appropriately targeted.

3. Options identification

3.1 Options

27. For each scheme (Working for Families tax credits, the student loan scheme and child support), the Group needs to consider whether it recommends including proceeds from capital gains in the definitions of "income". Similarly, the Group should consider whether it recommends capital losses affect a person's obligations and entitlements under each scheme.

3.2 Principles

28. The basis on which an entitlement or obligation is established is the concept of a person's (or family's) economic circumstances. The proxy used to determine economic circumstances is income.

    - For Working for Families tax credits, it is the income available to the family in the year to meet their needs.
    - For child support, it is the relative income of each parent as a reflection of their relative ability to contribute to the care of their child.
    - For student loans, it is the borrower's ability to repay their loan.

29. Some considerations when determining whether to include income for social policy purposes are:

    - **Fairness and equity.** A social assistance programme has integrity if people in the same circumstances receive the same level of assistance, regardless of how they structure or receive their income. Fairness is compromised to the extent to which not all of a person's (or family's) income is counted for social assistance purposes.
    - **Integrity.** Social assistance schemes need to have appropriate mechanisms that prevent people from accessing entitlements (or deferring obligations) that their true circumstances would not otherwise have justified.
    - **Efficiency of compliance and administration.** Social assistance programmes should minimise compliance and administration costs as far as practical. Assisting individuals or families to easily comply with their obligations will help to minimise the overall cost of compliance and administration. For example, having processes that minimise the time between the realisation of a tax liability and any reduction in social assistance entitlement should help to reduce the compliance impact on individuals and families.
    - **Sustainability**. A social assistance programme should be sustainable – that is, it should be consistent within itself and coherent with other assistance programmes, where appropriate.

30. As an initial point, the Secretariat has previously advised the Group that 82 percent of assets potentially affected by an extension of the taxation of capital income are held by the top 20 percent of households by wealth. Because it is typically households in the lower wealth and income range that are likely to receive social assistance, the interaction between the extension of taxation of capital income and social policy schemes that use an income tax definition of income is likely to only affect households on the margin (unless capital losses are able to be counted, which is discussed below).

3.3 Options not considered

31. The Secretariat note that the Welfare Expert Advisory Group is considering (among other things) high level recommendations to improve the Working for Families tax credits scheme. We do not presuppose the outcome of their recommendations. This paper looks at the implications of extending the taxation of capital income on social policy schemes in their current form.

32. As discussed above, the paper also notes that different social assistance programmes use different definitions of "income" for the purposes of assessing entitlements and obligations, so predominantly focuses on the effect extending the taxation of capital income will have on schemes which currently use an Income Tax Act 2007 definition of "income". The Community Services Card and the student allowance both sometimes use an income tax definition of "income" and to that end, these schemes have only been discussed briefly in the paper. Before making a recommendation as to whether extending the taxation of capital income should affect the tests for schemes that use an income tax definition of "income", the Secretariat would need to consult with the other agencies responsible for these schemes.

33. The recommendations in this paper to include capital gains (and exclude capital losses) are consistent with the approach taken in previous reviews of "income" for social policy schemes that use an Income Tax Act 2007 definition of "income".

4. Working for Families tax credits

4.1 Background

34. Broadly, "income" for Working for Families tax credits refers to the combined adjusted net income of the principal caregiver and their spouse, civil union partner or de facto partner (referred to in the legislation as "family scheme income"). The entitlement to Working for Families tax credits is established as part of the principal caregiver's end-of-year income tax assessment process, and takes into account necessary income adjustments (discussed below) and the income of the principal caregiver's spouse, civil union partner or de facto partner, if applicable.

35. As noted earlier, the rationale for the amendments to the definition of "income" for the purposes of the Working for Families tax credits scheme were for fairness and integrity reasons, and to ensure a family cannot artificially decrease their income so as to obtain entitlements that are greater than what their true economic circumstances justify. The adjustments also capture some non-taxable amounts to more accurately reflect the actual funds available to the family. This ensures that assistance is more targeted at those who need it.

