

# REGULATORY IMPACT STATEMENT

## Proposed changes to business tax

### Agency disclosure statement

This Regulatory Impact Statement has been prepared by Inland Revenue. It provides an analysis of options to address concerns taxpayers have with the tax policy settings for businesses. The concerns addressed were identified from submissions on the government discussion document *Making Tax Simpler: A Government green paper on tax administration* and other consultation.

The options considered are intended to simplify the rules and reduce compliance costs for businesses, while ensuring the rules are robust. The options were developed in the context of the wider tax policy framework of a clear and coherent broad-base, low-rate tax system.

The options in this statement have been constrained as Ministers have asked for options that can be delivered with effect from 1 April 2017. However, some options will apply from 1 April 2018 due to the additional time needed for taxpayers and Inland Revenue to implement system changes.

It is challenging to accurately forecast some of the costs (including compliance, administrative and fiscal costs) for the options due to information not being available or difficulty in estimating likely behavioural changes. Equally, it is difficult to determine the number of taxpayers who may be impacted by the proposals as various factors may influence the decision to adopt a proposal. Instead, indications of the direction and order of magnitude have been provided where appropriate.

Officials have been mindful of the fiscal implications stemming from the proposals.

None of the policy options restrict market competition, impair property rights, reduce incentives for small businesses to operate, or override fundamental common law principles.



Keith Taylor  
Policy Manager, Policy and Strategy  
Inland Revenue

25 February 2016

## Contents

Reader's guide to this RIS .....	4
STATUS QUO AND PROBLEM DEFINITION .....	5
OBJECTIVES .....	7
REGULATORY ANALYSIS.....	7
A. Changes to provisional tax to increase certainty and reduce costs.....	8
B. Self-management and integrity.....	12
C. Making the system fairer .....	13
D. Making markets work better through tax transparency.....	14
E. Supplementary simplification measures.....	15
CONCLUSION.....	21
CONSULTATION.....	21
IMPLEMENTATION .....	22
MONITORING, EVALUATION AND REVIEW .....	23
APPENDIX A – CHANGES TO PROVISIONAL TAX TO INCREASE CERTAINTY AND REDUCE COSTS .....	24
1 – Extend the current safe harbour from UOMI .....	25
Recommendations.....	29
2 – Application of UOMI .....	29
Recommendations.....	33
3 – Calculation method for provisional tax.....	33
Recommendations.....	37
4 – Paying tax as agent for shareholder-employees .....	37
Recommendations.....	41
APPENDIX B – SELF-MANAGEMENT AND INTEGRITY .....	42
Recommendations.....	49
APPENDIX C – MAKING THE SYSTEM FAIRER .....	50
Recommendations.....	59
APPENDIX D – MAKING MARKETS WORK BETTER THROUGH TAX TRANSPARENCY.....	60
Recommendations.....	68
APPENDIX E – SUPPLEMENTARY SIMPLIFICATION MEASURES.....	69
1 – Simplified calculation of deductions for dual use vehicles.....	69
Recommendations.....	73
2 – Simplified calculation of deductions for business use of premises. ....	73
Recommendations.....	76

3 – Increase threshold for taxpayer self-corrections of minor errors .....	76
Recommendations.....	79
4 – Remove the requirement to renew RWT exemption certificates annually .....	79
Recommendations.....	82
5 – Increase the threshold for annual FBT returns from \$500,000 to \$1 million of PAYE/ESCT.....	82
Recommendations.....	84
6 – Modify the 63 day rule on employee remuneration .....	84
Recommendations.....	86
7 – Simplification of fringe benefit calculation for close companies.....	86
Recommendations.....	88

## **Reader's guide to this RIS**

This document covers 16 discrete proposals which have been grouped into five themes. To manage this large number of topics we have shifted the detailed analysis of each theme, and the component proposals within that theme, out of the Regulatory Analysis section and into a set of five appendices.

The body of the RIS still contains an overview of the options considered but the detailed analysis of the costs, benefits, impacts and recommendations is contained in the corresponding appendix. Within the overview tables the following symbols are used:

- ✓✓ - Fully meets objective
- ✓× - Partially meets objective
- ×× - Does not meet objective

Consultation section of the RIS provides a summary of our consultation approach with the feedback received on each proposal set out in corresponding appendix.

## **STATUS QUO AND PROBLEM DEFINITION**

### **Inland Revenue's transformation programme**

1. The Government's objective for the revenue system is for it to be as fair and efficient as possible in raising the revenue required to meet the Government's needs. For taxpayers the tax system should be simple to comply with, making it easy to get right and difficult to get wrong. It should serve the needs of all New Zealanders, put customers at the centre and help them from the start, rather than when things go wrong.

2. The shift to digital and greater globalisation has reshaped how businesses and individuals interact and connect, and their expectations of government.

3. Businesses are increasingly using software packages to automate processes and reduce their compliance burden. Businesses have consistently ranked tax as their highest compliance priority, and it often contributes the most to their overall compliance burden. Compliance costs could be reduced by making better use of businesses' everyday processes and systems to meet tax obligations. Enabling businesses to spend less time on tax and more time on running their business will support Government's wider goals of building a more competitive economy and delivering better public services.

4. The ways in which individuals work has changed with different types of employment and working arrangements. The New Zealand workforce has become more casualised as permanent employment has become less common, and temporary, casual and contract work has become more prominent. Other trends include part-time and temporary workers increasingly holding multiple jobs, and more self-employment and small businesses. Many of the current tax policies and administrative processes were designed for an era when New Zealand's workforce was more strongly characterised by salary and wage earners in permanent full-time employment arrangements.

5. To protect the Government's ability to collect sufficient revenue to keep providing services, it is important that New Zealand's revenue system keeps pace with change and is as efficient as possible. The fiscal challenges associated with an ageing population and associated demand for high quality healthcare and other services will add impetus to the need for a highly efficient and responsive revenue system. To meet these challenges, Inland Revenue requires a fundamental shift in the way it thinks, designs, and operates.

6. The Government has agreed to change the revenue system through business process and technology change. A digitally-based revenue system, simplified policies, and better use of data and intelligence to better understand customers will simplify how services are delivered and change how customers interact with the revenue system.

7. Having a good overall revenue system means having both good policies and good administration. While the policy framework is fundamentally sound, there is an opportunity to review current policy and legislative settings as levers to help modernise the revenue system and ensure it is responsive to global changes.

8. There is no doubt that Inland Revenue's computer systems (known as FIRST) need replacement to improve resilience and agility. They have reached the end of their life and are not sustainable in the medium to long term. The FIRST systems are aging, extremely

complex, very difficult and costly to maintain, and inflexible. Since FIRST was implemented, a number of income-related social policies have been added to the platform. Implementing social policies within a platform designed for tax administration has added layers of complexity and risk to Inland Revenue's business processes and technology infrastructure. This in turn limits the department's ability to respond to government policy priorities.

9. However, Business Transformation is far more than just updating a computer system. It is a long-term programme to modernise New Zealand's revenue system, and will re-shape the way Inland Revenue works with customers, including improvements to policy and legislative settings and enabling more timely policy changes. A new operating model and new systems will be the catalysts for these changes.

10. This regulatory impact statement outlines options for simplifying the tax policy settings for businesses.

11. In March 2015 the Government released a discussion document entitled *Making tax simpler: A Government green paper on tax administration*. The feedback from submitters relating to business tax and other consultation/feedback from taxpayers can be grouped into five main areas:

- **Provisional tax is hard to get right and expensive to get wrong.** This affects businesses' ability to comply, results in compliance or administration costs, and adversely impacts perceptions of fairness.
- **The withholding tax regime for contractors is inflexible, out of date and open to abuse.** This affects the accuracy and timing of tax payments, results in compliance or administrative costs, and adversely impacts perceptions of fairness of the tax system.
- **Penalties are punitive and can reduce taxpayer compliance.** The current penalty rules do not take account of businesses' circumstances or the interaction of the use of money interest (UOMI) and penalty rules and the affect these have in conjunction with the provisional tax rules. Also an automatic penalty is frequently levied against those who did not pay due to an administrative error (as they have underdeveloped business processes), cannot pay (as they do not have the resources) or will not pay (as they have the resources, but choose not to pay). This adversely impacts fairness by imposing excessive costs on businesses who are trying to comply, and reduces compliance.
- **Tax information is not used to protect businesses.** Compliant businesses would be better protected if data held by Inland Revenue indicating serious debt or malpractice was shared appropriately. However, legislation currently restricts this.
- **Rules require accuracy regardless of costs.** Tax rules that try to get to a "perfect" answer can impose undue costs when, in some instances, close enough should be good enough.

12. More detail on each of these areas is provided below and in the appendices.

### ***Problems and their magnitude***

13. Provisional tax is particularly problematic for taxpayers who have relatively simple systems and who have difficulty in forecasting their income. It leaves these particular taxpayers in an uncertain position in terms of their total liability for tax and UOMI.

14. Feedback suggests this creates stress for taxpayers during and at the end of the year for something that could be well outside their ability to control. The current UOMI regime also has relatively expensive interest rates for taxpayers which can mean that UOMI can appear to be a penalty.

## **OBJECTIVES**

15. The Government is committed to making positive changes to reduce the time and costs to businesses of meeting their tax obligations. The objectives against which the options have been assessed are:

- *Fairness and equity*: to support fairness in the tax system, options should, to the extent possible, seek to treat similar taxpayers in similar circumstances in a similar way.
- *Efficiency of compliance and administration*: the compliance impacts on taxpayers and the administrative costs to Inland Revenue should be minimised as far as possible.
- *Sustainability of tax system*: options should collect the revenue required in a transparent and timely manner while not leading to tax driven outcomes.

16. These objectives are weighted equally.

17. There are no social, environmental or cultural impacts from these recommended changes.

## **REGULATORY ANALYSIS**

18. Officials have developed options to address the above issues. These options have been grouped into the following five key themes:

- A. Changes to provisional tax to increase certainty and reduce costs.
- B. Self-management and integrity.
- C. Making the system fairer.
- D. Making markets work better through tax transparency.
- E. Supplementary simplification measures.

19. Each of these themes and the options under them are summarised below. Further detail on the issues and options under each theme is contained in the appendices.

20. Within the overview tables the following symbols are used:

- ✓✓ - Fully meets objective
- ✓× - Partially meets objective
- ×× - Does not meet objective

#### **A. Changes to provisional tax to increase certainty and reduce costs**

21. While the consultation on the *Making tax simpler: A Government green paper on tax administration* discussion document sought views on issues across the tax system, the majority of submissions received identified issues with the current provisional tax rules, and expressed enthusiasm for different approaches. For example, of the 750 comments made on the 17 questions on the Green paper online forum, more than 200 comments were made in response to a single question about provisional tax.

22. While taxpayers generally agree with having to pay tax as they earn income, the perceived penalising effect of UOMI promotes general dissatisfaction with provisional tax rather than solely with the application of UOMI. This adversely affects the fairness of the provisional tax system.

23. Maintaining the current rules would continue to cause taxpayers stress and difficulties especially for those who pay provisional tax based on their best indicator of current year performance being their immediately prior income year. This increases the costs of complying with the provisional tax rules.

24. Another issue with the current provisional tax regime is that it attempts to approximate a pay as you earn system by assuming, wrongly in a large number of cases, that income is earned evenly throughout an income year. This means that what was intended to be a pay as you earn type system can become a pay before you have earned system which can cause cash-flow issues. This is particularly so for smaller, unsophisticated businesses. This can have a financial impact on taxpayers and increases compliance costs.

25. A final issue with provisional tax relates to close companies where all parties are related. In this situation there can be multiple taxpayers who are subject to provisional tax on different rules. In essence, there is one taxpaying group which should be subject to one rule to ease compliance and reduce the number of people subject to provisional tax. This adversely impacts the fairness of the system and increases compliance and administration costs.

#### ***Options and analysis***

26. The proposals to address the issues identified are:

- Extend the safe harbour from UOMI;
- Remove the application of UOMI;
- Introduce a new method of calculating provisional tax; and
- Enable tax to be paid by companies as agents for shareholder-employees.



Extend the safe harbour from UOMI

27. To address concerns about fairness of the UOMI rules, officials have considered a number of options to address the issue of provisional taxpayers' exposure to UOMI. These options focus on the dollar threshold below which provisional taxpayers are not subject to UOMI and the scope of the threshold (who it applies to).

28. These options are summarised below and are outlined further in appendix A-1.

<b>Options</b>	<b>Analysis against the objectives</b>
1. Retain the status quo	<i>Fairness and equity:</i> ×× <i>Compliance and administration:</i> ×× <i>Sustainability:</i> ×× <i>Revenue:</i> no impact
2. Increase the safe harbour threshold to \$60,000 and expansion of safe harbour from UOMI to non-individuals	<i>Fairness and equity:</i> ✓✓ <i>Compliance and administration:</i> ✓✓ <i>Sustainability:</i> ✓✓ <i>Revenue:</i> revenue cost of \$47 million over 4 years
3. Increase the safe harbour threshold to \$70,000 and expansion of safe harbour from UOMI to non-individuals	<i>Fairness and equity:</i> ×× <i>Compliance and administration:</i> ✓× <i>Sustainability:</i> ✓× <i>Revenue:</i> higher fiscal cost than option 2.
4. Increase to the safe harbour from UOMI to \$60,000 with no extension to non-individuals	<i>Fairness and equity:</i> ×× <i>Compliance and administration:</i> ×× <i>Sustainability:</i> ✓✓ <i>Revenue:</i> marginal revenue impact

*Recommendation*

29. Officials recommend option 2 to increase the safe harbour from UOMI to \$60,000 and to extend it to non-individual taxpayers. This option deals with the problems of uncertainty of tax payments and reduces the stress that some taxpayers with low levels of tax payments feel over provisional tax and the application of UOMI. As a result 67,000 taxpayers will no longer be subject to UOMI. Option 2 has been chosen over the other options principally on the basis that option 3 does not fit within fiscal constraints and option 4 affects very few taxpayers.

Remove the application of UOMI

30. In some cases taxpayers who use the best information available to them to pay their provisional tax payments are effectively penalised. For taxpayers who use the standard uplift method of calculating provisional tax, if their residual income tax (RIT) exceeds the safe harbour threshold and is different from the instalments paid during the year, UOMI will apply from the first instalment date. Although this seeks to compensate the party who ends up funding this difference in tax liability, it can result in taxpayers overpaying their tax to ensure they end up being the funding party so as not to incur large amounts of UOMI.

31. These options are summarised below and are outlined further in appendix A-2.

<b>Options</b>	<b>Analysis against the objectives</b>
----------------	--

1. Retain the status quo	<i>Fairness and equity: ××</i> <i>Compliance and administration: ××</i> <i>Sustainability: ××</i> <i>Revenue: ××</i>
2. Remove the application of UOMI for <b>the first two provisional tax payments</b> for all taxpayers who use the standard uplift method	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ✓✓</i> <i>Sustainability: ✓✓</i> <i>Revenue: revenue cost of \$7.5 million and a cash-flow cost of \$334 million over 4 years</i>
3. Remove the application of UOMI for <b>all provisional tax payments</b> for all taxpayers who use the standard uplift method	<i>Fairness and equity: ××</i> <i>Compliance and administration: ××</i> <i>Sustainability: ✓✓</i> <i>Revenue: this measure has a higher revenue and cash-flow cost than option 2.</i>
4. Remove the application of UOMI for <b>the first provisional tax payment</b> for all taxpayers who use the standard uplift method	<i>Fairness and equity: ××</i> <i>Compliance and administration: ××</i> <i>Sustainability: ××</i> <i>Revenue: this measure has a lower revenue and cash-flow cost than option 2.</i>

### *Recommendation*

32. Officials recommend option 2 as it reduces the exposure to UOMI for taxpayers who struggle to estimate their income during the year. This option is expected to remove 19,000 taxpayers from the requirement to pay UOMI on their first two instalments of provisional tax. Option 2 was selected as option 3 did not provide enough benefits to taxpayers as UOMI would still have some type of penalty aspect to it. Option 2 balances fiscal constraints with benefits to taxpayers.

