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Reducing the Tax Compliance Costs of Small Businesses

FINAL QUALITATIVE RESEARCH REPORT

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Executive Summary

At the request of the Minister of Revenue, Inland Revenue in partnership with Treasury, are looking at ways to reduce the compliance costs of small businesses. As part of a wider consultation process, Inland Revenue have commissioned **colmar brunton** to undertake both qualitative and quantitative research with businesses and tax agents to seek their input. This report presents the findings of the qualitative research.

A summary of the salient points is provided below.

Barriers to small business success

Small businesses face a range of barriers to success in New Zealand. These include a general lack of knowledge and expertise in running a business, lack of capital, difficulties in recruiting and retaining suitable staff, difficulties in releasing unsuitable staff, and parental leave laws.

There are also a range of barriers that are directly related to the compliance demands of the following government departments: Inland Revenue, ACC, Statistics New Zealand, OSH, Ministry of Health; and the Resource Management Act.

These demands largely relate to the amount of time and paperwork required to comply as well as the perceived complexity of the regulations. The compliance costs associated with employing staff are felt to be particularly onerous with some businesses discouraging others from employing staff for this reason.

Tax Compliance Costs

Small businesses face a range of tax-related compliance costs. These are:

- Penalties and interest. Small businesses' principal concerns are that the system does not differentiate between dishonest taxpayers and those that fall short of the mark due to 'honest' mistakes, and that the system seems to be out of proportion with the size of the business.
- Reliance on accountants. Small businesses feel that they need to use tax agents for a range of purposes (not restricted to year-end income tax return filing) because of the complexity of the tax system, a need to minimise the time they spend on things that are not 'core business', a desire to minimise their tax, and a fear of being penalised should they make mistakes in doing tax work themselves.
- The volume of returns, payments and information. This impacts businesses in terms of the time required to complete these tasks, but also in terms of contributing to a sense of feeling overwhelmed and anxious about their tax obligations. Some businesses specifically struggle with the number of different payment dates for different tax revenues.
- Difficulties in accessing knowledgeable staff. Businesses' perceptions of Inland Revenue's Call Centres are polarised. Some have had positive experiences while others hold very negative perceptions. The most common complaint relates to the waiting time.
- Inadequate Inland Revenue processes. Businesses experience frustrations with one-off processes and services that Inland Revenue provides when businesses start or stop ongoing operations, such as

continuing to receive GST returns after a company has deregistered. They also experience problems with processing or computer errors regarding steady state activities, e.g. incorrect statements of account.

- **Provisional Tax and Use of Money Interest.** Many businesses in this research project struggled to pay the three equal instalments of provisional tax due to significant cyclical and seasonal variations in their business income. Some needed to borrow finance to do this. Further, for those that have unpredictable incomes, exposure to Use of Money Interest is a large concern.
- **Fringe Benefit Tax.** Employers and tax agents alike strongly resent FBT. They perceive it to be both unfair and a very complicated tax to calculate. Many businesses avoid offering their staff fringe benefits because of this.
- **Collecting child support payments.** Employers resent having to collect child support payments as they feel that it is both an intrusion into the personal lives of their employees and incurs administration costs for which they are not reimbursed by the Government.
- **Unpaid envelopes.** Businesses regard the postage they have to pay on envelopes sent to Inland Revenue as a compliance cost. This issue is considerably bigger than the financial outlay of the stamps; it is considered to be unfair and unreasonable especially given the small business's role as an unpaid tax collector of GST and PAYE.
- **Transacting electronically with Inland Revenue.** This is not considered to be a compliance cost as such, but rather a favoured solution to overcome a number of compliance costs.

Current practices

Businesses vary considerably in the way they approach their tax obligations from the highly organised and disciplined businesses that attend to their tax bookwork on a weekly basis to those that rarely plan ahead and tend to leave any tax work until just before a return is due.

Many businesses no longer feel that cashflow cycles exist. If there is a best time in the month for paying bills, this tends to be the end of the month when the majority of their customers have sent in payments.