36. The following table outlines notable adjustments to the definition of net income for the purposes of Working for Families tax credits and may assist the Group understand the rationale behind the Secretariat's recommendations to include capital gains as income for the purposes of Working for Families tax credits (and paragraphs 38 to 41 explain the adjustments):

	Subject to income tax	**Not taxable, or not taxable in the hands of the recipient**
Included for the purposes of establishing entitlement to WfFTC	All forms of taxable income, unless specifically excluded. This includes income from salary, wages, interest, dividends, foreign investment fund (FIF) income, self-employment, income from taxable property sales, etc.	Tax-exempt salary or wages "Other payments" made to the family to help them meet ordinary day-to-day living expenses, provided the amount exceeds a de minimis of $5,000 in a tax year. Attributable fringe benefits, close company income and trustee income.
Excluded for the purposes of establishing entitlement to WfFTC	Refunds from the main income equalisation scheme. Locked-in PIE income that was taxed at an incorrect rate and subsequently included in a person's annual income tax return.[3]	Money won from gambling or from the New Zealand lottery. The proceeds from *current* capital gains which are not subject to income tax.

[3] Non-locked in PIE income that is taxed at the correct rate is also included as income. This is consistent with the principle that it is an amount that a person has access to, despite it not forming part of a person's net income.

Not taxable, or not taxable in the hands of the recipient

37. **Tax-exempt salary or wages**. These are counted in a person's income for the purposes of establishing entitlement. This is because the amounts received can be used to support the person's family. Further, if the amounts were not counted in the calculation, a person could have a significant level of income which is not subject to tax, and be entitled to the same amount of Working for Families tax credits as someone on very low income. This would raise questions of fairness and equity.

38. **Attributable amounts from trusts, closely held companies and fringe benefits**. These adjustments are made to count amounts that are subject to tax via other entities or regimes, and consequently would not be included in a person's income for Working for Families tax credits or student loan purposes without rules that specifically counted them.

    - **Trust income –** Counted as income is the net income from trading and investment activities of a trust (excluding beneficiary income) and the net income of a company controlled by the trust. The trustee income is attributed to the individuals who are settlors – as defined in the Income Tax Act 2007 – of the trust.
    - **Closely held companies income -** Major shareholders[4] of closely held companies are allocated the total amount of company income (minus dividends paid by the company) to shareholders based on their proportional shareholding. This has the effect of more closely reflecting the family's economic income.
    - **Fringe benefits –** This includes fringe benefits that are substitutable for cash or household expenditure. Only attributable fringe benefits within the meaning of the fringe benefit tax rules in the Income Tax Act 2007 are counted. This only applies to shareholder-employees who control the company for which they work.

Subject to income tax

39. **Refunds from the main income equalisation scheme.** The main income equalisation scheme effectively enables farmers, fishers and foresters to even out fluctuations in their income by spreading their gross income from year to year. When a person makes a deposit into the main income equalisation scheme, this reduces their taxable income for the year. These deductions are ignored for the purposes of the Working for Families tax credits scheme, as, if not ignored, they could incentivise a person to make deposits to obtain greater entitlements to Working for Families tax credits. Subsequent refunds from the scheme are included as a person's taxable income, but these refunds are ignored for Working for Families tax credits purposes.

[4] A major shareholder is a person that owns at least 10 percent of the shares of the company.

40. **Locked-in PIE income taxed at an incorrect rate.** Typically income from a PIE is excluded income and is not included in a person's assessable income for a tax year. It becomes assessable income if it is subject to tax at an incorrect rate. If a person is required to declare PIE income in their income tax return (because it was taxed at an incorrect rate), it is ignored for the purposes of establishing the person's Working for Families tax credits entitlement if it is an amount from a "locked-in" PIE (such as a KiwiSaver scheme). This recognises that the person does not have *access* to the income during the year, and to that end, it should not affect the amount they are entitled to in assistance.

41. A Working for Families tax credits entitlement can either be paid as a lump sum at the end of the relevant tax year, once the family's income has been established, or paid in weekly or fortnightly instalments throughout the year based on a family's estimated income.