### *Introduce a new method of calculating provisional tax*

33. To approximate the objective that tax payments should be made when income is earned, provisional tax rules assume that income is evenly earned throughout the year. This assumption is not realistic for many taxpayers, especially those who have seasonal income who may have to make payments before they earn their income, or for businesses with varying income throughout the year. Where a taxpayer does not pay the correct amount at each instalment UOMI applies, which can act as a penalty for something that is outside their immediate control.

34. In a world with perfect foresight, most businesses would pay the amount of their actual liability during the year. The difficulty is that for most taxpayers forecasting their final income tax amounts is an art more than a science and differences will inevitably arise which were not predictable.

35. A new provisional tax method that better aligns the payment of tax with the income earning activity of a business should result in a closer match between the provisional tax payments and the end of year liability. Reducing the gap between provisional and actual liabilities could mean that UOMI is not required. Officials have considered a number of options to address these concerns

36. These options are summarised below and are outlined further in appendix A-3.

<b>Options</b>	<b>Analysis against the objectives</b>
1. Retain the status quo	<i>Fairness and equity: ××</i> <i>Compliance and administration: ××</i> <i>Sustainability: ××</i> <i>Revenue: no impact</i>
2. Introduce the accounting income method	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ✓✓</i> <i>Sustainability: ✓✓</i> <i>Revenue: Impact is expected to be neutral</i>
3. Extend the GST ratio method	<i>Fairness and equity: ✓×</i> <i>Compliance and administration: ××</i> <i>Sustainability: ××</i> <i>Revenue: no impact</i>
4. Introduce a turnover method	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ××</i> <i>Sustainability: ××</i> <i>Revenue: no impact</i>

#### *Recommendation*

37. Officials recommend option 2 as tax payments based on actual rather than forecast income, excluding shareholder salaries, will work for a large number of businesses where income accumulates over the year. This will reduce stress around year end payments and UOMI for taxpayers who use this method.

#### *Paying tax as agent for shareholder-employees*

38. Provisional tax gives rise to particular concerns for small businesses and their owners. The current rules apply separate obligations to a company and each of its shareholders. At its core what is happening is that a flow of income is being derived in a single economic entity and being partitioned out at the end of the year between the company and its shareholders, normally by way of shareholder salary. Each shareholder will typically be liable for provisional tax on that income.

39. The current approach does not align with the principle that tax should be collected by the person who is able to do so most efficiently, and compliance costs minimised.

40. Officials have considered a number of options to address these concerns, which are summarised below and outlined in more detail in appendix A-4.

<b>Options</b>	<b>Analysis against the objectives</b>
1. Retain the status quo	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ××</i> <i>Sustainability: ✓×</i> <i>Revenue: no impact</i>
2. <b>Allow</b> companies to pay tax as agent for shareholder-employees	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ✓×</i>

	<i>Sustainability: ✓✓</i> <i>Revenue: no impact</i>
3. <b>Require</b> businesses to pay tax as agent for related parties	<i>Fairness and equity: ✓×</i> <i>Compliance and administration: ✓×</i> <i>Sustainability: ✓×</i> <i>Revenue: no impact</i>
4. <b>Exclude</b> those associated with small businesses from paying provisional tax entirely and pay at terminal tax date	<i>Fairness and equity: ××</i> <i>Compliance and administration: ✓✓</i> <i>Sustainability: ××</i> <i>Revenue: unquantified revenue cost due to deferral</i>

### *Recommendation*

41. Option 2 is recommended by officials as this enables businesses and associated individuals to evaluate whether the benefits from removing associated parties from the requirement to pay provisional tax outweighs any additional costs or complexity. This option is also supported by the stakeholders consulted.

## **B. Self-management and integrity**

42. Withholding tax at source from payments to contractors reduces compliance costs for the majority of contractors, is a more accurate method of matching tax payments to when income is earned and ensures contractors pay their fair share of tax. However, the current withholding tax rules are out of date, inflexible, and don't cover modern employment arrangements and industries. There are 130,000 contractors who are subject to withholding tax who could benefit from changes to the withholding tax rules.

43. There also are groups of contractors who are not covered by the rules having to manage their own tax obligations and incur higher compliance costs as a result. For example, at least 4,200 contractors of labour hire firms are not covered by the rules, but could have an easier means of paying their tax if withholding tax was extended to them.<sup>1</sup>

### *Options and analysis*

44. There are a number of options to address the issues with the current withholding tax rules. However the requirement for options to apply from 1 April 2017 has limited the feasible options available to three.

45. These options are summarised below and are outlined further in appendix B.

<b>Option</b>	<b>Analysis against the objectives</b>
1. Retain the status quo	<i>Fairness and equity: ××</i> <i>Compliance and administration: ××</i> <i>Sustainability: ××</i> <i>Revenue: no impact</i>

<sup>1</sup> From an Inland Revenue audit project we know that the largest 11 labour-hire firms in New Zealand engage 4,200 contractors. The total number of contractors working for labour-hire firms will be greater than this.

2. Allow contractors currently in the withholding tax rules to elect their own withholding rate (with a 10% minimum)	<i>Fairness and equity:</i> ✓✓ <i>Compliance and administration:</i> ✓✓ <i>Sustainability:</i> ✓✓ <i>Revenue:</i> one-off fiscal cost of approximately \$35 million
3. Allow contractors not covered by the current withholding tax rules to enter into voluntary withholding agreements with their employer	<i>Fairness and equity:</i> ✓✓ <i>Compliance and administration:</i> ✓✓ <i>Sustainability:</i> ✓✓ <i>Revenue:</i> marginal upfront gain
4. Extend the withholding tax rules to contractors of labour hire firms	<i>Fairness and equity:</i> ✓✓ <i>Compliance and administration:</i> ✓✓ <i>Sustainability:</i> ✓✓ <i>Revenue:</i> difficult to measure but expect a small revenue benefit

46. Other options considered but that could not be developed in the time available include:

- Extending withholding to other contractors (for example, IT contractors).
- Removing or amending the company exception to the schedular payment rules comprehensively.
- Using banks as an intermediary for withholding rather than the payer of the contractor.

47. We consider that these measures require greater policy work and consultation than can be achieved in time for a 1 April 2017 application date.

### ***Recommendation***

48. Officials recommend that options 2, 3, and 4 be adopted as they reduce overall compliance costs and provide a fairer, more sustainable tax system. As a result we consider them an improvement over the status quo. Approximately 130,000 taxpayers currently subject to withholding tax for contract work will have greater flexibility to self-manage, and at least 4,200 labour hire contractors will be brought into withholding.

### **C. Making the system fairer**

49. The current late payment penalty is imposed in two stages: the initial penalty, of 1% the day after the due date and a further 4% imposed seven days after the due date, and an incremental penalty of 1% imposed each month the tax remains outstanding.

50. The late payment penalty does not effectively encourage all taxpayers to comply. For some taxpayers, late payment penalties can be seen as ineffective if they are imposed on people who did not pay due to an administrative error (as they have underdeveloped business processes), cannot pay (as they do not have the resources) or will not pay (as they have the resources, but choose not to pay). The first group feel Inland Revenue is penalising them for an honest mistake and will grudgingly pay the penalty. The second cannot pay the initial

amount and so will not be able to pay the penalties. The third is unlikely to be motivated by a financial penalty and so other tools would likely be more effective.

51. The issues with the late payment penalty are its size, blunt application, and imposition on groups where it is ineffective as a collection tool.

### ***Options and analysis***

52. To address concerns about the fairness and efficacy of the late payment penalty regime officials have considered a number of options focussing on the amount of penalty charged and the circumstances when a penalty should be charged.

53. These options are summarised below and are outlined further in appendix C.

<b>Option</b>	<b>Analysis against the objectives</b>
1. Retain the status quo	<i>Fairness and equity: ✓ ×</i> <i>Compliance and administration: × ×</i> <i>Sustainability: × ×</i> <i>Revenue: no impact</i>
2. Reduce the rate of the incremental late payment penalty	<i>Fairness and equity: ✓ ×</i> <i>Compliance and administration: ✓ ×</i> <i>Sustainability: × ×</i> <i>Revenue: higher cost than status quo but lower cost than recommended options</i>
3. Remove the 1% monthly incremental late payment penalty	<i>Fairness and equity: ✓ ×</i> <i>Compliance and administration: ✓ ✓</i> <i>Sustainability: ✓ ✓</i> <i>Revenue: fiscal cost of \$87 million over 4 years</i>
4. Remove all late payment penalties and apply UOMI only	<i>Fairness and equity: × ×</i> <i>Compliance and administration: × ×</i> <i>Sustainability: × ×</i> <i>Revenue: higher fiscal cost than both status quo and recommended options</i>
5. Broad discretion to impose penalties based on individual circumstances	<i>Fairness and equity: × ×</i> <i>Compliance and administration: × ×</i> <i>Sustainability: × ×</i> <i>Revenue: fiscal impact cannot be determined</i>

### ***Recommendation***

54. Officials recommend that options 3 be adopted as they will improve the effectiveness of the late payment penalty and thus improve the fairness and sustainability of the tax system. Once fully implemented option 3 will result in the incremental late payment penalty no longer being imposed on 65,000 taxpayers with income tax debt, 67,000 taxpayers with GST tax debt, and 23,000 families with Working for Families Tax Credit debt.

## **D. Making markets work better through tax transparency**

55. Tax secrecy rules mean that Inland Revenue cannot generally disclose information relating to significant business tax debt, or information relating to non-compliance with wider business legal obligations to relevant enforcement agencies. As a result businesses may be unaware of the credit risks they are dealing with, and enforcement agencies may be unaware of illegal conduct taking place.

56. In these ways tax secrecy can lead to inefficiencies and can allow non-compliant businesses to unfairly compete with compliant businesses. Making certain tax information available to others would assist in making markets work better.

### ***Options and analysis***

57. Officials have considered a number of options to address these concerns which consider sharing both financial debt information and other intelligence.

58. These options are summarised below and are outlined further in appendix D.

<b>Option</b>	<b>Analysis against the objectives</b>
1. Retain the status quo	<i>Fairness and equity:</i> xx <i>Compliance and administration:</i> xx <i>Sustainability:</i> xx <i>Revenue:</i> no impact
2. Share information on significant tax debt with credit reporting agencies	<i>Fairness and equity:</i> ✓✓ <i>Compliance and administration:</i> ✓✓ <i>Sustainability:</i> ✓✓ <i>Revenue:</i> potentially positive impact
3. Share information on significant tax debt with the wider public	<i>Fairness and equity:</i> xx <i>Compliance and administration:</i> xx <i>Sustainability:</i> ✓x <i>Revenue:</i> potentially positive impact
4. Share information on serious offences with the Registrar of Companies	<i>Fairness and equity:</i> ✓✓ <i>Compliance and administration:</i> ✓✓ <i>Sustainability:</i> ✓✓ <i>Revenue:</i> potentially positive impact
5. Share information for enforcement of wider business obligations	<i>Fairness and equity:</i> xx <i>Compliance and administration:</i> xx <i>Sustainability:</i> xx <i>Revenue:</i> potentially positive impact

### ***Recommendation***

59. Officials recommend options 2 and 4 as these options appear to be justifiable exceptions to tax secrecy principles and would benefit market efficiency. These options address policy problem and would achieve the objectives without unreasonably disclosing tax secret information.

## **E. Supplementary simplification measures**

60. Research shows that tax compliance costs are relatively high for small businesses. However measures to simplify tax rules often face a trade-off between the accuracy of the rules in question and reduced compliance costs. This section outlines supporting simplification measures to address these concerns and move towards a close enough is good enough tax outcome at lower compliance costs. They will reduce the amount of paperwork required by businesses and make it easier to manage their tax affairs without significantly affecting the amount of revenue collected by the government. The measures include simplified rules for businesses to calculate fringe benefit tax (FBT), account for vehicles and premises, and deduct employee remuneration. They also include some threshold adjustments to enable more small businesses access to simplified rules for filing and correcting errors.

### *Simplified calculation of deductions for dual use vehicles and premises*

61. Small business owners often use their personal vehicles and homes for both business and private purposes. Currently they need to allocate all their related expenses between private and business use. The private use percentage might also vary between different items of expenditure. Because there are numerous expenses for these items, allocating these between business and personal use can create large compliance obligations compared to the amount of tax at stake.

### *Simplified calculation of deductions for dual use vehicles*

#### *Options and analysis*

62. Officials have considered a number of options to address these concerns, which are summarised below and outlined in more detail in appendix E-1 to this report.

<b>Options</b>	<b>Analysis against the objectives</b>
1. Retain the status quo for vehicles	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ✕✕</i> <i>Sustainability: ✓✓</i> <i>Revenue: no impact</i>
2. Optional single rate for vehicles	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ✓✓</i> <i>Sustainability: ✓✓</i> <i>Revenue: small revenue cost</i>
3. Compulsory single rate for vehicles	<i>Fairness and equity: ✕✕</i> <i>Compliance and administration: ✓✓</i> <i>Sustainability: ✓✓</i> <i>Revenue: no impact</i>

#### *Recommendation*

63. Officials recommend option 2 be adopted as the calculation method for vehicles. While an optional method has some disadvantages in terms of efficiency and sustainability, officials consider the variance in the actual costs of car ownership is too wide for a compulsory single rate to be acceptably fair. Introducing a new option will prompt some taxpayers to undertake both sets of calculations, in order to determine which gives the best



result, and thereby undermine the compliance savings. It is unlikely that taxpayers would do this every year as vehicle expenses would likely remain fairly stable and so a reassessment of the calculation options would not be necessary. Owners of newer and more expensive cars may see a compulsory measure as a cap on their deductions rather than a simplification. A more accurate compulsory method could be developed, but this would erode the compliance cost benefits.

*Simplified calculation of deductions for dual use premises*

**Options and analysis**

64. Officials have considered a number of options to address these concerns, which are summarised below and outlined in more detail in appendix E-2 to this report.

<b>Option</b>	<b>Analysis against the objectives</b>
1. Retain the status quo for premises	<i>Fairness and equity:</i> ✓✓ <i>Compliance and administration:</i> ×× <i>Sustainability:</i> ✓✓ <i>Revenue:</i> no impact
2. Optional single rate for premises	<i>Fairness and equity:</i> ✓✓ <i>Compliance and administration:</i> ✓✓ <i>Sustainability:</i> ✓✓ <i>Revenue:</i> small revenue cost
3. Compulsory single rate for premises	<i>Fairness and equity:</i> ✓✓ <i>Compliance and administration:</i> ✓✓ <i>Sustainability:</i> ✓✓ <i>Revenue:</i> no impact

**Recommendation**

65. Officials recommend option 2 is adopted for premises. While the method should produce a fairly accurate measure for most taxpayers, some taxpayers will be entitled to smaller deductions under the method than their actual costs. Such taxpayers may consequently regard a compulsory measure as a cap on their deductions rather than a simplification. Introducing a new option will prompt some taxpayers to undertake both sets of calculations, in order to determine which gives the best result, and thereby undermine the compliance savings. It is unlikely though that taxpayers would do this every year as premises expenses would likely remain fairly stable and so a reassessment of the calculation options would not be necessary.

***Increase threshold for taxpayer's self-corrections of minor errors***

66. Currently if a taxpayer makes a minor error in their tax return with a tax effect of less than \$500, they can self-correct the error in their next tax return.<sup>2</sup> However if the error results

---

<sup>2</sup> Section 113A of the Tax Administration Act 1994

in more than a \$500 tax difference, then the taxpayer must request the Commissioner to correct the error. This imposes compliance costs on the taxpayer in having to apply to the Commissioner for a small adjustment. It also imposes administration costs on Inland Revenue in having to manage these low value items. These costs are high compared with the amount of tax at stake.