Reaction to possible solutions

Payment dates

Having a common payment date each month for all revenue types has strong appeal to some customers as they feel the payment dates would be easier to remember. Preference, however, appears to be for a common date at the end of the month. The main disadvantage of a single payment date is perceived to be greater pressure on cashflow. Different payment dates has the advantage of spreading the demand on cashflow.

Retaining the current dates, but having a single date for penalties is generally perceived to be unnecessarily complex. Nevertheless, a few see merit in the idea as it would ease pressure in times of cashflow difficulties.

Statements

Businesses value statements for two reasons. They enable businesses to 1) check that their transactions have been received and correctly processed by Inland Revenue and 2) check whether they have incurred any penalties. The value that businesses get from the current statements is significantly hampered by their perceived complexity and lack of timeliness.

One statement that covers all revenues does not appeal unless it is accompanied by other changes such as having one payment date (and in this case the statement would need to be monthly). Even so, some businesses would object to tax revenues being amalgamated on a statement as they operate separate filing systems for the different tax revenues.

Amalgamating tax revenues

Larger employers advocate the amalgamation of all tax revenues so that the business pays set monthly amounts (via automatic payment). A reconciliation process would be required on an annual or more frequent basis.

GST and provisional tax

Filing frequencies

Businesses are strongly reluctant to consider less frequent filing of GST returns as they fear becoming less disciplined in doing their tax bookwork and are concerned that they will be tempted to spend the money for other purposes.

Some businesses favour more frequent provisional tax returns and payments as it has the potential to ease cashflow difficulties (i.e. there is less temptation to spend the money on other things). However, others feel that this could potentially worsen their cashflow situation as shorter provisional tax periods mean a higher probability that a tax period will include a month or two with high income levels.

Filing GST six monthly or annually, but with monthly automatic payments does not appeal because businesses dislike the uncertainty that would be introduced by the need to reconcile at the end of the period.

Tying provisional tax to GST

Businesses with significant seasonal or cyclical variations in their business income strongly favour the concept of paying provisional tax and GST together by using last year's tax liability and total sales to determine a rate for paying provisional tax in the current year.

The main reservation with this concept relates to whether turnover on its own sufficiently reflects profit. Some would like to see labour costs, large asset sales, shareholder payments and interest on loans brought into the equation. Nevertheless, both tax agents and businesses generally agree that the proposed system is superior to the current system of provisional tax payments. Further, there is an acknowledgement that changing the concept to incorporate other costs could be overly complex and defeat the initial intent.

A common suggestion is to remove the safe harbour component by replacing the 105% in the formula with 100%.

Voluntary provisional tax payments in first year of business

Paying provisional tax payments in the first year of business in return for a discount holds appeal as it removes the 'double hit' businesses face in their second year of business when they have to pay income tax for the first year and commence provisional tax payments for the second year. The strength of the

appeal depends on the size of the discount. The main perceived problem with this concept is the difficulty a business will have in estimating their first year's income.

PAYE and FBT

Using a payroll company

Small employers see little benefit in using a payroll company. They feel that it would take just as long to prepare the information for the payroll company as it would to do the entire task themselves.

Paying PAYE every two months

Some small employers like the idea of paying PAYE on a two monthly basis as this is perceived to result in less paperwork. Conversely, others including tax agents feel there is a danger in businesses being less disciplined in their bookwork if returns only have to be filed every two months.

Incorporating fringe benefit information on EMS

Larger employers favour incorporating fringe benefit information with the employer monthly schedule to enable Inland Revenue to take responsibility for doing the complex calculations, but only if Inland Revenue provide documentation that explicitly shows how the fringe benefit tax was derived.

Advisory Service

Inland Revenue's advisory service is well regarded. However, the key issue is lack of follow-up support. Businesses would also like to see Inland Revenue being proactive in offering the service in a range of situations. These include instances when a business makes a mistake in their GST return and when new initiatives are introduced.

E-enablement

Transacting electronically

There is much support, and in some cases enthusiasm, for Inland Revenue's direction in the area of e-enablement. Even among those that do not currently see electronic transactions as appropriate or relevant to their business, many are resigned to this being the way of the future.