42. Where a person opts to receive their entitlement as a lump sum, the risk of overpayment is heavily mitigated, as entitlement calculated with reference to the family's known income.

43. Where a person chooses to receive weekly or fortnightly instalments throughout the year, payments are made to the principal caregiver, who, along with their spouse, civil union partner or de facto partner, must keep Inland Revenue informed of any changes to the family's estimated income, so that Inland Revenue can calculate the correct level of payments to make.

44. At the end of the tax year once the family's income is known, there will be a square-up process. If a family has received more in Working for Families tax credits than they should have, they will be required to pay this back. If they received less than they should have, they will be paid the remaining entitlement. Any overpayment must generally be paid back by 7 February following the end of the tax year to which the overpayment relates, for example an overpayment that relates to the year ending 31 March 202X must be paid by 7 February 202Y.

4.2 Calculation of entitlement and the abatement rules

45. The annual entitlement is determined with reference to the family's level of income and circumstances for the particular tax year, for example number of dependent children in the family care, sources of income and hours of work. Entitlement starts to decrease at a rate of 25 cents per every dollar of income that exceeds the abatement threshold, which is currently $42,700.

Example 1 – WfFTC calculation for a two-parent family with three children under 15

Sally works full-time as an IT consultant and earns $40,000 a year and Charlie runs a small business part-time from home while looking after the children. Usually Charlie's business makes a profit of $5,000 a year.

Sally and Charlie have twins, aged six, and an older son aged 10.

Based on the family's circumstances and an estimated income of $45,000 a year, Sally and Charlie have an annual Working for Families tax credits entitlement of $17,603. This is comprised of the family tax credit of $14,408 and the in-work tax credit of $3,770 and reduced by the applicable abatement.

If the family opts to receive the payments during the year, the amount the family would receive each week would be $349.

4.3 Effect on entitlement if capital losses reduce income

46. The practical effect of allowing capital losses to affect the calculations in terms of a person's Working for Families tax credits entitlement is that it would increase the amount of tax credits available. See the example below.

Example 2 – effect of allowing capital losses to affect income calculation for Working for Families tax credits purposes

John and Mary are the parents of four dependent children. The family is not currently entitled to Working for Families tax credits payments because when Mary's annual salary of $250,000 is combined with the $50,000 of dividends John receives, the family income is too high for them to qualify.

John has a share portfolio worth $5 million which comprises many different shares.

Due to the volatility of the share market this year, a number of shares have increased substantially in value, while an equal number have declined substantially in value.

John sells shares that have declined in value, and realises a capital loss of $350,000. This would result in the family having access to the same level of entitlement as a family who earns wages only and has income below $42,700.

If the capital loss was ignored for the purposes of Working for Families tax credits, the family's income would remain too high for there to be an entitlement to Working for Families tax credits.

47. Current year revenue losses are currently excluded for the purposes of establishing entitlement. This has been the case since the 1 April 2011 (the 2011-12 tax year).

Example 3 – effect on Working for Families tax credits entitlement of excluding losses

Bronwyn and Peter receive income from an investment rental property and are eligible to receive Working for Families tax credits as they have dependent children.

Peter earns consistent wages during the year of $60,000. Bronwyn does not work.

The rental property is rented for $300 a week. When combined with the deductible mortgage interest, the rental produces a net loss of $5,000 for the year.

Peter's income tax liability for the year is calculated with reference to $55,000 (i.e., wages of $60,000 minus the $5,000).

The Working for Families tax credits entitlement is calculated using $60,000 as the family's income, and the $5,000 loss is ignored.

48. Excluding revenue losses was implemented as a measure intended to improve the integrity of the Working for Families tax credits scheme by preventing higher income people gaining access to assistance they would not normally be entitled to.

49. The Secretariat recommends that the same treatment apply to capital losses. Otherwise, significant capital losses could result in substantial increases to a person's Working for Families tax credits entitlement, and would also be inconsistent with the rest of the scheme which ignores revenue losses.