***Options and analysis***

67. Officials have considered a number of options to address these concerns, which are summarised below and outlined in more detail in appendix E-3.

<b>Options</b>	<b>Analysis against the objectives</b>
1. Retain the status quo	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ××</i> <i>Sustainability: ✓✓</i> <i>Revenue: no impact</i>
2. Increase self-adjustment threshold to \$1,000	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ✓✓</i> <i>Sustainability: ✓✓</i> <i>Revenue: no impact</i>
3. Increase self-adjustment threshold to \$2,000	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ✓✓</i> <i>Sustainability: ✓×</i> <i>Revenue: no impact</i>
4. Revenue percentage threshold	<i>Fairness and equity: ××</i> <i>Compliance and administration: ✓✓</i> <i>Sustainability: ✓×</i> <i>Revenue: negative as open to abuse</i>

***Recommendation***

68. Officials recommend option 2, as it provides the best balance between meeting the objectives of fairness and equity, efficiency of compliance and administration, and sustainability of the tax system.

***Remove requirement to renew a resident withholding tax exemption certificate annually***

69. Currently some taxpayers who hold a certificate of exemption from resident withholding tax (RWT) must renew the certificate annually. This creates relatively large compliance costs where certificates are renewed for relatively little value. It also creates an administrative burden for Inland Revenue, as all the annual exemption certificates must be renewed at the same time each year.

***Options and analysis***

70. Officials have considered a number of options to address these concerns, which are summarised below and outlined in more detail in appendix E-4.

<b>Options</b>	<b>Analysis against the objectives</b>
1. Retain the status quo	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ××</i> <i>Sustainability: ✓✓</i> <i>Revenue: no impact</i>
2. Issue certificate for an unlimited period	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ✓✓</i> <i>Sustainability: ✓✓</i> <i>Revenue: no impact</i>
3. Issue certificate for period greater than a year	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ✓×</i> <i>Sustainability: ✓✓</i> <i>Revenue: no impact</i>

### **Recommendation**

71. Officials recommend option 2 as this meets the objectives of reducing compliance and administration costs with no impact on fairness or sustainability of the tax system.

#### ***Increase the threshold for annual FBT returns from \$500,000 to \$1 million of PAYE/ESCT***

Most businesses are required to calculate and return FBT on a quarterly basis. However businesses that have combined pay as you earn (PAYE) and employer superannuation contribution tax (ESCT) obligations of no more than \$500,000 per year are currently allowed to calculate and return FBT on an annual basis. As a smaller business becomes larger and employs more staff, it may exceed the \$500,000 threshold. Consequently the business will be required to calculate and pay FBT on a quarterly basis. This can impose compliance costs which are still significant relative to the size of the business.

### **Options and analysis**

72. Officials have considered a number of options to address these concerns, which are summarised below and outlined in more detail in appendix E-5.

<b>Options</b>	<b>Analysis against the objectives</b>
1. Retain the status quo	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ××</i> <i>Sustainability: ✓✓</i> <i>Revenue: no impact</i>
2. Increase threshold to \$1 million	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ✓✓</i> <i>Sustainability: ✓✓</i> <i>Revenue: small fiscal cost of approximately \$0.5 million over four years</i>
3. Increase threshold to \$2 million	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ✓✓</i> <i>Sustainability: ✓✓</i> <i>Revenue: more significant fiscal cost than option 2</i>

### ***Recommendations***

73. Officials recommend option 2, as it meets the objective without a significant fiscal cost. Officials do not recommend option 3, as officials consider a business with combined PAYE and ESCT obligations of over \$1 million is sufficiently large to be subject to the standard quarterly filing requirement.

#### ***Modify the 63 day rule on employee remuneration***

74. There is a special deduction and timing rule for the deferred payment of employee remuneration. Currently, in order to comply with this deferred payment rule, taxpayers need to work out what employee remuneration has been paid during the 63 day period that relates to the previous income year. This creates an additional compliance burden for taxpayers because they need to track payments accrued at year end and paid within 63 days of the end of the income year.

### ***Options and analysis***

75. Officials have considered a number of options to address these concerns, which are summarised below and outlined in more detail in appendix E-6.

<b>Option</b>	<b>Analysis against the objectives</b>
1. Retain the status quo	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ✕✕</i> <i>Sustainability: ✓✓</i> <i>Revenue: no impact</i>
2. Optional 63 day rule	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ✓✓</i> <i>Sustainability: ✓✓</i> <i>Revenue: small upfront gain</i>
3. Optional 63 day rule for different classes of employee remuneration	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ✓✕</i> <i>Sustainability: ✓✓</i> <i>Revenue: small upfront gain</i>

### ***Recommendations***

76. Officials recommend adopting option 2 as it will provide compliance savings and improve efficiency by providing taxpayers with a choice. This option also has no disadvantage in terms of fairness, equity and sustainability of the tax system because the same deductibility and timing rule will apply to all employee remuneration rather than different rules for different types of employee remuneration.

#### ***Simplification of fringe benefit calculation for close companies***

77. Close companies that provide their shareholder-employees with a motor vehicle for private use are required to register and pay FBT for that benefit, subject to certain exemptions. Sole traders and partners in a partnership who use a motor vehicle in a similar

way are not required to register and pay FBT. Instead these taxpayers apportion their motor vehicle expenditure between the business and private use using special motor vehicle expenditure rules. These differences in treatment for what is essentially the same benefit (i.e. the private use of a motor vehicle) arise because of the different entities involved.

### ***Options and analysis***

78. Officials have considered a number of options to address these concerns, which are summarised below and outlined in more detail in appendix E-7.

<b>Option</b>	<b>Analysis against the objectives</b>
1. Retain the status quo	<i>Fairness and equity: ××</i> <i>Compliance and administration: ××</i> <i>Sustainability: ××</i> <i>Revenue: no impact</i>
2. Allow close companies to use the motor vehicle expenditure rules instead of paying FBT	<i>Fairness and equity: ✓✓</i> <i>Compliance and administration: ✓✓</i> <i>Sustainability: ✓✓</i> <i>Revenue: small fiscal cost</i>

### ***Recommendations***

79. Officials recommend adopting option 2 as this provides consistency of treatment and will achieve the objective of providing compliance savings while also improving compliance overall. Introducing a new option will prompt some taxpayers to undertake both sets of calculations, in order to determine which gives the best result, and thereby undermine the compliance savings. It is unlikely that taxpayers would do this every year as vehicle expenses would likely remain fairly stable and so a reassessment of the calculation options would not be necessary. This option also has no major disadvantages in terms of fairness, equity and sustainability of the tax system.

## **CONCLUSION**

80. The recommended options under these themes collectively form a sensible tax package that would provide significant compliance cost reductions, while maintaining New Zealand's broad base, low rate framework.

## **CONSULTATION**

81. Several forms of consultation have been undertaken in developing the options outlined in this statement.

82. In June 2014, Inland Revenue, the Treasury and Victoria University hosted a conference entitled *Tax administration for the 21<sup>st</sup> Century*. The conference explored options for making tax easier through reducing both compliance and administration costs, while balancing increased voluntary compliance against the core tax policy objectives of raising sufficient revenue and ensuring fairness and efficiency. The main points made by attendees were to give people the ability to self-manage their tax affairs through improved services and more flexible legislative frameworks, the importance of involving businesses and others in

the design of the rules and processes, the need to ensure that there is an overall net benefit to society of the changes not just a cost shift from Inland Revenue to businesses, and to ensure the continued maintenance of the current tax system whilst the reforms occur.

83. Following this conference the Government issued *Making tax simpler – a Government green paper on tax administration* which outlined the scope and direction of the review of the tax administration, and sought feedback on the future for business tax and the problems taxpayers face with the current system. The options proposed in this regulatory impact statement address the five main issues identified as part of the consultation with taxpayers and feedback on the green paper. These issues are outlined under the status quo and problem definition section above.

84. The Government has decided not to issue a discussion document on the options in this regulatory impact statement, which would normally occur as part of the policy development process. However, in developing these options, Ministers have asked officials to undertake selected consultation with key players, including the Chartered Accountants of Australia and New Zealand, Corporate Taxpayer Group, Business New Zealand, selected labour hire firms, selected credit reporting agencies, and a small group of accountants. Feedback from these consultations has informed the development of the options.

85. Also, once the Government announces the changes it is expected that an issues paper will be released seeking public feedback on the detailed design of each of the proposals.

## **IMPLEMENTATION**

86. It is proposed to include the recommended options in a bill to be introduced in July 2016 and enacted by the end of the year.

87. All the recommended options (apart from the accounting income method and paying tax as agent for shareholder-employees) will apply from 1 April 2017. The accounting income method and paying provisional tax on behalf of related individuals' options will apply from 1 April 2018.

88. The new provisional tax option using an accounting income method has an implementation date of 1 April 2018 as both Inland Revenue and external suppliers will have changes to make to systems and products that will require a lead in time of between 12 to 18 months.

89. The migration of income tax processing from Inland Revenue's heritage system to the new technology platform is a good transition point for the introduction of a new provisional tax calculation method. This period will also allow external suppliers to develop and modify products to use the new method.

90. The option of paying tax on behalf of shareholder-employees is required to be implemented in Inland Revenue's new platform in order to reduce the implementation costs. The new platform is expected to be deployed for income tax on 1 April 2018 and this option will apply from then. The compliance cost saving this option offers may also be useful for other types of income paid out by companies to related parties, and as an alternative to Resident Withholding Tax. Depending on the uptake of this option, officials may recommend

its extension to other income types in the future. It may also be useful to extend it to partnerships in the future, based on a similar assessment. This wider use of the paying tax as agent proposal is not addressed in this RIS.

91. The removal of the incremental late payment penalty for GST will apply from when the new platform begins to administer GST, which is scheduled to be taxable periods beginning February 2017. The first GST returns filed will be due after the 1 April 2017 application date of the new penalty rules. For income tax and Working for Families Tax Credits the removal of the incremental late payment penalty will apply from the income year beginning 1 April 2017.

## **MONITORING, EVALUATION AND REVIEW**

92. Inland Revenue will monitor the outcomes pursuant to the Generic Tax Policy Process ("GTTP") to confirm that they match the policy objectives. The GTTP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995.

93. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation, and the identification of remedial issues. Post-implementation review is expected to occur around 12 months after implementation. Opportunities for external consultation are built into this stage. Any necessary changes identified as a result of the review would be recommended for addition to the Government's tax policy work programme.

94. Also, as part of Inland Revenue's business transformation programme a benefit management strategy has been developed and endorsed. The strategy provides the framework for managing benefits within the programme, and:

- defines benefit components;
- details how programme benefits will be quantified and measured;
- documents how progress will be tracked; and
- describes what governance arrangements will be in place.

95. Both internal and external stakeholders will be actively involved in the on-going assessment of timeframes, benefits identification and benefits realisation for each stage of the transformation programme.

## **APPENDIX A – CHANGES TO PROVISIONAL TAX TO INCREASE CERTAINTY AND REDUCE COSTS**

### *Status Quo and problem definition*

There are around 300,000 provisional taxpayers in New Zealand:

- 24% of Government revenue comes from provisional tax
- 75% of provisional taxpayers are individuals
- 75% of provisional tax payments come from companies
- The top 5% of companies represent approximately 43% of the total provisional tax collected.

Currently taxpayers have three options for calculating provisional tax:

- The standard (or uplift) option which is based on the prior year's residual income tax (RIT) of the taxpayer plus 5%, or the year previous to the prior year RIT plus 10%; or
- The estimation option where the taxpayer makes an estimate of their current year tax liability and pays provisional tax based on that estimate; or
- The GST ratio option which is available only to a small subset of taxpayers and is based on a ratio of RIT from the prior year to total GST taxable supplies for that year applied to GST taxable supplies for the current year.

Comprehensive UOMI applies to instalments under the standard and estimation methods. The UOMI calculation divides the RIT for the taxpayer by the three provisional tax instalments and compares this to the provisional tax payments made by the taxpayer, charging or paying UOMI on the resulting shortfall or surplus. The current rates of UOMI are 9.21% for underpayments and 2.63% for overpayments. This results in taxpayers tending to overpay tax on the first instalment to avoid negative UOMI impacts.

Feedback indicates attitudes to provisional tax fall on a spectrum from taxpayers who find provisional tax difficult and stressful to those who are happy with the current rules. One consistent trend from taxpayers consulted was that they had issues with the application of UOMI, which looks more like a penalty rather than a time value of money charge when taxpayers have unexpected income during the year. This causes taxpayers stress and increased compliance costs.

A reduction or elimination of the negative impacts of UOMI to taxpayers would reduce these negative perceptions of provisional tax. This is especially so for those who are committing to a minimum level of tax payments based on the prior year plus an uplift where the application of UOMI can be particularly harsh.

Another issue with the current provisional tax regime is that it attempts to approximate a pay as you earn system by assuming, wrongly in a large number of cases, that income is earned



evenly throughout an income year. This means that what was intended to be a pay as you earn type system can become a pay before you have earned system which can cause cash-flow issues. This is particularly so for smaller, unsophisticated businesses.

A final issue with provisional tax relates to close companies and partnerships. In this situation there can be multiple taxpayers who are subject to provisional tax where in essence, there is one taxpaying group which should be subject to one rule to ease compliance and reduce the number of people subject to provisional tax.

### ***Constraints***

Ministers have asked officials for options that could be included in a business tax package to apply from 1 April 2017. This has limited the feasible options that officials could consider to those that can be implemented within the timeframe.

### ***Options***

The proposals to address the issue are:

1. Extend the safe harbour from UOMI;
2. Remove the application of UOMI;
3. Introduce a new method of calculating provisional tax; and
4. Enable tax to be paid by close companies and partnerships as agent for shareholders and partners.

### **1 – Extend the current safe harbour from UOMI**

UOMI applies from the first provisional tax date unless the taxpayer is an individual (i.e. a natural person) and their RIT is less than \$50,000, in which case UOMI will apply only from the terminal tax date.

One way of alleviating the concern expressed by some taxpayers around the application of UOMI would be to either increase the RIT threshold at which UOMI is imposed and/or extend the threshold to include other groups of taxpayers. Taxpayers with smaller amounts of tax to pay are relatively unsophisticated and are committing to pay a minimum amount of tax using previous years' assessments as a proxy for their current year tax liability.

Increasing the threshold will take more taxpayers out of the UOMI regime which should reduce stress and increase certainty around their tax payments. In addition, the application of the safe harbour could be extended to non-individuals who have low levels of income and are likely to be unsophisticated taxpayers.

There are a number of levels that the RIT threshold could be increased to. At the time the threshold was increased to \$50,000, it was forecast that 97% of individual taxpayers would fall within the new safe harbour. This means even a small movement in the threshold could remove almost all individuals from the application of UOMI.

This also suggests any further increase in the safe harbour RIT threshold would have limited appeal unless it was extended to other types of taxpayers, specifically, non-individual taxpayers.

Non-individuals were previously excluded from the safe harbour regime because of concerns around income shifting between individuals and related entities to ensure that no UOMI was payable. It was also possible for related parties to switch income from one party to another to ensure that provisional tax was also not payable due to the application of the provisional tax threshold (i.e., those with residual income tax of less than \$2,500 are not subject to provisional tax).

Whilst the rules will require some protection mechanisms to restrict taxpayers' ability to undertake this switching, the benefits to most taxpayers will outweigh these restrictions. In addition, since these rules were reviewed the prospect of increased visibility through more comprehensive systems should enable any potential gaming to be identified.

This proposal increases the threshold before UOMI will apply from \$50,000 to \$60,000 and expands the scope of this rule to non-individuals as well as individuals.