Key barriers to transacting electronically include lack of hardware and software capability, a lack of knowledge and confidence in using computers generally as well as a lack of understanding of how the options work, for example, whether an ir-file user can review a file after they have sent it.

There is a number of ways in which Inland Revenue can support and encourage businesses to transact electronically. These include offering an advisory service whereby an Inland Revenue staff person provides training on the new products (and if necessary set their computer up to facilitate the task), providing Inland Revenue approved software packages, and assurances about security.

Corresponding on-line

Corresponding on-line with Inland Revenue staff appeals strongly to some small businesses. The main benefit is time related; users can avoid Call Centre waiting times and can correspond outside of Call Centre hours. There is an expectation that a question would be acknowledged immediately and usually answered within 24 or 48 hours, and a desire for the Inland Revenue person responding to the email to provide their contact details should a follow-up telephone call be required.

Agents are less keen on corresponding on-line principally because they are satisfied with their alternatives of the Agentline and their Account Manager. Also, tax agents are not likely to be strong advocates of their clients corresponding with Inland Revenue on-line as some agents discourage direct contact with Inland Revenue of any type.

Accessing account information on-line

This option also holds considerable appeal for some as it is perceived to have the potential to provide more up-to-date information than the current statements. For this option to be implemented effectively, however, businesses urge Inland Revenue to present the information in a simple and clear way (in contrast to the current statements).

On-line tools for complex calculations

Reaction to this concept is somewhat mixed. On the one hand, access to a mechanism that provides a binding decision is appealing. However, businesses and tax agents are unsure about the reliability of such tools, especially the ability of the tools to cope with a multitude of individual circumstances and scenarios.

Unpaid tax collector role

There are three areas in which Inland Revenue can better recognise the unpaid job that businesses do in collecting GST and PAYE on behalf of the Government: penalties and interest; service delivery; and ways of showing appreciation.

Penalties and interest

The ideal penalties and interest system recognises taxpayers' past histories, rewards taxpayers who exhibit 'good behaviour', assumes taxpayers are innocent until proven guilty, educates people who make 'honest' mistakes rather than punishing them, is flexible enough to cater for special circumstances, and has appropriate systems in place to encourage people to comply. Practical examples of these principles are a type of credit rating which allows the taxpayer to 'slip up' once or twice if their past history has been good, tax discounts for on-time payment, and Inland Revenue sending businesses email reminders.

The new system (encompassing both the April and December changes) is considered to be more lenient and is therefore generally well received. Small businesses particularly like the allowance for filing one employer monthly schedule late. One aspect disliked is the \$250 late filing penalty for any subsequent schedule filed late within 12 months. Businesses feel that the \$250 is too high for small businesses and too low for large businesses. The penalty should be proportional to the size of the business.

Service delivery

Businesses feel that Inland Revenue can better recognise their role as an unpaid tax collector by offering businesses the following:

- Advisory visits (not just new businesses)
- Seminars
- Account Managers
- The full name of the Inland Revenue staff person when a business calls Inland Revenue.

Showing appreciation to small businesses

Businesses have many suggestions for how Inland Revenue can show their appreciation of small businesses. Participants in this research were most enthusiastic about pre-paid envelopes, a fairer penalty and interest regime, a 'thank you' letter, and some form of tax discount.

End of year adjustments/costs

Tax agents favour:

- increasing the threshold below which trading stock does not have to be valued from \$5,000 to around \$10,000
- increasing the threshold below which new assets can be expensed from \$200 to \$500 or \$1,000.

Tax agents see little benefit in the introduction of a threshold whereby if a business's combined value of debtors and creditors fell below it, they would not be required to adjust for it in their end-of-year tax calculations. Some tax agents believe a more pertinent issue is the period of time that needs to have passed before bad debt can be written off.