50. If the Group thought that this treatment might be too strict in some circumstances, another option would be to revisit this question when the Group has made decisions on the level of capital loss ringfencing. If capital loss ringfencing is extensive, it might be that in cases where capital losses are **not** ringfenced, it would be appropriate to include those losses for social policy income calculation purposes. In that case, the rule could be that it is only ringfenced capital losses that would be excluded from social policy calculations.

4.4 Effect on entitlement if capital gain counted as income

51. If a capital gain is counted as income for the purposes of the Working for Families tax credits, this will reduce the level of entitlement in accordance with the abatement rules.

52. Depending on the amount of the capital gain, this could have the effect of reducing the entitlement to nil. This would mean that, when a family has claimed payments during the year, there would be an amount to pay back to Inland Revenue.

Example 4 – Sally and Charlie sell a bach and make a capital gain of $200,000

Carrying on from example 1 above, if Sally and Charlie sell a bach in March 202X and make a taxable capital gain of $200,000, the effect this would have on their Working for Families tax credits entitlement for 202X is as follows:

Unabated annual entitlement based on family circumstances:	$18,178
Apply abatement rules[5]:	($50,575)
Results in annual entitlement of:	$0
Family has received payments of:	$18,148
Amount to pay back to Inland Revenue:	$18,148
When amount due to be paid to Inland Revenue[6]:	7 Feb 202Y

The annual entitlement of nil will crystallise when Sally and the Charlie complete their annual income tax return process.

If the return filing process happens shortly after 31 March, the family will have close to a year to make a payment to Inland Revenue without being subject to late payment penalties or use-of-money interest.

Families that are overpaid during the year will generally know that there is an amount to pay back, as they are obliged to keep their estimated income for the year up to date with Inland Revenue so the correct payments can be made to the family.

53. In the circumstances outlined in the example above, the family could use part of the capital gain to pay Inland Revenue the amount that was overpaid.

54. The Secretariat notes that this will result in some capital gains being subject to high effective marginal tax rates in the event that the gain amount increases income through the abatement range. However, such a treatment is consistent with what currently happens when a family has a significant unexpected increase to their Working for Families tax credits income, such as a large redundancy payment, or a taxable property sale, e.g., the sale of residential property that is taxed under the bright-line rule.

55. If capital gains were excluded from the definition of income for Working for Families tax credits purposes, two families in different circumstances could have the

[5] ($200,000 + $45,000 – $42,700 [current abatement threshold]) × 25 cents [current abatement rate]

[6] This assumes full integration into the current annual income tax return process with no separate changes to the due dates for overpayments caused by under-estimated capital income.

same level of entitlement. Consider two separate families with two parents and two children. One family has income from salary of $55,000 and a capital gain of $200,000. The other family has income of $55,000 and no capital gain. Excluding capital gains from the calculation would provide both families with the same Working for Families tax credits entitlement. This would raise questions of fairness.

56. Where a person makes a capital gain that affects their Working for Families tax credits entitlement, it would only affect entitlement for the year of the capital gain. The following year's entitlement will be calculated with reference to the family's estimated income for that year, and would not take into account capital gains that relate to a previous tax year.

4.5 Community Services card eligibility for those that receive Working for Families tax credits

57. The Community Services card helps individuals and families with the costs of health care. A person will pay less on some health services and prescriptions if they have a Community Services Card.

58. A family that receives Working for Families tax credits payments will qualify for a Community Services card if their income, as is defined for Working for Families tax credits (when combined with the Working for Families tax credits entitlement) does not exceed the certain thresholds. Including capital gains from extending the taxation of capital income could affect a person's entitlement to a Community Services Card.

4.6 "Family scheme income" and the parental income test for the Student Allowance

59. The student allowance is a weekly payment that helps students with their living expenses while they study. It does not have to be paid back. If a person is under 24 and does not have children, the student allowance is calculated with reference to the income of the person's parents.