This will reduce the number of taxpayers subject to UOMI by an additional 67,000 taxpayers, the majority being non-individuals. The object of the change is to remove smaller taxpayers from the UOMI rules, reducing their stress and increasing certainty around their tax liabilities.

Several thresholds were considered. The option of increasing the threshold to \$60,000 of RIT and the extension of the rule to non-individuals fitted within the fiscal parameters. A \$60,000 level reduces the application of UOMI to individuals to very small numbers, while the extension removes a significant number of non-individuals from the UOMI rules.

A higher RIT level such as \$70,000 or \$80,000 would remove more taxpayers from the UOMI rules, but would have additional cost and would result in some reasonably sophisticated taxpayers being included within the rules. This would defeat the intention of removing those taxpayers who can struggle with predicting their income.

Another option would have been to retain the \$50,000 threshold but extend the rules to non-individuals. The number of taxpayers that are within the \$50-60,000 band of RIT is approximately 4,000.

Consequently the proposal is to increase the safe harbour threshold from \$50,000 to \$60,000 and make this available to non-individuals as well as individuals. This proposal deals with the issues around certainty of tax payments and the stress some taxpayers feel over provisional tax and the application of UOMI.

These options are analysed against the objectives in the table on the next page.

<b>Options</b>	<b>Fairness and equity</b>	<b>Efficiency of compliance and administration</b>	<b>Sustainability of tax system</b>	<b>Revenue</b>
1. Retain the status quo	<p>Not met</p> <p>The application of UOMI will continue to have a penal effect rather than a use of funds effect.</p> <p>The application of UOMI to taxpayers who use the standard method will continue to have an impact on fairness aspects.</p>	<p>Not met</p> <p>Taxpayers will continue to experience uncertainty in the application of UOMI to them, creating compliance costs.</p>	<p>Not met</p> <p>Some taxpayers will continue to view provisional tax in a negative light with the current rules providing uncertainty as to the total tax liability including interest.</p>	<p>No impact</p>
2. Increase the safe harbour threshold to \$60,000 and expansion of safe harbour from UOMI to non-individuals	<p>Met</p> <p>Provides more fairness to those taxpayers who have limited tax knowledge by removing uncertainty as to the application of UOMI for relatively small amounts of tax.</p>	<p>Met</p> <p>For smaller taxpayers, reduces compliance costs of having to deal with provisional tax and unexpected UOMI costs.</p> <p>Inland Revenue will have less administration costs from taxpayer contact around provisional tax as this proposal will reduce the number of taxpayers subject to interest.</p>	<p>Met</p> <p>Provides more certainty for taxpayers on the application of UOMI.</p>	<p>This measure will cost \$47 million over four years.</p>

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax system	Revenue
<p>3. Increase the safe harbour threshold to \$70,000 and expansion of safe harbour from UOMI to non-individuals</p>	<p>Not met</p> <p>Higher threshold brings more sophisticated taxpayers into the safe harbour.</p> <p>These taxpayers should have sufficient ability to determine their tax position without safe harbour which creates unfairness to those who cannot.</p>	<p>Partially met</p> <p>Reduces compliance costs for some taxpayers, and for taxpayers who have no real issues with provisional tax as their business processes include forecasting and budgeting.</p>	<p>Partially met</p> <p>Provides more certainty on the application of UOMI for some, but makes little difference to those at the top end of the scale.</p>	<p>This option would have a greater fiscal cost than option 2 which makes this less viable for government.</p>
<p>4. Increase to the safe harbour from UOMI to \$60,000 with no extension to non-individuals</p>	<p>Not met</p> <p>Changes to the safe harbour to increase it to \$60,000 without extending it to non-individuals would not have a large effect on taxpayers because of the narrow group of taxpayers that would benefit.</p> <p>This provides an inequity to taxpayers because of the vehicle of choice they have made for predominately non-tax reasons (e.g. limited liability).</p>	<p>Not met</p> <p>Increases administration costs for Inland Revenue in having to change systems for a very small group of taxpayers.</p> <p>Reduced compliance costs for the limited number of taxpayers who are affected, but may not outweigh the costs.</p>	<p>Met</p>	<p>Marginal revenue impact</p>

## ***Recommendations***

Officials recommend option 2 – increase the current safe harbour from UOMI to \$60,000 and extend the application of the safe harbour to non-individuals. Both these measures will reduce stress and compliance costs for taxpayers who have tax liabilities at relatively low levels. As a result, 67,000 taxpayers will no longer be subject to UOMI.

## **2 – Application of UOMI**

At present, for those taxpayers who use the standard method of calculating, provisional tax instalments are based on 105% of the prior year or 110% of the year preceding the prior year. Notwithstanding this uplift method, if a taxpayer's RIT exceeds the safe harbour threshold and is different from the instalments paid, comprehensive UOMI will apply from the first instalment date.

Where taxpayers have used the standard or uplift method of calculating provisional tax they have committed to a minimum amount of tax payments no matter what their actual income is. This could be more or less than the tax payments required on their current year income. Currently UOMI seeks to compensate the party who ends up funding this difference (i.e., the taxpayer or the government).

The issue here is that the funding party may not be apparent until the end of the income year. This can result in taxpayers overpaying their tax to ensure they end up being the funding party and not incurring large amounts of interest. Alternatively, if the taxpayer doesn't overpay early instalments they are effectively penalised from using the best information available to most taxpayers, being the prior year results plus a growth factor, on which to base their current year payments. This is one instance where UOMI can be a penalty rather than a use of funds charge.

The first option is to remove UOMI from taxpayers who pay based on the standard method for the first two instalments giving taxpayers the ability to pay the correct amount of tax and reduce or eliminate UOMI. This option will apply to large and small taxpayers but will be of main benefit to those larger taxpayers who fall outside the \$60,000 RIT safe harbour. These taxpayers will tend to be more sophisticated and should be able to pay their total tax liability by the last instalment date and have no exposure to UOMI as long as they have committed to and paid a certain level of tax during the income year.

Again this option deals with the issues around certainty of tax payments and exposure to UOMI for taxpayers who struggle to estimate their income. This option provides them with certainty around tax payments and overall liability in respect of those payments.

Another option considered was to only impose UOMI from the terminal tax date, extending the safe harbour rules to all taxpayers using the standard uplift method. This option is not recommended due to fiscal concerns and the fact that this group of taxpayers is reasonably sophisticated and should be able to calculate a reasonable tax liability to ensure that UOMI is eliminated or reduced from the last instalment date. This would also increase the fiscal costs of the solution which would have made the proposal uneconomic.

Consideration was also given to imposing UOMI from the second instalment date as this should be sufficient time for a business to understand how their income was tracking for the income year. However, this would effectively require everyone to estimate their income from the second instalment date. This would defeat the intent to make things more certain for taxpayers who cannot reasonably estimate their income for the year and is not recommended. These options are analysed against the objectives in the table on the next page.

Officials' analysis of the options is set out in the table on the next page.

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax system	Revenue
1. Status quo	<p>Not met</p> <p>The application of UOMI will continue to have a penal effect rather than a use of funds effect for those taxpayers who have unexpected income.</p> <p>The application of UOMI to taxpayers who use the standard method will continue to have an impact on fairness aspects.</p>	<p>Not met</p> <p>Taxpayers will continue to experience uncertainty in the application of UOMI to them, creating compliance costs.</p> <p>Taxpayers who commit to paying a minimum amount of tax through the standard method will continue to view UOMI as a penalty.</p>	<p>Not met</p> <p>Some taxpayers will continue to view provisional tax in a negative light with the current rules providing uncertainty as to the total tax liability including interest.</p>	<p>No impact</p>
2. Remove the application of UOMI for the first two provisional tax instalments for taxpayers who use the standard method	<p>Met</p> <p>Taxpayers who commit to making a minimum level of tax payments during a year based on the best information available on their performance should not be penalised by the application of UOMI where the actual liability is different.</p> <p>Increases the fairness to taxpayers of unexpected changes in income.</p>	<p>Met</p> <p>Makes provisional tax simpler for the majority of provisional taxpayers who currently use the standard method to calculate their provisional tax.</p> <p>Reduces administration costs as Inland Revenue will have a better picture of provisional tax payments that will be payable for a year.</p>	<p>Met</p> <p>Increases certainty for taxpayers in terms of their total liability to tax and UOMI for a year.</p>	<p>This measure has a revenue cost of \$7.5 million and a cash-flow cost of \$334 million over four years.</p>
3. Remove the application of	<p>Not met</p>	<p>Not met</p>	<p>Met</p>	<p>This measure has a prohibitive cash-flow and</p>

<b>Options</b>	<b>Fairness and equity</b>	<b>Efficiency of compliance and administration</b>	<b>Sustainability of tax system</b>	<b>Revenue</b>
UOMI to terminal tax for taxpayers who use the standard method	<p>The current safe harbour removes those who have lower levels of RIT from the application of UOMI. This is to ensure that those on those lower levels have certainty around UOMI.</p> <p>To allow all taxpayers to have this concessionary treatment is not appropriate as some taxpayers are sophisticated and should be able to manage their tax payments accordingly.</p>	Reduces the compliance costs for those taxpayers using the safe harbour method. Increases the incentive to change between the standard and estimation methods for more sophisticated taxpayers, as they will determine on which basis to pay provisional tax based on the standard method or estimate.	Increases certainty for taxpayers in terms of their total liability for tax and UOMI for a year.	revenue cost.
4. Remove the application of UOMI for the first instalment for taxpayers who use the standard method to calculate provisional tax	<p>Not met</p> <p>Removing the application of UOMI from the first instalment provides no real relief for taxpayers from the current provisional tax problems.</p> <p>This would continue to have issues around fairness of the application of UOMI, albeit they would be reduced slightly.</p>	<p>Not met</p> <p>Doesn't reduce compliance costs of taxpayers overly as it only relieves interest from one payment. Will still require taxpayers to either overpay from the second instalment or risk the application of UOMI, or to estimate their liability.</p>	<p>Not met</p> <p>Still results in uncertainty for taxpayers regarding their total liability for provisional tax payments and UOMI, which does not change perceptions of provisional tax.</p>	<p>This measure would have a lower cost both in terms of revenue and cash-flow than the recommended option.</p>



## ***Recommendations***

Officials recommend option 2 – remove UOMI from the first two instalments of provisional tax where taxpayers use the standard uplift method. This will provide certainty to all taxpayers who use the standard uplift method. This option is expected to remove 19,000 taxpayers from the requirement to pay UOMI on their first two instalments of provisional tax.

### **3 – Calculation method for provisional tax**

There are three methods for the calculation of provisional tax. The standard method based on an uplift of the prior year's RIT, an estimate made by the taxpayer and the GST ratio method which is only available to a small subset of taxpayers.

UOMI is charged as if income is earned evenly over an income year, which is not a realistic proposition for many taxpayers. Whilst there are a number of options to bring tax payments more in line with the earning of income, there are difficulties and restrictions on doing this.

One difficulty is the assumption that income is either cumulative or static. Businesses can have fluctuations in income from profit to loss between months, unlike salary and wage earners who have accumulating income throughout the year. Methods that work well for accumulating income aren't effective where a business alternates between profit and loss from month to month.

Officials considered three options to more closely align the calculation of provisional tax with the income earning process.

The first option is basing provisional tax instalments on a taxpayer's accounting results for a period. This method uses actual calculations from actual results and has been titled the "accounting income method".

This proposal introduces a new method of calculating provisional tax instalments for smaller taxpayers. It allows them to base provisional tax instalments on their accounting results for a two month period. Essentially this provides for a pay as you go type of payment which bases payments on actual results rather than forecast income, excluding shareholder salaries.

For businesses with accumulating income throughout an income year, this method should provide the correct amount of tax payments for a year. For those with fluctuating profits and losses, an overpayment issue may still arise. However, as this is one of a choice of methods, another method may be more appropriate for taxpayers with that profile.

Under this option the number of provisional tax payments is increased from three to six to more closely align payments with the income earning of a taxpayer.

The option will not be permitted for larger taxpayers at this point in time as there are concerns about the accuracy of the option for those with large tax adjustments around year end. Work will continue on this option to assess its suitability for use with larger taxpayers.

The second option is an extension of the GST ratio method. This method takes the RIT from the prior year and divides it by the GST taxable supplies for that same year to calculate a ratio

that is applied to current year GST taxable supplies to give an approximation of an annual tax liability.

This method can work well where the taxpayer has static tax adjustments to accounting profits during a year which results in that ratio being reasonably static. It also relies on constant margins. This method works well for taxpayers with lower turnovers, but as turnover grows this ratio can become inaccurate. This is the reason that the GST ratio method is only available to a limited subset of taxpayers and its acceptance by taxpayers is also very low with only 2-3,000 taxpayers currently using this method.

A third option to more closely link tax payments with the earning of income is a turnover method, which is used in the Australian pay as you go instalment system. In essence this is very similar to the GST ratio method used in New Zealand. The turnover method again uses a ratio which is the RIT for a taxpayer divided by total turnover or revenue in the same year. Instead of using a GST reference point, the turnover method uses the accounting notion of turnover or income to generate a ratio which is then applied to the actual turnover for the current period to determine provisional tax instalments.

This method has advantages in that it deals with volatility between profits and losses during a year much better than the other options, as it works on an average tax rate throughout the year rather than a result for a particular period.

Again, however, it has disadvantages in that, similar to the GST ratio method, it relies on static tax adjustments and margins to be accurate. There is the potential that the higher the turnover, the more inaccurate this method could become.

These options are analysed against the objectives in the table on the next page.

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax system	Revenue
1. Status quo				
2. Introduce the accounting income method	<p>Met</p> <p>Provides a more fair and equitable way for small businesses to calculate provisional tax by moving to a more “pay as you go” type system.</p>	<p>Met</p> <p>Moves the calculation of provisional tax to a process that is more aligned to normal business processes.</p> <p>Should ease compliance for small businesses and also provide Inland Revenue with better information to effectively administer those taxpayers.</p>	<p>Met</p> <p>Links the payment of tax with ordinary business processes, providing greater certainty to taxpayers on the timing of tax payments and the earning of income.</p>	<p>No impact</p>
3. Extend the GST ratio method	<p>Partially met</p> <p>The extension of the GST ratio method to a larger group of taxpayers may assist to provide a closer pay as you go mechanism than the current provisional tax methods. However for taxpayers who have non-static margins or tax adjustments, issues with over or underpayment can still arise.</p> <p>In addition, the conclusion at the time the GST ratio method was introduced was that the larger the turnover, the less accurate the method was. This would still leave</p>	<p>Not met</p> <p>A GST ratio method has some compliance costs associated with it that may result in higher costs than a pure uplift method.</p> <p>The possibility of overpayments for larger taxpayers could also create larger compliance costs through the overpayment of tax where margins or tax adjustments are not static.</p>	<p>Not met</p> <p>The possibility of taxpayers having overpayments under the GST ratio option could make the system unstable and inherently unfair to taxpayers.</p>	<p>No impact</p>

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax system	Revenue
	unfairness within the system.			
4. Introduce a turnover method	<p>Met</p> <p>Provides a method that better approximates a pay as you go system.</p>	<p>Not met</p> <p>The method works off a prior year ratio of RIT to total income. It requires taxpayers to apply that ratio to actual turnover in the current year.</p> <p>This increases compliance costs compared to current methods. Issues will remain with overpayments, which will increase compliance costs.</p>	<p>Not met</p> <p>Similar issues to the GST ratio in respect of overpayments destabilising the overall structure of the system.</p>	No impact

## ***Recommendations***

Officials recommend option 2 – Introduction of an accounting income method. The introduction of a new method that more closely aligns to the income earning pattern of the taxpayer will allow for a more pay as you go type system for business taxpayers. This will allow them to more accurately pay tax during the year in a way which matches their income seasonality rather than on a straight line basis.