They also see no benefit in a concept whereby shareholder employees, partners etc stop filing returns if their income is subject to withholding tax by the parent entity. This is because tax agents tend to do both the company and shareholder returns at the same time (and then lump any amounts together and write one cheque to the company). They are also perplexed as to how they would know what rate to deduct the withholding tax at as they would not know the tax rate of the end-recipient.

Tax agent issues

Tax agents are frustrated with a number of aspects of Inland Revenue's processes that result in a waste of their time (and their clients' time). Examples include Inland Revenue transferring amounts into the wrong period and wrong accounts, NOPAs (Notices of Proposed Adjustments) not being processed as requested, and incorrect statements of account and assessment.

Likewise, there are a number of policies that cause frustration. For example, the rules that apply to amending returns (e.g. GST returns). Because of the cost and effort required to amend GST returns, tax agents sometimes recommend their clients ignore the error, rectify it in the next return, and hope that an Inland Revenue audit doesn't pick it up.

Tax agents suggest a number of ways in which Inland Revenue can better support them. These include greater ability to transact with Inland Revenue electronically, more agents meetings and seminars, and for their Account Manager to make personal visits.

Conclusions

Research recommendations will be formulated once the quantitative phase of this research project has been completed. However, the qualitative research points to a number of issues that we feel are pertinent to address here - in particular, the factors involved in a successful programme of change.

A number of opportunities exist to reduce tax-related compliance costs

This research indicates that there is a number of proposed initiatives with strong appeal. For example:

- Tying GST to provisional tax
- E-enablement products
- Having one payment date per month
- Transferring the responsibility of calculating FBT to Inland Revenue.

(The quantitative research will provide clearer direction on the size of these opportunities).

These initiatives appear to have the potential to significantly reduce the tax compliance costs of small businesses in terms of time, cost and worry. Other ideas, such as prepaid envelopes, may not involve big changes to the tax system, but are gestures of goodwill that have the potential to make a positive impact on small businesses' perceptions of Inland Revenue including the value that they perceive the Department places on the small business community.

This research has highlighted a number of key challenges for Inland Revenue in implementing a programme of change. Indeed, we believe the following issues are critical to the success of the programme.

Small businesses desire flexibility

A strong theme in this research is the desire for Inland Revenue to be flexible.

"Flexibility...you can't have strict down the line rules because there is always something that fits outside of them and there is always a situation that occurs in businesses that throws all the good plans out the window." (Small business)

Flexibility is also about recognising that small businesses are not all alike. They differ not only in terms of the physical and financial characteristics of their business, but also in terms of the approaches they take to their bookwork and their levels of confidence, knowledge and anxiety.

This has a number of implications. First and foremost, small businesses (and tax agents) call for new initiatives to be optional. Providing options is not just about acknowledging that new initiatives may not meet the business needs of some businesses. It also recognises that some businesses are strongly resistant to change because the current system is familiar and they are fearful of any change. (The types of support that these businesses require in taking on new initiatives are different to those required by businesses that are keen to embrace change; this is addressed later in this section).