60. The parental income test uses a slightly modified version of the definition of income for Working for Families tax credits purposes. It excludes:

- maintenance payments – being child support or spousal maintenance paid or received by a person;
- passive income derived by children of the family; and
- any non-resident foreign-sourced income of the principal caregiver's spouse, civil union partner or de facto partner.

61. For a person under 24 without a child, the before tax student allowance entitlement is $217.02 for a person living in a parental home, or $257.12 for a person not living

in a parental home. The amount starts to decrease as the student's parents' income increases.

62. To that end, including capital gains in the definition of income for Working for Families tax credits purposes could affect the level of student allowance a person is entitled to. Ignoring capital losses in the parental income test would not affect the level of student allowance a person is entitled to.

5. Child Support

5.1 Background

63. A person's child support is calculated using the child support formula assessment.

64. Both parents' taxable income is included in the formula assessment calculation. Including both parents' income means that the assessment is balanced as the costs of the child (or children) is shared between both parties.

65. Child support uses the income tax definition of "taxable income" and there are no adjustments made such as those for Working for Families tax credits and student loans. Any change that affects taxable income will automatically flow through to child support. As such, extending the taxation of capital income will impact on child support to the extent that a parents' taxable income is affected.

66. In July 2017 the Government released a Discussion Document[7] proposing to align the definition of "income" used for child support with the definitions used for Working for Families tax credits and student loans purposes. Should the definition of income change for child support purposes, the rationale for including capital gains (and excluding capital losses) from the child support calculations is the same that applies for Working for Families tax credits and student loans purposes.

67. The formula assessment currently uses taxable income from either:

    - the previous calendar year (1 January to 31 December) if the person is a salary or wage earner; or
    - two tax years ago (1 April to 31 March) if the person is required to file an annual income tax return, or earns overseas income. An inflation factor is also added in these circumstances.

68. Because of how the rules work, if "taxable income" were to include a capital gain or loss, it would not be taken into account for the purposes of a child support formula assessment until two tax years after the year in which it was realised.

69. The Discussion Document also noted that because child support payments are assessed in February each year, based on information about income two tax years ago in many cases, the old information means it does not always show how well either parent can contribute to the cost of raising a child right now. It noted options to change the child support period of assessment in order to use more up to date income information to better reflect how well a parent can contribute to the cost of raising a child right now.

70. Reduced taxable income (as a result of a capital loss) for a parent with child support could have the effect of:

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- If they are the receiving parent, increasing their child support entitlement; and
- If they are the liable parent, reducing their child support obligation.

71. Increased taxable income (through a capital gain) for a parent with child support could have the effect of:

    - If they are the receiving parent, decreasing the amount of their child support entitlement; and
    - If they are the liable parent, increasing their child support obligation.

72. However, the child support rules allow parents to estimate their income for the purposes of the formula assessment, if they believe their income will be 85 percent or less of what it was the year referred to in paragraph 67 above.[8] The effect of this is that irregular capital gains may have little to no effect on a person's child support entitlement or obligations.

Example 5 – estimating income for the purposes of the child support formula assessment   A receiving carer has ordinary taxable income of $50,000 from wages every year. This year, the person makes a capital gain of $300,000 and this is included in their taxable income for the year. In two years' time, assuming all other circumstances remain the same, this would reduce the amount of child support the person is entitled to as, for the purposes of the formula assessment, the person's income would be $350,000 and not $50,000 as it ordinarily is.   However, the person meets the criteria to estimate their income, because their ordinary income of $50,000 will be at least 15 percent less than what was used in the formula assessment.

73. The child support regime has a review process, which allows both liable parents and receiving carers to have their formula assessment looked at to see if it can be altered to fit their particular circumstances. Reviews are based on the Family Court departure order process and are organised by Inland Revenue and conducted by independent review officers, who are experienced in law and are required to follow precedents set by past court cases.