This will have a number of advantages for taxpayers regarding the funding of tax payments and removal of the application of UOMI. This will reduce compliance costs and increase certainty for taxpayers.

### **4 – Paying tax as agent for shareholder-employees**

A typical small company will be owned by one or more related parties – often a husband and wife, or one or more family trusts, or a combination of these. There will typically be a number of transactions between the company and its owners (and other related parties); salaries, dividends, interest, and sometimes payment for things like the rent of premises. The company and each of the owners and related parties will have their own liability to account for provisional tax.

Both calculating and paying provisional tax creates compliance costs for those who are liable; and as outlined earlier there is significant concern amongst small businesses about those compliance costs. Tax compliance costs incurred by business reduce the ability of those businesses to grow, which has negative impacts on economic growth and employment.

While compliance concerns are the key issues with the status quo, a wider efficiency argument also arises. Some individuals who might like to set up in business on their own could be discouraged from doing so because of the complexity of provisional tax. Inefficiency will always arise where tax influences behaviour.

Some taxpayers consider the application of provisional tax rules to them in their current form to be unfair, because of the work required to calculate and pay, and the risk of exposure to UOMI. The degree of public concern expressed about provisional tax means that it is arguably not sustainable in the long term – hence the focus in this paper on alternatives. This also gives rise to a minor revenue risk – a self-assessment system requires voluntary engagement by taxpayers, and some may disengage if they perceive the rules as unfair or too complex.

Current rules do allow taxpayers to transfer provisional tax to others, but the amount transferred must be excess tax, and the transferee remains a provisional tax payer.

In 2014 there were approximately 305,000 companies which paid income out to shareholders without deduction of tax at source.

Four options to address the issue were looked at.

The first option is to retain the status quo and accept that tax operates on the basis of legal form. If individuals want to put their business activities in a separate company, they

inevitably create a requirement for transactions – with tax consequences – between that company and themselves.

The second option is to allow a model which acknowledges that a single economic entity exists. Where a company and its shareholder-employees opt in to this approach the company will be able to make tax payments on behalf of shareholders, which may enable them to stay outside provisional tax.

The third option would require companies with shareholder-employees to operate a model which acknowledges that a single economic entity exists. Companies will be required to make tax payments on behalf of shareholder-employees, to ensure they are no longer subject to provisional tax on their shareholder salaries.

The fourth option is to exempt shareholder salaries from provisional tax and require tax on these payments to be paid at terminal tax date.

These options are analysed against the objectives in the table on the next page.

### ***Consultation***

Participants in the pre-announcement consultation saw the proposal to allow a company to pay tax on behalf of its shareholder-employees as an improvement over the status quo. One accountant observed that it provided the opportunity to create a mini-tax pool inside a group of related entities, although another with access to a tax pool thought the approach might not add much to what they could already do.

Accountants noted that some compliance work would remain for them, as they would still need to calculate the tax liability of each entity and individual in the same way as if they had all remained subject to provisional tax, but that the removal of direct provisional tax liabilities and the requirement to engage with Inland Revenue in relation to each taxpayer would deliver some compliance cost savings.

Chartered Accountants Australia and New Zealand (CAANZ) considered that companies should have the ability to choose to pay tax as an agent of shareholder employees (option 2), rather than being required to (option 3). They saw option 2 as giving businesses the ability to choose this option if it suited them and they felt comfortable using it, but allowing them to remain with the status quo if it did not. They thought that the mechanism could be simpler than if it was compulsory, because it would not need to cover every possible circumstance. CAANZ expressed enthusiasm about removing provisional tax from shareholder salaries entirely (option 4) but acknowledged that it would give rise to fairness and revenue concerns and was not a realistic option.

Officials' analysis of the options is set out in the table on the next page.

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax system	Revenue
1. Status quo	<p>Met</p> <p>Shareholder-employees who receive salaries from companies, and which is not taxed at source, are liable to pay provisional tax, just as individuals who receive other income not taxed at source are</p>	<p>Not met</p> <p>The current system has compliance costs which are of significant concern to business and government.</p>	<p>Partially met</p> <p>The fairness of the status quo approach supports sustainability, but the degree of concern around the compliance costs of provisional tax does not support sustainability.</p>	<p>No impact</p>
2. Allow companies to pay tax as agent for shareholder-employees.	<p>Met</p> <p>Fairness will be maintained provided these rules are implemented in such a way that tax paid on behalf of related parties is paid at the time that those related parties would have paid it themselves if these rules had not applied.</p>	<p>Partially met</p> <p>This option allows shareholder-employees to be entirely removed from provisional tax. However, calculations of their underlying tax liability are still required, to enable the correct amount of tax to be paid on their behalf. Some companies will also incur compliance costs in determining whether to opt into these rules or not.</p>	<p>Met</p> <p>This option is both fair and reduces the compliance cost impact of provisional tax.</p> <p>The non-compulsory nature means it is unlikely to be opposed by business.</p>	<p>No impact</p> <p>(provided this option is implemented in a way which ensures that no revenue leakage occurs.) Monitoring is likely to be required in initial years.</p>

<b>Options</b>	<b>Fairness and equity</b>	<b>Efficiency of compliance and administration</b>	<b>Sustainability of tax system</b>	<b>Revenue</b>
<p>3. Require companies to pay tax as agent for shareholder-employees.</p>	<p>Partially met</p> <p>The reservation immediately above applies. Some may also consider it unfair that taxpayers in this situation are required to pay tax through an agency relationship, whereas situations where income is received from an unrelated party do not require an agency relationship.</p>	<p>Partially met</p> <p>The reservation immediately above applies.</p> <p>The compulsory nature of this option also means that some taxpayers who may be happy with the status quo will be required to use it and will identify themselves as incurring additional compliance costs. However, there will be no compliance costs incurred in choosing whether or not to implement this option, and administration will be simplified.</p>	<p>Partially met</p> <p>This option is both fair and reduces the compliance cost impact of provisional tax.</p> <p>However, there may be objections to the compulsory nature of this option.</p>	<p>No impact</p> <p>Subject to the condition described above.</p>
<p>4. Exclude shareholder salaries from provisional tax entirely and allow tax to be paid at terminal tax date.</p>	<p>Not met</p> <p>Those who fall under this rule would have a timing advantage and removal of interest benefit over those who derive non-source deducted income from non-associated sources, and those who derive income subject to source deduction, as both groups pay tax as income is earned.</p>	<p>Met</p> <p>There would be a significant reduction in compliance cost as a result of removing those associated with small business from provisional tax.</p>	<p>Not met</p> <p>While the timing advantage this option would create would not threaten the broad base, low rate philosophy which underpins the New Zealand tax system, this kind of difference would still create a risk that other provisional taxpayers would seek similar concessions and undermine the key concept of paying tax on income as it is earned..</p>	<p>Revenue cost</p> <p>Introduction of this option would delay the receipt of revenue compared with the status quo. It could also encourage greater amounts to be paid out to shareholders – and so taxed at lower rates – instead of being retained in the company.</p>



### ***Recommendations***

Officials recommend option 2 – allowing companies to pay tax as agent for shareholder-employees. As this mechanism may give rise to additional cost or complexity for some, the most efficient overall outcome will be achieved by allowing each business to evaluate the costs and benefits of using it. This also provides a gradual uptake path for those businesses initially reluctant to use something new, but may become more comfortable once the mechanism has been in place for a period of time and is better-understood. Also, option 2 is supported by the stakeholders this was discussed with.

## **APPENDIX B – SELF-MANAGEMENT AND INTEGRITY**

### *Status quo and problem definition*

Withholding at source systems are widely considered to be the foundation of an effective tax system. Such systems impose an obligation on an independent third party (for example, an employer or financial institution) to withhold an amount of tax from a payment of income.

Withholding at source systems:

- remove taxpayers from the obligations around provisional tax or at least reduce those obligations to a level where safe harbour from UOMI may apply;
- are a more cost-effective way for both taxpayers and the revenue agency to interact;
- provide a timely flow of income to the government;
- reduce the likelihood of non-payment that might otherwise arise where the taxpayer reports the income but is unable to pay some or all of the tax assessed; and
- can significantly reduce the ability for taxpayers to understate their income.

New Zealand has a number of domestic withholding taxes, most notably PAYE and RWT. The “schedular payments” rules are another example of withholding.

The schedular payment rules apply a withholding tax for payments made to contractors who are in a set of limited industries (and even for these limited industries, the coverage is patchy). The schedular payment rules are intended to supplement the standard PAYE rules and provide a more efficient means of collecting tax for contractors. There are currently approximately 130,000 contractors who are subject to withholding tax.

The rules require withholding at flat rates. These rates have not been reviewed since 1979 and for the majority of taxpayers, the amounts withheld do not match their final tax liability (the current rates generally over-withhold on contractors).

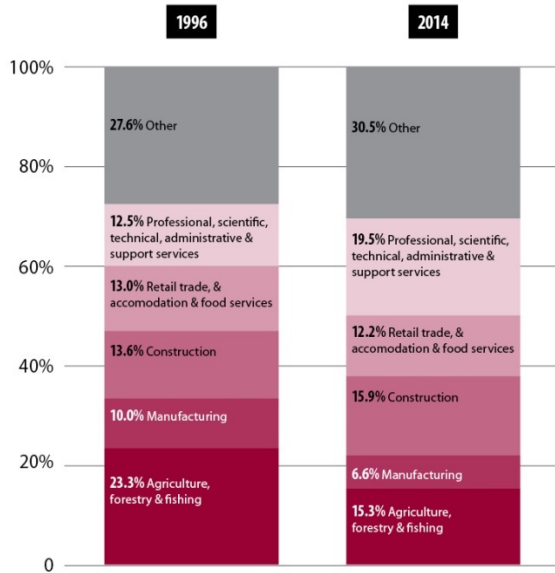
The withholding rules do not generally apply to companies. A contractor can also apply to Inland Revenue to obtain a certificate of exemption from withholding.

There are significant issues with the schedular payment rules. The rules are neither comprehensive in scope nor simple in application.

Although the withholding tax rules for schedular payments have not changed for many years, the labour market has undergone significant shifts. While the proportion of people who are self-employed (with no employees) has not changed much over the last 20 years, the industry make-up of these self-employed persons is changing. There has been a decrease in those working in industries such as agriculture and manufacturing, and an increase in the professional, scientific, and technical services and administrative and support services.

The current withholding tax rules generally do not apply to these modern, professional industries. This means more self-employed people are working in industries not covered by the withholding tax rules.

PROPORTION OF SELF-EMPLOYED BY INDUSTRY



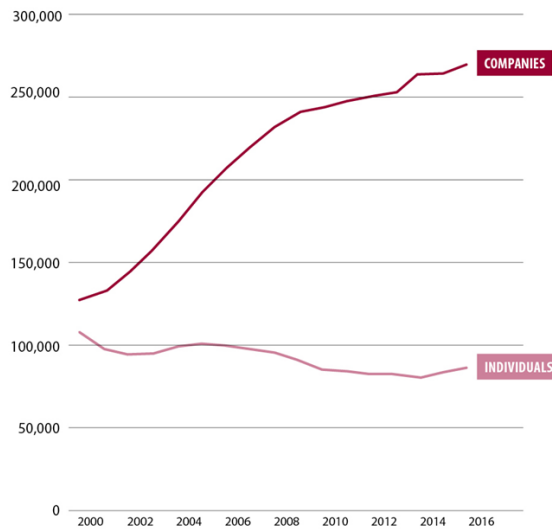
3

In addition, using a company structure has become increasingly popular with contractors. Payments to companies are generally not subject to withholding tax under the schedular payment rules.<sup>4</sup> The diagram below illustrates the increasing use of companies as a vehicle through which to carry out a business over the period 2000-2014.

<sup>3</sup> Household Labour Force Survey. This work is based on/includes customised Statistics New Zealand's data which are licensed by Statistics New Zealand for re-use under the Creative Commons Attribution 3.0 New Zealand licence.

<sup>4</sup> Companies in the agricultural, horticultural, and viticulture industries and non-resident contractor companies are subject to withholding under the schedular payment rules.

#### BUSINESS VEHICLE OF CHOICE



5

These out of date rules are creating issues. Many modern contractors are not subject to the withholding rules and are instead required to manage their own tax obligations (including provisional tax). Contractors subject to the withholding rules face an inflexible set of rules that prescribe flat rates of withholding and do not give them the tools to self-manage their obligations.

These contractors also have the opportunity to suppress income and operate totally or partially in the hidden economy. Investigators within Inland Revenue are reporting that there are compliance issues with contractors not subject to withholding. These contractors are not paying their fair share of tax and are claiming social policy benefits they are not entitled to.

This imposes greater costs and creates inefficiencies. Source deductions are a more efficient means of collecting tax for both contractors as well as Inland Revenue. It costs Inland Revenue \$0.28 to collect \$100 of tax from withheld PAYE income compared with \$2.28 for \$100 of income tax from non-withheld income. The out of date rules are imposing greater costs on both contractors and the government.

This regulatory impact statement considers three measures to address these issues that are feasible to implement with a 1 April 2017 application date.

#### *Options and analysis*

The options to address the issue are:

1. Retain the status quo.
2. Allow contractors subject to the schedular payment rules to elect their own withholding rate.

---

<sup>5</sup> Business Demography Statistics. This work is based on/includes customised Statistics New Zealand's data which are licenced by Statistics New Zealand for re-use under the Creative Commons Attribution 3.0 New Zealand licence.

3. Allow contractors not subject to the schedular payment rules to voluntarily elect into the withholding rules.
4. Extend withholding to labour-hire firms.

The three measures 2, 3, and 4, are not mutually exclusive.

#### *Measures not considered*

There are a number of other options that would address these issues that are not considered in this regulatory impact statement. This includes:

- Extending withholding to other directly engaged contractors (for example, IT contractors).
- Removing or amending the company exception to the schedular payment rules.
- Using banks as an intermediary for withholding rather than the payer of the contractor.

These options are not considered in this regulatory impact statement because officials do not consider them feasible to implement by 1 April 2017. These measures require greater policy work and consultation than can be achieved in time for a 1 April 2017 application date.

#### *Option 2 - Electing own withholding rate*

At present the schedular payment rules specify flat rates of withholding to be applied to payments to contractors. These rates will often not match the contractor's actual income tax liability. Contractors can obtain a special tax code to alter their rate; however the process can be cumbersome and requires an application to Inland Revenue with supporting information.

This option would allow contractors to select their own withholding rate without needing to apply to Inland Revenue. This means that an application for a special tax code will no longer be needed to alter the rate applied to a schedular payment.

#### *Option 3- Voluntary withholding agreements*

Contractors not covered by the schedular payment withholding rules are not currently able to have tax withheld on a payday basis.

This measure will allow contractors to opt in to withholding through voluntary agreements. The proposal will require both the contractor and the payer to agree before withholding would apply. This will enable these contractors to have greater flexibility to manage their tax obligations.

#### *Option 4 - Extending withholding to labour-hire firms*

A labour-hire firm is a firm that arranges for workers to do work for clients. The labour-hire firm receives payment from the client and on-pays the worker.

Workers engaged through labour-hire firms are often contractors for the labour-hire firm and the current withholding rules do not generally apply to them. There are at least 4,200 contractors of labour hire firms that are required to manage their own tax obligations and have to deal with provisional tax.

These contractors also have opportunities for non-compliance (whether deliberate or accidental). Investigators within Inland Revenue are reporting that there are compliance issues with some labour-hire firm contractors not paying their fair share of tax and claiming social policy benefits they are not entitled to.

This option would extend the current withholding tax rules to these contractors. The contractors would be able to elect their own withholding rate (as per option 2) and tax would be deducted at this rate and paid to Inland Revenue. If the contractor picks a rate that generally matches their final tax liability they will not be required to pay provisional tax.

These options are analysed against the objectives in the table on the next page.