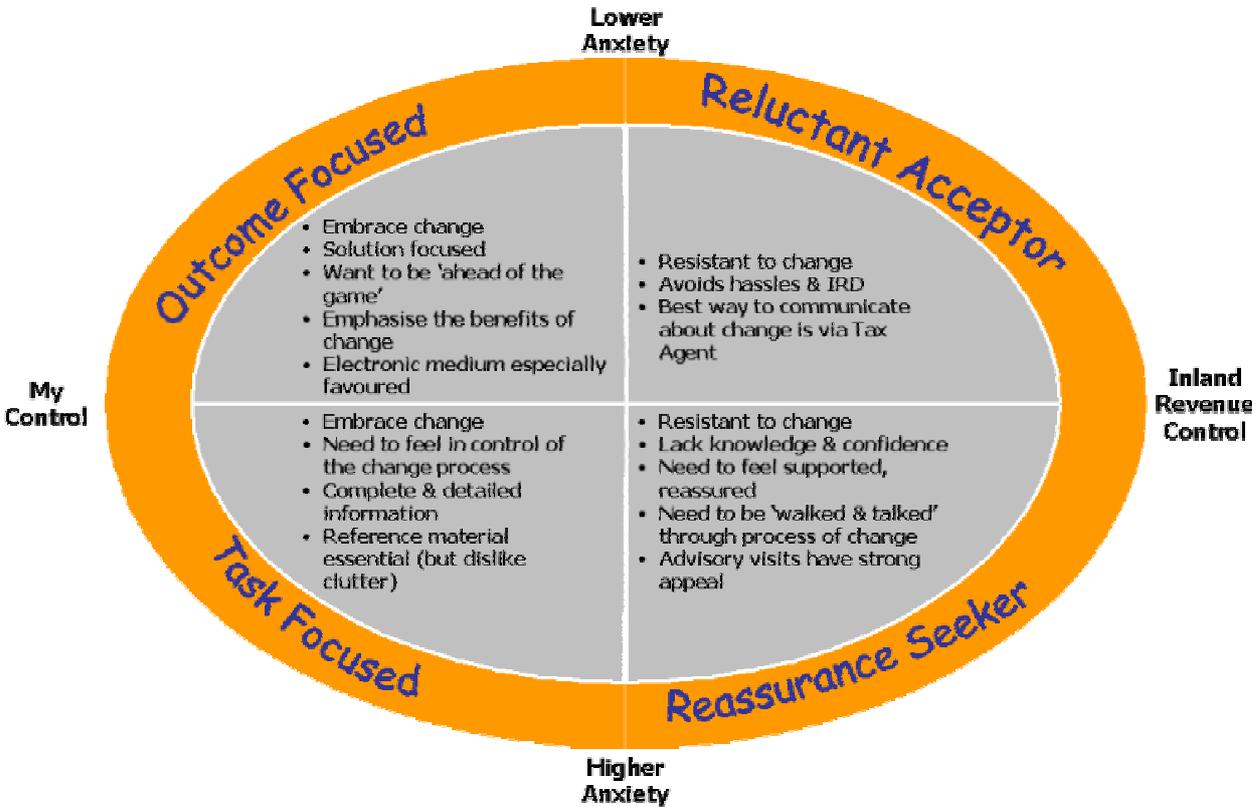
Herein lies a dilemma. Whilst businesses demand options, there is a real danger of overwhelming businesses with 'yet more options'. This could lead to businesses feeling like the 'load' is heavier than it

was before the changes (this is a fear of the Reassurance Seekers and the Reluctant Acceptors). Inland Revenue will need to consider these opposing tensions carefully for each proposed initiative.

Different needs require different types of support

Further, for any initiatives to be implemented successfully, Inland Revenue must deliver different types and levels of support to cater for different needs. Small businesses vary in the level of anxiety they experience in dealing with tax and Inland Revenue and the extent to which they feel their relationship with Inland Revenue is an equal one versus Inland Revenue being in control. This is also closely linked to the extent to which businesses embrace or resist change.

Four different sets of small business needs are illustrated in the following diagram.



Let's take the Reassurance Seeker as an example. These businesses lack knowledge and confidence in dealing with tax. Hence, they tend to be quite dependent on their tax agent. Although resistant to change, because they fear not being able to cope, the Reassurance Seeker can see potential benefits to their business in a number of the proposed initiatives. However, to cope with taking up these initiatives they will need to be walked through the change process step by step. Their driving need to is to feel supported and reassured in the process of change. One of the best ways that this can be achieved is via a face-to-face visit from an Inland Revenue person. In this way, Inland Revenue can build the Reassurance Seeker's confidence and show that the Department is willing to listen.

Not all businesses will need or want advisory visits, for example the Outcome Focused. However, this research indicates that the need appears to be greater than the current service currently caters for. This research therefore has significant implications in term of expanding Inland Revenue's Advisory service.

In addition, there may be a need to upskill Advisory service staff to be able to effectively assist businesses with the e-enablement initiatives.