74. There are three different types of child support reviews: administrative reviews, exemption reviews and Commissioner reviews. Exemption reviews are not relevant in the context of extending the taxation of capital income. Administrative reviews

[8] Both liable parents and receiving carers can estimate their taxable income if it has reduced by 15 percent or more from the income used in the assessment.

and Commissioner reviews can be used to alter a person's taxable income for the purposes of a child support assessment. This would include considering whether it is appropriate for a capital gain or loss to be taken into consideration in determining a person's child support obligations and entitlements.

75. When considering whether or not a parent's income should be adjusted, a review will consider "whether or not it would be just and equitable to all parties (including the children impact), and otherwise proper".[9]

5.2 Excluding capital losses

76. The Secretariat also recommends that losses be ignored for the purposes of the child support formula assessment. This would ensure that crystallising a significant capital loss would not have the effect of reducing a person's child support assessment (for paying parents) or increasing the amount of child support a person is entitled to (for receiving carers).

77. As has been noted in this paper, the Secretariat notes the Government is currently considering more closely aligning the definition of income for child support purposes to the definitions used for Working for Families tax credits and student loan purposes. This includes shifting away from the current income tax definition of "taxable income" approach, which results in ignoring revenue losses and losses brought forward from previous years. The Secretariat's recommendation in this respect is therefore consistent with what is currently being considered by the Government and our recommendation regarding Working for Families tax credit adjustments.

[9] See sections 96C, 96R and 105 of the Child Support Act 1991.

6. Student loans

6.1 Background

78. Entitlement to a loan under the student loan scheme is not based on any income tests. For a person to be eligible to borrow under the student loan scheme, they must be:

    - a New Zealand citizen, or ordinarily resident in New Zealand and either have been living in New Zealand for the last three years while holding a residence class visa, or a be a refugee or protected person, or be sponsored into New Zealand by someone in the person's family who, at the time they were sponsored, was a refugee or protected person; and
    - studying an approved course run by an approved education provider.

79. The Ministry of Social Development administers applications for student loans under the student loan scheme. Inland Revenue is responsible for collecting student loan repayments.

80. Once a New Zealand based borrower starts earning income, provided certain thresholds are exceeded, the borrower will have an obligation to begin to repay their loan. Overseas based borrowers have a repayment obligation that is based on the size of their loan balance, and is not based on their income. For this reason, they are not discussed further in this paper.

81. Excluding certain types of income for the purposes of the student loan scheme would have significant impacts on the value of the scheme. It could take longer for borrowers to fully repay their loans and reduce the number of borrowers who repay in full. It is important the borrowers who can afford to make student loan repayments do so. This ensures loans are repaid in reasonable timeframes and the cost of administering the student loan scheme is reduced for the Government.

82. For borrowers who earn income from salary or wages, deductions are automatically made by the borrower's employer through the PAYE system. Borrowers who have additional amounts of income, for example, those from self-employment, interest, dividends, taxable property sales etc, have to report this income to Inland Revenue as part of the end-of-year income tax return (provided the amount of income exceeds $1,500) and a repayment obligation is calculated based on the income reported.

83. If a borrower earns a combination of salary or wage income, and other income which is not subject to student loan deductions, the repayment obligation is calculated on 12 percent of the amount of income, provided the borrower's total annual income exceeds the annual repayment threshold of, which is currently $19,448 (but is reviewed annually). The effect of this is demonstrated below.

Example 6 – borrower with a combination of salary or wage income and other income

Ben has an ordinary salary of $50,000. He also sells residential property which is subject to tax under the bright-line rule, and makes a profit of $150,000.

The deductions that are made from Ben's salary are isolated from the calculation that establishes his repayment obligation from his other income.

Ben's additional repayment obligation which relates to this capital gain is $18,000 (i.e., 12 percent of $150,000). Ben will pay this towards his student loan, in addition to the student loan deductions from his salary payments.

84. If a person has salary or wage income that is below the annual repayment threshold and additional income, they will be given the benefit of any unused annual repayment threshold to reduce the amount of their repayment obligation for the year.

85. Generally, where borrowers have amounts that are not subject to student loan deductions at source, they have to pay 12 percent of the amount over the annual repayment threshold. An example of this is below.