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax system	Revenue
1. Status quo	<p>Not met</p> <p>Some contractors are not paying their fair share of tax and are claiming social policy benefits they are not entitled to.</p> <p>Contractors and employees are often doing very similar work, yet have very different rules apply to them.</p>	<p>Not met</p> <p>Contractors not subject to withholding have to manage their own tax obligations. Contractors subject to withholding face inflexible rules and are not given effective tools to self-manage.</p> <p>Does not decrease compliance costs for payers (unlike options 2 and 3).</p> <p>Higher processing and enforcement costs for Inland Revenue.</p>	<p>Not met</p> <p>Some employers and contractors are structuring to avoid the rules and avoid paying their fair share of tax.</p>	<p>No impact</p>
2. Electing own withholding rate	<p>Met</p> <p>Contractors in the schedular payment rules are currently generally over-deducted from resulting in a cash-flow cost to them that other contractors do not have.</p> <p>This change will make it easier for them to have the correct amount deducted.</p>	<p>Met</p> <p>Contractors that are subject to withholding will be given more flexibility to pick the correct rate of withholding. Their compliance costs will decrease as they will not have to apply for a special tax code to change their rate of withholding and therefore can more easily get their tax obligations right from the start.</p> <p>Payers of contractors may have an increase in compliance costs as they will have to more frequently change withholding rates. However, this is expected to be small and outweighed by the decrease in compliance costs for contractors.</p> <p>Inland Revenue will have less administration costs from administering special tax code applications and end of year tax bills and refunds.</p>	<p>No impact</p>	<p>The measure is expected to have an initial upfront fiscal cost of approximately \$54 million (of which \$19 million is recovered in following two years).</p> <p>This upfront cost arises primarily because the majority of contractors in the schedular payment rules are currently over-withheld and receive a tax refund in the following year. This over-withholding provides a one year fiscal benefit to the government. The proposal is expected to</p>

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax system	Revenue
				decrease the number of contractors who are over-withheld and therefore reduce this fiscal benefit to the government.
3. Voluntary withholding agreements	<p>Met</p> <p>Contractors will be able to voluntarily choose to have withholding apply and so have similar treatment to employees.</p>	<p>Met</p> <p>Compliance costs for contractors who enter voluntary agreements will decrease as they have an easier means to pay their tax. Administration costs for Inland Revenue will decrease for these contractors as well.</p>	No impact	Marginal upfront gain.
4. Extending withholding to labour-hire firms	<p>Met</p> <p>Contractors working for labour-hire firms will not be able to avoid paying their fair share of tax and claim social policy benefits they are not entitled to.</p> <p>This option would make the treatment of employees and contractors more similar for tax purposes.</p>	<p>Met</p> <p>Will reduce compliance costs for labour-hire firm contractors as they will have an easier means to pay their tax.</p> <p>Compliance costs will increase for labour-hire firms. However, this is expected to be less than the decrease in compliance costs for contractors and as a result overall compliance costs are expected to decrease.</p> <p>Large labour-hire firms have reported that the compliance costs of the proposal for them would be low, while smaller firms have reported that the compliance costs would be higher.</p> <p>Reduced administration costs for Inland Revenue in processing and enforcement for labour-hire firm contractors.</p>	<p>Met</p> <p>Contractors working for labour-hire firms will not have the opportunity to structure to avoid paying their fair share of tax.</p> <p>Some contractors may attempt to avoid the rules by contracting with clients directly; however following consultation with labour-hire firms we consider that this impact will be low.</p>	<p>The impact of this option is difficult to measure as it relies on estimations of the hidden economy.</p> <p>A conservative estimate shows a revenue benefit of \$5 million-\$10 million a year.</p>



### ***Minimum rates of withholding***

One design decision for the electing own withholding rate proposal is whether or not to require contractors to have a minimum rate of withholding. With a minimum rate, contractors who want to have a rate of withholding below the minimum will need to apply for a special tax code.

The key advantage of a minimum rate is that it reduces the fiscal risk that contractors may attempt to defer or avoid paying their tax through picking artificially low rates. The key disadvantage is that it limits choice for contractors and therefore imposes withholding tax on compliant contractors who may prefer provisional tax.

With a minimum rate of 10%, the fiscal impact of the proposal is expected to be approximately \$54 million (with \$19 million of this recovered in the subsequent two years). With no minimum rate this increases to approximately \$111m (with \$39 million recovered in subsequent two years).

### ***Consultation***

Inland Revenue and Treasury officials have consulted on these measures with industry groups and businesses, including small and large labour-hire firms.

These groups were generally supportive of the measures and believed they would reduce overall compliance costs.

Larger labour-hire firms have said that compliance costs of the proposals would be relatively low, while smaller labour-hire firms have reported that compliance costs would be relatively greater for them. In their submissions, labour-hire firms said the labour-hire rules need to apply consistently across all labour-hire industries, and that it is unlikely that labour-hire contractors will change their behaviour to avoid the rules by contracting directly with clients.

The analysis and rules recommended in this regulatory impact statement reflect these submissions.

One concern raised by submitters was that the electing own withholding rate proposal could significantly increase compliance costs for withholders if contractors repeatedly alter their withholding rates. We are proposing to address this through requiring the consent of the withholder to further changes in a contractor's withholding rate if the contractor has previously changed their withholding rate twice within one year.

### ***Recommendations***

Inland Revenue supports options 2, 3, and 4. These three measures take the first step in modernising the withholding rules for contractors and can be implemented by 1 April 2017.

These three options will reduce overall compliance costs and provide a fairer, more sustainable tax system. As a result we consider them an improvement over the status quo. Approximately 130,000 taxpayers currently subject to withholding tax for contract work will have greater flexibility to self-manage and at least 4,200 labour hire contractors will be brought into withholding.

## APPENDIX C – MAKING THE SYSTEM FAIRER

### *Status quo and problem definition*

Taxpayers are required to pay the right amount of tax on time. To encourage taxpayers to pay on time, late payment penalties are imposed on overdue tax.

The late payment penalty is imposed in two stages: the initial late payment penalty and the incremental late payment penalty. The initial late payment penalty is also applied in two steps: a one per cent penalty imposed the day after the due date and a four per cent penalty imposed on the seventh day if the tax remains outstanding. An incremental late payment penalty of one per cent is imposed each month the tax remains outstanding.

In addition, UOMI is imposed from day one on the outstanding amount and any initial and incremental late payment penalties. Interest is calculated on a daily basis on the amount of underpaid tax (including late payment penalties) but is not included in the calculation of the late payment penalty, and does not compound. The current rate for the underpayment of tax is 9.21% per annum.

In some circumstances late payment penalties are not imposed such as where the taxpayer is under a formal instalment arrangement, the taxpayer is providing information to the Commissioner to consider debt relief, where the unpaid tax is below \$100 or in certain circumstances where the underlying tax assessment is being disputed by the taxpayer. In addition there is a grace period for taxpayers who have been compliant for the previous two years. These taxpayers are not charged late payment penalties if the payment is made up quickly.

Total debt is approximately \$5.15 billion<sup>6</sup>, with penalties and interest representing a significant proportion of the total debt book. Many of these accumulated late payment penalties are written off by Inland Revenue as uncollectible.

In past surveys, taxpayers have advised Inland Revenue that their reasons for incurring late payment penalties are due to administrative error, short-term and long-term cash-flow problems.

The late payment penalty does not effectively encourage all taxpayers to comply. For some taxpayers, late payment penalties can be seen as ineffective if they are imposed on people who did not pay due to an administrative error (as they have underdeveloped business processes), cannot pay (as they do not have the resources) or will not pay (as they have the resources, but choose not to pay). The first group feel Inland Revenue is penalising them for an honest mistake and will grudgingly pay the penalty. The second cannot pay the initial amount and so will not be able to pay the penalties. The third is unlikely to be motivated by a financial penalty and so other tools would be more effective.

The issues with the late payment penalty are its size, blunt application, and imposition on groups where it is ineffective as a collection tool.

---

<sup>6</sup> Inland Revenue Annual Report, 2015.

Together, the late payment penalties and UOMI mean taxpayers incur a combined rate of approximately 27% in the first year. This combined penalty and interest rate is less in subsequent years as only the monthly incremental late payment penalty is imposed. UOMI rates are based on the Reserve Bank rates and fluctuate depending on the market. In previous years UOMI has been set at over 14% per annum, resulting in a combined penalty and interest rate of over 30% in the first year. This also has a significant impact on the amount of uncollectible penalties that are added to the tax debt book.

Under the current penalty and interest rules, within two years (without repayments), penalties and interest compound to more than 50% of the original tax owed. Inland Revenue's research has shown that for many indebted SME taxpayers, once the component of the penalties and interest reaches this point, they feel overwhelmed by their debt and become disengaged. At this point, imposing any additional late payment penalties becomes counterproductive as their imposition may further discourage the taxpayer from complying.

Working for Families Tax Credits (WFFTC) shares many income tax administrative and enforcement rules including filing requirements, terminal tax date, and the penalty (i.e. late payment penalty) rules. Therefore, WFFTC recipients face similar issues to taxpayers regarding how quickly penalties and interest accumulate. However, unlike income tax, WFFTC has a different purpose; to financially support families' day-to-day living costs. Currently, the late payment penalty rules can subject many indebted low income recipients to significant stress and anxiety as they struggle to afford to repay their WFFTC debt (due to overpayments), while watching their debt quickly grow to an unmanageable level. As a consequence much of this debt is written off.

New Zealand's current combined penalty and interest rate is significantly higher than most commercial lending institutions in New Zealand, as well as other OECD countries, including Australia.

### *Constraints*

Ministers have asked officials for options that could be included in a business tax package to apply from 1 April 2017. This has limited the feasible options that officials could consider to those that can be implemented within the timeframe. This limitation extends to the scope of the options as well as their design – that is, whether the option could apply to all tax types or just specific tax types such as GST or Working for Families.

It is difficult to estimate the behavioural impact any changes to the penalty rules might have on both compliant and non-compliant groups of taxpayers.

Any financial penalty that is imposed and consequently paid by the taxpayer is revenue to the government. Due to the difficulty in estimating the behavioural impact of any changes, officials are unable to fully estimate the fiscal cost of any changes in the late payment penalty rules.

Inland Revenue is deploying a new IT system (START) which will supersede the legacy system (FIRST) over the course of the next few years. To avoid having to amend both the legacy system and build the new rules into START, any changes to late payment penalties will only apply to taxes as they migrate to START.

## *Options and analysis*

Options to address the issue are:

1. Retain the status quo.
2. Reduce the rate of the incremental late payment penalty.
3. Remove the 1% monthly incremental late payment penalty.
4. Remove all late payment penalties and apply UOMI only.
5. Broad discretion to impose penalties based on individual circumstances.

### *Option 1 – Retain the status quo*

The high combined rate leads to increasing debt and high compliance costs for the taxpayer and high administration costs for Inland Revenue. Inland Revenue will continue to struggle to constructively engage with indebted taxpayers. The lack of flexibility around the late payment penalty rules will prevent Inland Revenue from being able to effectively support newly indebted taxpayers.

### *Option 2 – Reduce the 1% monthly incremental late payment penalty*

Attempting to have a meaningful incremental late payment penalty will still result in a higher than desirable combined penalty and interest rate. For example, based on current UOMI rates, an incremental late payment penalty rate of 0.5% will result in the combined penalty and interest rate of approximately 21% per annum, in the first year.

On its own, a reduced incremental late payment penalty is unlikely to provide a significant compliance benefit over the status quo, as taxpayers are unlikely to be further encouraged to comply by anticipating a reduced incremental late payment penalty if they do not comply. In addition, these unpaid incremental late payment penalties will continue to be added to the tax debt book.

This option will continue to maintain a financial incentive for indebted taxpayers to enter into instalment arrangements, in order to avoid the imposition of the monthly incremental late payment penalty.

Overall, this option, in effect, maintains the current incremental late payment penalty framework, including continuing to penalise taxpayers long after the debt was due, and in most cases imposing an additional financial penalty which is unlikely to encourage the taxpayer to comply.

### *Option 3 – Remove the 1% incremental late payment penalty*

Only the one-off initial late payment penalty of 1% one day after the due date and 4% after seven days will be imposed. This option results in the combined penalty and interest rate decreasing from approximately 27% per annum, to approximately 15% per annum, in the first year.

This revised rate is more in line with unsecured lending from traditional commercial lenders. It ensures there continues to be a financial cost to taxpayers who do not pay on time. In addition, this option will enable taxpayers to repay their debt in a more sustainable way, as the debt is not incurring continuous late payment penalties.

Currently, indebted taxpayers that enter into instalment arrangements have their future incremental late payment penalties suppressed (not imposed). In effect, this option removes the financial incentive to enter into an instalment arrangement. However, taxpayers would continue to have an incentive to enter into an instalment arrangement before the due date, to avoid the 4% penalty. In addition, the taxpayer continues to receive certainty that Inland Revenue will also adhere to the instalment arrangement and allow the taxpayer to repay the unpaid tax, over time, without taking action to enforce the tax debt.

Removing the incremental late payment penalty means indebted taxpayers no longer incur late payment penalties that might have otherwise encouraged some to pay months or years after the due date. However, the reduced combined penalty and interest rate will reduce the growth of the debt and consequently provide more opportunity to all indebted taxpayers to repay their tax debt before it becomes too big to resolve.

*Option 4 - Remove all late payment penalties and impose UOMI only*

This option removes all late payment penalties (initial and incremental) and only imposes UOMI on unpaid tax, one day after the due date.

This single rate will provide a better understanding to taxpayers of the consequences of not paying on time.

As UOMI is compensation to the government for the loss of the use of the money, this option does not contain any financial penalty element notwithstanding some taxpayers' perception that UOMI is punitive. The financial consequences of non-payment would be significantly lower than under the status quo, even during the time the tax has become initially outstanding.

For taxpayers struggling financially, this option will likely encourage further non-compliance. Due to their likely credit risk, the taxpayer's marginal cost of borrowing is likely to be higher than the UOMI being imposed on tax debt. This would lead to most indebted taxpayers choosing not to pay their tax liability because it is cheaper to owe Inland Revenue than to borrow the money to pay the outstanding tax. This places Inland Revenue at a distinct disadvantage and will likely lead to an increase in Inland Revenue's tax debt book.

This option will also likely erode confidence in the integrity of the tax system as compliant taxpayers will not see non-compliant taxpayers being penalised for failing to pay tax.

*Option 5 – Broad discretion to impose penalties based on individual circumstances*

This option would have Inland Revenue officers exercising discretion to decide whether to impose a late payment penalty.

This option would provide Inland Revenue with the legislative flexibility to impose a late payment penalty of any amount, at any time, on any taxpayer it chooses. The financial penalty would be imposed on taxpayers that have consistently demonstrated non-compliant behaviour, rather than taxpayers that have paid late due to genuine error.

This option will likely have very high administration costs as Inland Revenue would be required to manually intervene and telephone all taxpayers that have not paid on time to determine the reasons for the late payment and whether a late payment penalty should be imposed. It will be very difficult for Inland Revenue to make this determination with a reasonable level of certainty.

This option provides several avenues for indebted taxpayers to successfully avoid incurring a late payment penalty. Some taxpayers may take less care in making their payments on time if they feel that they could successfully argue that the late payment was due to a genuine mistake. Taxpayers may be less concerned about making their payments on time if they feel that they can successfully resist Inland Revenue's efforts to contact them to discuss the reasons for their late payment. Taxpayers with more knowledge of the tax system would be more likely to be successful in not having a late payment penalty imposed.

Due to this option requiring Inland Revenue to make highly subjective decisions, inconsistencies may occur. Over time, differences in treatment and other inconsistencies are likely to reduce taxpayers confidence in the integrity of the tax system.

These options are analysed against the objectives in the table on the next page.