Background and Objectives

Inland Revenue, in partnership with Treasury, is embarking on a major exploration into ways of reducing the compliance costs of small businesses. This exploration is at the request of the Minister of Revenue and is in line with Inland Revenue's Statement of Intent; in particular that Inland Revenue's desired future involve taxpayers meeting their obligations of their own accord – and Inland Revenue making this easy.

From previous research, Inland Revenue has identified the following areas where compliance cost reductions could be made for small business:

1. The time involved in completing the sheer volume of returns and payments that businesses must send to Inland Revenue each year (steady state activity)
2. The 'one-off' processes and services that Inland Revenue provides when business start or stop ongoing operations (exceptions to steady state)
3. Concern that the penalties and interest regime don't have regard to the businesses (generally good) compliance history, or acknowledge their "unpaid tax collector" role
4. Prompt access to knowledgeable Inland Revenue inquiry services staff
5. Greater ability to transact tax business electronically
6. The costs incurred in acquiring accounting services for year-end Income Tax return filing. These costs are primarily incurred for the precise profit determination required by tax law, but this level of accuracy is often superfluous to small business information needs.

It is envisaged that a comprehensive approach and mix of interventions will be required including improvements to administrative processes and greater use of electronic technology, as well as legislative changes.

Inland Revenue are undertaking a consultation process with the business community to seek their input. Primary research with businesses and tax agents is one component of this consultation process. Inland Revenue have commissioned **colmar brunton** to undertake two primary research phases: qualitative and quantitative research with both small businesses and tax agents.

The broad objectives of both phases of the research are to:

1. understand and prioritise common tax-related compliance cost issues, as perceived by small business operators
2. identify and discuss possible solutions to those small business tax-related compliance cost problems
3. understand compliance cost problems specific to those business operators who have recently ended or set up a new operation or entity
4. identify barriers to the implementation of new electronic solutions to be offered by Inland Revenue, and how these might be overcome
5. determine probable take up rates of any solutions that Inland Revenue is able to offer to reduce compliance costs.

Note, the prioritisation of tax-related compliance cost issues and an estimation of the probable take-up rates of specific initiatives will be addressed in the quantitative research phase.

This report presents the findings of the qualitative research phase.

Research Methodology

This research was carried out using a number of qualitative research methods:

- Mini-groups of businesses
- Mini-groups of businesses and tax agents (where possible, a case-study approach was used whereby both a business and their agent participated)
- Solution workshops
- Individual interviews with tax agents¹.

Mini-groups consisted of between two and five research participants. Solution workshops consisted of between four and eight research participants. Research participants were recruited using lists provide by Inland Revenue.

In total, the research consisted of 11 mini-groups, five solution workshops, and five individual interviews. Details of the sample are provided in the table below.

| Business Type | Number of mini-groups | Number of solution workshops |
|--|-----------------------|------------------------------|
| GST registered payers (between \$100,000 and \$1 million turnover) | 2 | 1 |
| Larger employers paying FBT (between 5 and 25 employees) | 2 | 1 |
| Small employers (less than six employees) | 2 | 1 |
| Annual return filers | 2 | 1 |
| Recent entry (new employer since or new GST registrant since early 1999) | 2 | 1 |
| Recent exit (businesses that ceased being employer since early 1999) | 1 | |
| Total | 11 | 5 |

All groups were up to 2½ hours in length and were conducted by senior, experienced qualitative researchers from **colmar brunton**.

The qualitative fieldwork was carried out between 31 October and 27 November 2002 in the following areas:

- Whangarei
- Auckland
- Napier
- Wairarapa
- Upper Hutt
- Wellington

¹ The purpose of these individual interviews with tax agents was twofold. First to test the respondent understanding and interpretation of the draft questionnaire for the quantitative phase in a qualitative setting, and second to check for any additional tax agent issues not already elicited in the qualitative research or covered in the survey questionnaire.

- Christchurch
- Ashburton
- Timaru.

As qualitative research involves relatively small sample sizes and non-random sampling, it provides indicative findings only. The second phase of this research consists of quantitative research. This stage will statistically extrapolate key findings from the qualitative research to the wider population of interest.