Example 7 – borrower with non-salary or wage income

Marley is self-employed and makes a profit on average of about $30,000 per year. His student loan repayment obligation is 12 percent of the amount over the annual repayment threshold (currently $19,448) so is $1,266.

If Marley also made a capital gain of $50,000 that was counted as income for the purposes of the student loan repayment obligation rules, Marley's student loan repayment obligation for the year would increase to $7,266.

86. Extra payments are not required if the borrower's total income for student loan purposes is less than the annual repayment threshold.

6.2 Effect of including a capital gain as income

87. Consistent with the treatment for other types of income that have a similar nature, the Secretariat recommends that the proceeds from capital gains should be counted as income for the purposes of a borrower's student loan repayment obligation. This would have the effect of requiring the borrower to use 12 percent of the amount received to pay towards their student loan and is illustrated in Example 4 above. The amount may be somewhat lower if the borrow has access to the unused repayment threshold.

88. If a capital gain would cause a borrower to have a repayment obligation of $1,000 or more[10] for a year, they would be assessed for an interim student loan repayment obligation in the following year. An interim obligation is similar to provisional tax for student loan borrowers. Because of the similarities, the effect on a borrower's interim assessment obligations will be discussed in further detail in the event that the Group requests a second paper on the administrative implications of extending the taxation of capital income.

6.3 Treatment of losses

89. Revenue losses are ignored for the purposes of determining a borrower's student loan repayment obligation.

> ***Example 8 – effect of ignoring losses for the purposes of determining a person's student loan repayment obligation***
>
> Jason works full time for a salary of $70,000. He also runs a side business selling protein supplements. Usually business is profitable, but this year Jason has income from the business of $5,000 and deductible expenses of $10,000.
>
> Jason's taxable income for the year is $65,000 (i.e., $70,000 + $5,000 - $10,000).
>
> For the purposes of determining his student loan repayment obligation, the loss he made from his protein supplement selling business is ignored. This means he does not have an additional student loan repayment obligation, and the only amount he needs to pay towards his student loan for the year are the deductions made through the PAYE system.

90. The Secretariat recommends that this applies for capital losses as well. This would reduce compliance costs on borrowers (and administration costs for Inland Revenue) who would not need to distinguish between revenue and capital losses and recognises that despite a person crystallising a loss there should be no corresponding reduction in student loan repayment obligations.

[10] Assuming the borrower's annual income exceeds the annual repayment threshold of $19,448, the amount of the capital gain the person would have to derive would be approx. $8,330.

Example 9 – proposed effect of ignoring capital losses for the purposes of a person's student loan repayment obligation

Claire has self-employed income from a scrap paper business and she also owns a jewellery shop.

In 202Y, the scrap paper business made a profit of $25,000, and Claire made a decision to sell her jewellery shop to focus her energies on increasing sales through the scrap paper business. She sells the jewellery shop for $50,000 (having paid $80,000 for it two years earlier) and realises a capital loss of $30,000.
Claire has access to funds of $75,000 (i.e., $25,000 profit from her business, and $50,000 from the sale of the jewellery shop).

Assuming the loss is not ring-fenced, Claire has a net loss for the year of $5,000 (i.e., $25,000 - $30,000) and has no tax liability. If Claire was able to use the capital loss to reduce her student loan repayment obligation, she would owe nothing towards her student loan for that year.

If the capital loss was ignored, Claire would have a student loan repayment obligation of $666 (i.e., 12 percent of $25,000 - $19,448).

91. Taking into account capital losses for the purposes of establishing a borrower's student loan repayment obligation would decrease the rate at which they would need to pay back their student loan, and would do so in circumstances where the borrower has access to funds that could be used to repay the student loan.