<b>Options</b>	<b>Fairness and equity</b>	<b>Efficiency of compliance and administration</b>	<b>Sustainability of tax system</b>	<b>Revenue</b>
<p>1. Retain the status quo</p>	<p>Partially met</p> <p>Taxpayers in similar circumstances are treated in a similar way. However, for some taxpayers, imposing the financial penalty may be disproportionate to their circumstances and may be viewed as unfair.</p> <p>Once the existing debt is significant, any additional financial penalty becomes ineffective at motivating the taxpayer to actively attempt to comply.</p> <p>It is unfair to repeatedly impose unreasonably high financial penalties for the late payment of tax.</p>	<p>Not met</p> <p>Continue to create compliance costs for taxpayers having to pay significant financial penalties in order to repay their tax debt in full.</p> <p>Continue to create compliance costs of stress and anxiety on taxpayers, due to the high growth of their tax debt.</p> <p>Higher administration and enforcement costs for Inland Revenue, to manage and recover tax debt.</p>	<p>Not met</p> <p>High growth of penalties leads to many taxpayers becoming insolvent. Their continued non-compliance leads to Inland Revenue taking legal action. As a result other taxpayers become negatively affected.</p> <p>Some taxpayers are incurring significant penalties on their tax debt, only for them to be later written off, leading to uncertainty about how many outstanding late payment penalties are recoverable.</p> <p>The overall portion of financial penalties in the debt book that are unrecoverable will continue to increase.</p>	<p>No impact</p>

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax system	Revenue
<p>2. Reduce the rate of the incremental late payment penalty.</p>	<p>Partially met</p> <p>While the incremental late payment penalty rate is reduced, the combined penalty and interest rate may be too high to effectively encourage significantly indebted taxpayers to engage with Inland Revenue.</p> <p>Lacks fairness as Inland Revenue continues to impose a high combined rate, while expecting the taxpayer to be motivated to repay their tax debt.</p> <p>Taxpayers will continue to have a financial incentive to enter into an instalment arrangement.</p>	<p>Partially met</p> <p>Taxpayers will continue to incur significant stress and anxiety in attempting to resolve their tax debt, due to the continued imposition of penalties on their tax debt long after it is due.</p> <p>Inland Revenue would likely have a small reduction in its administration and enforcement costs (compared to the status quo), due to the smaller incremental late payment penalties being added to the tax debt book.</p>	<p>Not met</p> <p>Unpaid and potentially uncollectible incremental late payment penalties will continue to be added to the debt book, though this will be less than the status quo.</p>	<p>This option would likely have a negative revenue impact, lower than the recommended option.</p>
<p>3. Remove the 1% incremental late payment penalty</p>	<p>Partially met</p> <p>Maintains fairness between compliant and non-compliant taxpayers, as taxpayers will continue to have an incentive to pay their tax liability by the due date or shortly after.</p> <p>While some taxpayers will no longer receive a financial incentive to enter into an instalment</p>	<p>Met</p> <p>Keeping the tax debt at a more manageable level for longer will allow taxpayers more opportunity to resolve their tax debt, reducing their stress and anxiety.</p> <p>Inland Revenue's administration and enforcement costs will</p>	<p>Met</p> <p>Less uncollectible penalties are added to the debt book. The value of the debt book will more fairly reflect what is collectible, giving more certainty to government about its value.</p>	<p>The total cost over four years is \$87 million.</p>



Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax system	Revenue
	arrangement, they will continue to receive certainty that Inland Revenue will not take enforcement action.	reduce as less uncollectible penalties will be added to the debt book.		
4. Remove all late payment penalties and impose UOMI only.	<p>Not met</p> <p>Unfair for compliant taxpayers as the financial cost of a taxpayer's non-compliance has been completely removed. There is no penalty imposed on taxpayers that do not pay on time.</p>	<p>Not met</p> <p>Reduced compliance impact as taxpayers will have reduced growth in their tax debt. However overall, the compliance impact may increase as indebted taxpayers will have more interaction with Inland Revenue as Inland Revenue make greater attempts to encourage them to pay the tax debt.</p> <p>Likely increase in Inland Revenue's administration and enforcement costs due to an increase in total tax debt being managed.</p>	<p>Not met</p> <p>A UOMI only rate may lead to some compliant taxpayers deciding that it is financial justification to pay other creditors instead of Inland Revenue and thus become non-compliant.</p> <p>The lack of a penalty for non-compliance would likely lead to an erosion of taxpayer confidence in the integrity of the tax system, as compliant taxpayers will perceive that non-compliant taxpayers are not being penalised.</p>	<p>This option would have a higher cost than the recommended option. This makes this option less viable for the government.</p>
5. Broad discretion to impose penalties based on individual circumstances	<p>Not met</p> <p>Due to the level of subjectivity in the decision making process, it is highly unlikely Inland Revenue will be able to ensure consistency in</p>	<p>Not met</p> <p>Taxpayers will incur higher compliance costs with increased contact with Inland Revenue to discuss</p>	<p>Not met</p> <p>This option rewards taxpayers that successfully evade Inland Revenue.</p>	<p>The impact is difficult to measure as it relies on subjectivity. Therefore it is not possible to estimate</p>

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax system	Revenue
	<p>decisions. Over time this could give rise to significant differences in treatment between taxpayers in similar circumstances.</p> <p>Taxpayers with more knowledge of the tax system would be more likely to be successful in not having a late payment penalty imposed.</p>	<p>their non-compliance and to establish the value of the financial penalty.</p> <p>Very complex to understand and to implement. High administration costs to Inland Revenue.</p>	<p>Unfairness in treatment will lead to taxpayers losing confidence in the integrity of the tax system and its administration by Inland Revenue.</p>	<p>its fiscal impacts.</p>

### ***Consultation***

Officials have consulted with key insolvency practitioners within the large accounting firms, Chartered Accountants Australia and New Zealand, Business New Zealand, and the Corporate Taxpayers Group.

These groups were generally supportive of the preferred options, as the recommended changes will result in a late payment penalty that is more fairly set and imposed.

### ***Recommendations***

Officials recommend option 3 - remove the 1% incremental late payment penalty. This will reduce the combined penalty and interest rate to a more sustainable level and over time will reduce the amount of unrecoverable late payment penalties in the debt book. This option continues to incentivise taxpayers to pay on the due date by continuing with the initial late payment penalty. This will also ensure that compliant taxpayers will continue to see non-compliant taxpayers being penalised for failing to pay on time.

This option does remove the financial incentive for indebted taxpayers to enter into an instalment arrangement. However, the other significant benefit of an instalment arrangement remains; the certainty that while the debt is being repaid under the instalment arrangement Inland Revenue will not take action to enforce the it.

Once fully implemented option 3 will result in the incremental late payment penalty no longer being imposed on 65,000 taxpayers with income tax debt, 67,000 taxpayers with GST tax debt, and 23,000 families with Working for Families Tax Credit debt.

## **APPENDIX D – MAKING MARKETS WORK BETTER THROUGH TAX TRANSPARENCY**

### *Status quo and problem definition*

Inland Revenue has extensive information collection powers. Revenue authorities tend to be granted wide powers to help them make sure all taxpayers comply with their tax obligations. As a counterbalance, these powers generally come with requirements on the revenue authority of tax secrecy. Tax secrecy has traditionally been considered necessary for promoting taxpayer compliance. Inland Revenue's tax secrecy laws are broad,<sup>7</sup> covering all matters relating to legislation administered by Inland Revenue. Communication of these matters is not normally permitted other than for the purpose of carrying into effect that legislation.

Over time exceptions have been made to this strict rule, the majority of which involve cross-government information sharing. These exceptions reflect the weighing of principles of tax secrecy against the need to support economic efficiency and growth, and wider government outcomes.

There are at least two areas where Inland Revenue does not currently have the power to share tax secret information, and where the sharing of this information would support economic efficiency. Specifically, there are opportunities to better inform and protect New Zealand's business community from risks associated with its non-compliant participants.

### *Significant tax debt*

Information about tax debt is tax secret. Inland Revenue does not disclose information about a taxpayer's tax debt to others, except where a claim is lodged in court for recovery of the debt.

However, there is arguably little difference between a tax debt and any other debt a taxpayer may have, especially in the context of risk posed to an indebted business's creditors. While unpaid tax is owed to the Crown as opposed to another business, it remains a debt with a corresponding repayment obligation on the non-compliant taxpayer and will attract interest (and potentially penalties) so long as it remains outstanding.

Mechanisms exist to facilitate creditors' and potential creditors' understanding of a business's creditworthiness in relation to commercial debt. The lack of visibility of tax debt can have a significant impact on other businesses that have made credit decisions without full information, especially if the business with tax debt collapses and these other businesses are unsecured creditors.

In addition to an information problem, the status quo raises concerns for the integrity of the tax system. Some taxpayers who are failing to resolve debt with Inland Revenue are not currently motivated to comply with their obligations despite the debt's accumulation of interest and penalties. While these taxpayers are able to ignore significant tax debt by virtue of it being isolated from their regular commercial dealings, non-compliant businesses that

---

<sup>7</sup> Section 81, Tax Administration Act 1994

remain in business and fail to address their debt are able to unfairly compete against those who pay on time and are compliant with their tax obligations.

### ***Enforcement of wider business obligations***

In the course of undertaking its core duties, Inland Revenue obtains and holds information about businesses' (and their directors') non-compliance with non-tax legal obligations. Inland Revenue research has shown that those that are non-compliant with their obligations under the law in one area are likely to be non-compliant in other areas.<sup>8</sup> Businesses that continue to defy their obligations without detection or sanction pose significant risks to other businesses and to New Zealand's reputation as a safe and transparent country in which to invest and do business. These businesses further represent a risk to the revenue and to the integrity of the tax system, because they are more likely to be non-compliant with their tax obligations and the tax obligations they are required to fulfil on behalf of employees.

With the exception of Inland Revenue's ability to share information with New Zealand Police in relation to serious criminal offences, Inland Revenue cannot usually share information about businesses' and directors' non-tax illegal conduct with agencies that enforce the relevant laws. This means that, without the sharing of information:

- some cases of illegal conduct are being committed and discovered (or partially discovered) by Inland Revenue, but are never brought to the attention of the relevant enforcement agency; and
- some cases of illegal conduct that are being investigated or prosecuted by another agency are not being handled as efficiently as they would be if that agency was able to request information already held by Inland Revenue.

If Inland Revenue was able to share information, the likelihood of non-compliant businesses being charged or prosecuted would increase and the associated harm reduce. Reducing harm caused to compliant businesses would ultimately support greater economic efficiency by lowering the risks and costs associated with being in business in New Zealand. More efficient enforcement of wider business obligations would also strengthen the integrity of the tax system by ensuring businesses and directors, who are non-compliant in multiple areas including tax obligations, are comprehensively held to account.

### ***Constraints***

Ministers have asked officials for options that could be included in a business tax package to apply from 1 April 2017. This has limited the feasible options that officials could consider to those that can be implemented within the timeframe.

The analysis that follows is also constrained by limits of measuring the scope of the issue. It is not possible to accurately measure the number of businesses and members of the public affected by non-compliant taxpayers that are able to conceal their significant tax debt or illegal activity. Officials' analysis relies on general assumptions including:

---

<sup>8</sup> Habitual Non Complier Tier 2 Analysis, Inland Revenue.

- Taxpayers in significant tax debt are likely to have a number of credit arrangements with a number of businesses; and some of these businesses will be unsecured creditors who are vulnerable in the event of the taxpayer’s business collapsing.
- Businesses (and their directors and management) behaving illegally are likely to pose a risk to a large number of other parties including their shareholders, creditors, and employees.

### *Options*

Officials have identified the following options:

1. Retain the status quo.
2. Share significant tax debt information with credit reporting agencies.
3. Share significant tax debt information with the general public.
4. Share information on serious offences with the Registrar of Companies.
5. Share information for enforcement of wider business obligations.

Options 2 and 3 are not mutually exclusive with measures 4 or 5.

#### *Option 1 – Status quo*

Tax secrecy laws would remain as they are and Inland Revenue would be unable to provide any information to credit reporting agencies. Businesses would continue to enter into arrangements with other parties with no visibility of the other party’s tax debt. This would expose them to risk if they were extending credit to a business that was heavily indebted to Inland Revenue.

#### *Option 2 - Share information on significant tax debt with credit reporting agencies*

Tax secrecy laws could be amended to permit the disclosure of certain tax debt information to credit reporting agencies, for use in credit ratings. This option would provide members of the business community who are seeking credit information on a taxpayer with a more complete understanding of that taxpayer’s creditworthiness. To target the option toward tax debt that poses the most risk to other businesses, officials recommend this disclosure be limited to significant income tax and GST debt, and unpaid PAYE, KiwiSaver, student loan and child support deductions.<sup>9</sup>

The scope of “significant” debt would be the subject of various legislative criteria. The criteria would be designed to ensure credit reporting was only an option when disclosure would be proportionate given the level of risk accompanying the debt. The detail of the

---

<sup>9</sup> Note, this proposal includes employer debt relating to employee deductions employers have failed to remit to Inland Revenue; it is not proposed that social policy debt be reported to credit agencies.

criteria would likely take into account factors including age and size of debt and the likelihood of it being repaid.

It is recommended that in all cases Inland Revenue should be required to have attempted to resolve the debt prior to disclosure, and that disclosure not be permitted if debt is under an instalment arrangement or is in dispute. Finally, prior to information being disclosed it is recommended that the affected taxpayer is given thirty days' notice, and that this notice is served on the taxpayer personally to ensure its effectiveness.

This option would require rigorous safeguards to ensure the accuracy and security of information being disclosed to credit reporting agencies. One advantage of this option is that credit reporting agencies already have robust processes in place as they are already in the business of dealing with debt information on a commercial scale. Inland Revenue would need to establish its own corresponding processes.

One limitation attached to this option is that within the time available, officials have been unable to comprehensively work through privacy issues around credit reporting significant tax debt of individuals. Specifically, more work is required to determine the consistency of this proposal with the Credit Reporting Privacy Code 2004, which contains obligations for credit reporting agencies' use of individual information.

Therefore this option would only initially be available for significant tax debt attached to non-individual taxpayers. Despite this limitation, officials believe the option remains well targeted to the policy problem. While individuals are capable of developing significant business tax debt and causing harm to other businesses, a large proportion of the significant debt information problem stems from non-individual taxpayers.

Officials continue to work with the Office of the Privacy Commissioner to better understand the issues around credit reporting individuals' significant tax debt.

### *Option 3 - Share information on significant tax debt with the general public*

This option could make use of similar criteria as described for option 2, with the difference being that debt information would eventually be published rather than used in determining credit ratings. The information would be available for general access, for example using a searchable website. This option would allow a broader range of people to gain information than would be the case under option 2. Disclosure to a wider range of people comes with potential compliance benefits through strongly incentivising the repayment of the debt.

On the other hand, the option is not as well targeted to the policy problem as option 2, as many people without a legitimate interest in a taxpayer's creditworthiness, and to whom the taxpayer's debt does not represent a risk, would have access to the information. The option would also lack some of the robust safeguards that accompany the use of credit reporting agencies. This option is likely to expose taxpayers to an inappropriate level of reputational risk without much further benefit to market efficiency.

### *Option 4 - Share serious offences information with the registrar of companies*

This option would involve a new exception to tax secrecy rules to allow Inland Revenue to share information with the Registrar of Companies in relation to certain serious offences

(meaning offences with a maximum sentence of imprisonment of 5 years or more) under the Companies Act 1993. These offences relate to serious harmful conduct by company directors and management.

Inland Revenue would be able to share information with the Registrar, either proactively or in response to a request, when:

- there is reasonable suspicion (on the part of the initiating agency) that a serious offence has been, is being, or will be committed;
- Inland Revenue considers the information being shared will prevent, detect, or provide evidence of, a serious offence that has been, is being, or will be committed; and
- Inland Revenue is satisfied that the information is readily available, it is reasonable and practicable to communicate it, and communication is in the public interest.