7. Other social policy schemes

7.1 Background

92. The Secretariat notes that there are a number of other social policy programmes administered by the Government that use "income" for the purposes of determining level (or access) to entitlements. For example:

    - **Rates rebates.** The legislation for rates rebates is administered by the Department of Internal Affairs. The definition of "income" for the purposes of a rates rebate sometimes uses the income tax definition of "income" but currently excludes "any capital money received from any source" so would not be consequentially affected by changes to the definition of "income" under the Income Tax Act 2007.
    - **Compensation for loss of earnings paid by the Accident Compensation Corporation.** The Secretariat believes these amounts are paid with reference to a person's "active" income (i.e., income from salary, wages, self-employment, or as a shareholder-employee) and will exclude passive amounts, such as the sale of a capital asset.
    - **Benefits paid by the Ministry of Social Development (including the Accommodation Supplement).** The definition of "income" for the purposes of the Social Security Act 1964 (which main benefits are paid under) does not appear to include amounts that would be consequentially caught by extending the definition of income in the Income Tax Act 2007.
    - **Community Services Card.** This scheme is administered by the Ministry of Health, and the regulations that provide for them import the definition of "income" from the Social Security Act 1964 for people who do not receive Working for Families tax credits. To that end, for those people it also appears that eligibility would not include amounts that would be consequentially caught by extending the definition of income in the Income Tax Act 2007.

93. The Secretariat recommends that further work is undertaken in this area to understand the flow-on implications for other schemes, in consultation with other agencies, and that this work is progressed by officials as part of the Generic Tax Policy Process as the details of any proposals are worked through.

8. Conclusion and recommendations

8.1 Summary of Secretariat's view

94. The Secretariat recommends:

- **Including capital gains as income.** The Secretariat recommends that the proceeds from capital gains should be counted as income for the purposes of the Working for Families tax credits, student loan and child support schemes. Including the proceeds from capital gains would be consistent with the treatment that applies to other similar amounts, such as proceeds under the current land taxing provisions (including the bright-line test) in the Income Tax Act 2007, being amounts that a person (or family) has access to. It would also be consistent with the principles that apply for other amounts counted as income in the schemes currently.

  Ignoring capital losses. The Secretariat recommends that capital losses be excluded from the calculations for Working for Families tax credits, student loans, and child support. There are two main reasons for this. The first is that ignoring them would be consistent with the treatment of revenue losses. The second is that it helps preserve the integrity of the schemes, by not increasing entitlements (or deferring or decreasing obligations) in situations where a person's ability to meet current living expenses during a year is unaffected.

- On the basis of the recommendations above, that the text in Appendix A be used for the Final Report.

Appendix A: Suggested text for Final Report

Effect on social policy schemes that use an income tax definition of "income"

1. The Group recommends that:

    - for child support, the effect of extending the taxation of capital income should naturally flow through as income for both the receiving carer and the liable parent, and recognises that the child support regime currently uses the income tax definition of "taxable income"; and
    - capital gains should be included in the definitions of income for the purposes of the Working for Families tax credits and student loan schemes.

2. The Group recognises that both the Working for Families tax credits and student loan schemes currently use a broader definition of "income" and that it would be consistent to include capital gains as income following the extension of the taxation of capital income.

3. The Group also notes that in July 2017 the Government proposed more closely aligning the definition of income used for child support purposes to the definitions currently used for Working for Families tax credits and student loans and notes that part of this would involve disregarding revenue losses (and losses brought forward from previous years) for the purposes of the child support formula assessment. To that end, for the same reasons capital losses are ignored for Working for Families tax credits and student loans, they should also be ignored for the purposes of the child support formula assessment.

4. The Group notes that:

    - including capital gains as income for the purposes of the Working for Families tax credits scheme would likely decrease the level of entitlement for families that realise capital gains in a year;
    - ignoring capital losses for Working for Families tax credits would have the effect of not increasing the level of Working for Families tax credits a family is entitled to, if a family realises a capital loss in a year; and
    - including capital gains as income for the purposes of the student loan scheme would result in increased repayment obligations for student loan borrowers who realise capital gains in a year.

5. The Group recognises that ignoring capital losses for the purposes of each of the above schemes is consistent with the treatment that applies for revenue losses, and is necessary to maintain the integrity of the schemes by ensuring entitlements (and obligations) are not misaligned with a person's circumstances.