This option would be developed to closely resemble Inland Revenue's current ability to share information with New Zealand Police in relation to serious crime. Due to the serious nature of the offences involved, it is not expected there will be a large number of shares taking place.

#### *Option 5 - Share information for enforcement of wider business obligations*

Exceptions to tax secrecy legislation could be developed to enable Inland Revenue to share information with other agencies for the enforcement of business obligations under various pieces of legislation. For example, Inland Revenue could share information generally to ensure other agencies' registry records match information held by Inland Revenue, or Inland Revenue could share information in relation to lower level offences. Due to Inland Revenue's wide information gathering powers it is very likely that it holds much of this information and that it would be useful to other agencies.

That being said, sharing tax secret information for the purpose of aiding other agencies' enforcement activity will often not be an appropriate use of taxpayers' information or Inland Revenue's resources, and exceptions to tax secrecy legislation should only be developed where they can be strongly justified. Sharing information below the serious offence threshold is likely to be an inappropriate use of the information and of Inland Revenue's resources.

It should be noted that there are non-criminal provisions, under the Companies Act and other legislation, that carry serious sanctions or serve an essential policy purpose despite not being serious criminal offences. There may be justification for including such provisions alongside serious criminal offences in future information sharing arrangements. For example, in developing these options officials considered the sharing of information in relation to two further Companies Act provisions:

- The requirement for a company to have a director based in New Zealand, which is intended to prevent the abuse of shell companies; and



- The Registrar of Companies' power to prohibit a director of a failed company from being a director of, or taking part in the management of, another company for up to ten years.

Ultimately these provisions have not been included in the recommended option because expanding information sharing beyond a serious criminal offence standard requires further analysis and this analysis could not be completed in the available time.

### **Options not considered**

#### *Share serious offences information with a range of agencies*

There are a number of enforcement agencies other than New Zealand Police and the Companies Office that investigate and prosecute serious offences, some involving business and director conduct. Information sharing with these agencies may also have the potential to improve market efficiency. Given the limited time available to advance policy options for this package, officials have prioritised work on information sharing with the Registrar of Companies for serious director offences. The nature of these offences means this particular sharing proposal has strong potential to better protect compliant participants in the business community. Inland Revenue is also likely to have information that is relevant to the investigation and prosecution of these offences.

The Government discussion document *Making tax simpler – Towards a new Tax Administration Act* discusses the future of cross government information sharing. The Government is currently considering how to better use agencies' information, and in particular how to use information more effectively to combat organised crime. The document seeks feedback on the extent to which Inland Revenue should increase information sharing with other government agencies. This feedback will inform future decisions on extending information sharing for other serious offences.

Officials' analysis of the options is set out in the table on the next page.

<b>Options</b>	<b>Fairness and equity</b>	<b>Efficiency of compliance and administration</b>	<b>Sustainability of tax system</b>	<b>Revenue impact</b>
1. Retain the status quo	<p>Not met</p> <p>Non-compliant businesses are able to continue trading while compliant businesses bear the risk.</p>	<p>Not met</p> <p>Compliant businesses can face high costs due to poor information on tax debt.</p> <p>Enforcement agencies and Inland Revenue have some inefficiency in administration in terms of habitually non-compliant businesses and directors.</p>	<p>Not met</p> <p>Taxpayers in significant tax debt can choose to isolate it from other obligations while it grows, or until the business collapses.</p>	<p>No impact</p>
2. Share significant tax debt information with credit reporting agencies	<p>Met</p> <p>Disclosure will only take place when it is a proportionate response to the risk represented by taxpayer debt to the business community. Compliant participants can operate with less risk due to more information.</p>	<p>Met</p> <p>The cost of doing business generally is reduced due to better information supporting better decision making.</p>	<p>Met</p> <p>Taxpayers who fail to address significant debt will not be able to use tax secrecy laws to hide this debt and cause undue risk to compliant taxpayers.</p>	<p>Potentially positive</p> <p>Compliant businesses will be less vulnerable to the adverse effects of other businesses collapsing. Also potentially positive as a result of an additional incentive to repay debt.</p>
3. Share significant tax debt information with general public	<p>Not met</p> <p>Affected taxpayers will be exposed to an inappropriate level of risk, with fewer safeguards, as a result of providing greater access to</p>	<p>Not met</p> <p>Potentially inefficient in terms of both compliance and administration costs because of high risk of inappropriate use of information.</p>	<p>Partially met</p> <p>While taxpayers would not be able to hide significant debt using secrecy rules, the risk of inappropriate uses of their information may be</p>	<p>Potentially positive</p> <p>Compliant businesses will be less vulnerable to adverse effects of other businesses collapsing.</p>

	tax debt information.		detrimental for voluntary compliance and integrity of the system.	Potentially positive as a result of there being an additional incentive to repay debt.
4. Share information on serious offences with Registrar of Companies	Met  Fairness is achievable with strict tests and high thresholds for sharing. It is also in the public interest to achieve efficient enforcement of criminal director offences rather than allow these directors to continue to pose a risk to the compliant business community.	Met  This option is expected to be implemented at a low administration cost. This option would only involve a small number of information shares; however it is likely that successful enforcement of serious Companies Act provisions would reduce harm to a larger population of compliant businesses.	Met  Seriously non-compliant directors are likely to also be posing a risk to the tax system.	Potentially positive  Compliant businesses will be less subject to harm from habitually non-compliant businesses and directors.
5. Share information for enforcement of wider business obligations	Not met  Sharing information for issues that are less significant than serious offences may not justify exceptions to tax secrecy.	Not met  This option would have a high administrative cost if comprehensively implemented.	Not met  There is a risk of unjustified breaches of tax secrecy principles, which could lead to decreased voluntary compliance.	Potentially positive  Compliant businesses will be less subject to harm from habitually non-compliant businesses and directors.

## ***Consultation***

Officials have consulted with a range of private and public sector stakeholders including the Corporate Taxpayers Group, credit reporting agencies, large accounting firms, Chartered Accountants Australia and New Zealand, the Ministry of Business, Innovation and Employment and the Office of the Privacy Commissioner (OPC).

Those consulted were broadly supportive of the policy intent underlying the options of credit reporting of significant tax debt and sharing information on serious offences with the Registrar of Companies. The majority of stakeholders consulted stressed that, given the potential consequences attached to sharing taxpayers' information for these purposes; there should be high thresholds and sensible criteria for disclosure.

Specifically regarding the option of credit reporting of significant tax debt, as stated above the OPC has assisted officials' understanding of issues surrounding credit reporting of individuals' information and officials will continue to work through these issues with OPC.

Specifically regarding options for information sharing with enforcement agencies, several stakeholders expressed a desire for an overarching framework for cross-Government information sharing of tax secret information. These stakeholders were supportive of sharing in relation to serious criminal offences, including company director offences, but were concerned that information sharing policy was being developed on an ad hoc basis. These comments have shaped officials' analysis around not including non-criminal Companies Act offences alongside serious director offences in option 2 without further work.

## ***Recommendations***

Officials recommend option 2 – share significant tax debt information with credit reporting agencies. Although this option would, at least initially, be limited to disclosure of non-individuals' information it would help to remedy the current information problem that exists for businesses that require information on other businesses' creditworthiness. The reporting of certain tax debts would allow these businesses to make more optimal lending decisions and leave them less vulnerable to the effects of other businesses collapsing with significant tax debt. The use of credit reporting agencies for the disclosure of this information would target the policy response to the problem and avoid unjustified disclosure of information.

Officials also recommend option 4 – share serious offence information with the Registrar of Companies. This option would lead to more efficient enforcement of serious director offences by the Registrar and reduce harm to the business community and wider public. The detection of this offending and sanction of seriously non-compliant directors would also benefit the tax administration system because it is likely that some of these directors are also not complying with their tax obligations.

As stated above, officials have prioritised sharing with the Registrar of Companies because improved enforcement of serious offences under the Companies Act would be especially beneficial for improving market efficiency. Officials recommend further work around the development of a clear framework for this sharing to occur.

## **APPENDIX E – SUPPLEMENTARY SIMPLIFICATION MEASURES**

Research shows that tax compliance costs are relatively high for small businesses. However, measures to simplify tax rules often face a trade-off between the accuracy of the rules in question and reduced compliance costs. This section outlines supporting simplification measures that will reduce the amount of paperwork required by businesses, and make it easier to manage their tax affairs without significantly affecting the amount of revenue collected by the government. The measures include simplified rules for businesses to calculate FBT, account for vehicles and premises, and deduct employee remuneration. They also include some threshold adjustments to enable more small businesses access to simplified rules for filing and correcting errors.

### ***Constraints***

Ministers have asked officials for options that could be included in a business tax package to apply from 1 April 2017. This has limited the feasible options that officials could consider to those that can be implemented within the timeframe.

### **1 – Simplified calculation of deductions for dual use vehicles**

#### ***Status quo and problem definition***

Small business owners often use their personal vehicles and homes for both business and private purposes. Currently they need to allocate their expenses between private and business use. The private use percentage might also vary between different items of expenditure. Because there are numerous expenses for these items, allocating these between business and personal use can create large compliance obligations compared to the amount of tax at stake.

The following options (other than the status quo) have been considered for addressing this issue.

#### *Simplified calculation of deductions for dual use vehicles*

#### ***Options and analysis***

The options to address this issue are:

##### *Option 1 – retain the status quo*

##### *Option 2 – optional single rate method*

This method would be optional and extend and modify the current per kilometre option for calculating business use deductions so it could be used regardless of kilometres travelled (the current rules only allow the method to be used if business use is less than 5,000 km).

Under this option:

- Taxpayers would deduct a fixed amount per kilometre travelled for business purposes based on rates published by Inland Revenue. This would be instead of deducting actual costs.

- The rates would be set by reference to industry figures, and based on the average per kilometre cost for the average vehicle. The rates would also assume a fixed amount of private use in respect of the fixed cost element, so no apportionment between actual business and private use would be required
- The rate would be divided into 2 tiers. The first tier would provide for the recovery of both the vehicle's fixed costs and per kilometre costs. The second tier would provide for the recovery of the per kilometre costs only.
- Taxpayers would keep a logbook for a 3 month representative test period to determine the vehicle's business kilometres as a proportion of the total distance travelled. Taxpayers could then multiply that fraction by the total distance travelled each year to give the business kilometres. Taxpayers would also be able to choose the current method of recording and using their actual business kilometres for an income year.

*Option 3 – Compulsory single rate method*

This option is the same as option 2, except the method would be compulsory.

Officials' analysis of the options is set out in the table on the next page.

<b>Options</b>	<b>Fairness and equity</b>	<b>Efficiency of compliance and administration</b>	<b>Sustainability of tax system</b>	<b>Revenue</b>
1. Retain the status quo	Met  Completely fair, as the business proportion of actual expenses is deductible.	Not met  Inefficient to comply with, due to the number of expenses and the small amount of tax. Not currently time-consuming to administer.	Met  The actual calculation can be complicated.	No impact
2. Optional single rate for Vehicles	Met  Generally fair, as the rate will be approximately accurate for most vehicles and owners of more expensive vehicles can elect to deduct based on their actual expenses. However owners of older cars may be able to claim greater deductions than their actual expenditure.	Met  More efficient for taxpayers to comply with, due to single rate calculation. Also easier to audit, but not otherwise easier to administer. However some taxpayers may elect to calculate their deductions under both this method and the other currently available methods so they can claim the greater amount. This would increase the tax calculations for such taxpayers. The measure will impact sole traders who use their vehicle for both business and personal purposes. There are up to 3,500 such taxpayers.	Met  The actual calculation is easier, rates will be broadly accurate for most taxpayers, and there is a significant cost floor for vehicle use.	Small cost  Taxpayers with older vehicles may be able to deduct more than their actual expenditure, while taxpayers with newer or more expensive vehicles can elect not to use the method. The estimated fiscal cost for this option is \$700,000 per year.

<b>Options</b>	<b>Fairness and equity</b>	<b>Efficiency of compliance and administration</b>	<b>Sustainability of tax system</b>	<b>Revenue</b>
3. Compulsory single rate for vehicles	<p>Not met</p> <p>The method will be unfair for taxpayers with newer or more expensive vehicles, as the variability of vehicle costs (especially depreciation) means that an average rate could be significantly less than their actual expenses.</p>	<p>Met</p> <p>More efficient for taxpayers to comply with, due to single rate calculation. Also easier to audit, but not otherwise easier to administer. The measure will impact the same number of taxpayers as option 2, although taxpayers will not be able to opt out of it.</p>	<p>Met</p> <p>The calculation is easier than the status quo. There should not be any fiscal cost or savings, as the rates will be set based on the average vehicle expenditure.</p>	<p>No impact</p> <p>There should not be any fiscal cost or savings, as the rates will be set based on the average vehicle expenditure.</p>



## ***Recommendations***

Officials recommend that option 2 be adopted – optional single rate for vehicles. While an optional method has some disadvantages in terms of efficiency and sustainability, officials consider the variance in the actual costs of car ownership is too wide for a compulsory single rate to be acceptably fair. Owners of newer and more expensive cars may see a compulsory measure as a cap on their deductions rather than a simplification. A more accurate compulsory method could be developed, but this would erode the compliance cost benefits.

## **2 – Simplified calculation of deductions for business use of premises.**

### ***Options and analysis***

Options to address this issue are:

*Option 1 – Retain the status quo*

*Option 2 – Optional single rate method*

Under this option, the deduction for business use of premises would be calculated by multiplying the number of square metres of the premises used primarily for business purposes by a single rate. A different rate would apply depending on whether the taxpayer owned or rented their premises. Taxpayers would also claim a deduction for their actual rates, mortgage interest or rental costs, based on the percentage of the premises used primarily for business purposes. This method would be optional.

*Option 3 Compulsory single rate method*

This option is the same as option 2, except the method would be compulsory.

Officials' analysis of the options is set out in the table on the next page.

<b>Options</b>	<b>Fairness and equity</b>	<b>Efficiency of compliance and administration</b>	<b>Sustainability of tax system</b>	<b>Revenue</b>
1. Status quo for premises	Met  The business proportion of actual expenses is deductible.	Not met  Inefficient to comply with, due to the number of expenses and the small amount of tax.	Met  Generally sustainable. However the actual calculation can be complicated.	No impact
2. Optional single rate for premises	Met  The rate should be fairly accurate and taxpayers will still have the option to deduct based on actual expenses. Some taxpayers may be able to claim greater deductions than their actual expenditure. This is not expected to be significant however, due to the small variance in utility charges.	Met  More efficient for taxpayers to comply with, due to single rate calculation. Also easier to audit, but not otherwise easier to administer. However some taxpayers may elect to calculate their deductions under both this method and the actual cost method so they can claim the greater amount. This would increase the tax calculations for such taxpayers. The measure will impact sole traders who use their premises for both business and personal purposes. There may be up to 3,500 such taxpayers.	Met  The actual calculation is easier.	Small cost  Taxpayers could elect to use this method only if it increased their deductions compared with the actual cost method. There is insufficient data to estimate this cost, however it is expected to be fiscally immaterial due to the small variance in utility charges.
3. Compulsory Single rate for premises	Met  The rate for utilities etc should be fairly accurate across taxpayers and the more	Met  More efficient for taxpayers to comply with, due to single rate calculation. The measure will impact the same number of	Met  The calculation is easier than the status quo.	No impact  There should not be any fiscal cost or savings, as the rates will be set based on the average

<b>Options</b>	<b>Fairness and equity</b>	<b>Efficiency of compliance and administration</b>	<b>Sustainability of tax system</b>	<b>Revenue</b>
	variable interest, rent and rates are still deducted based on actual expenses. Some taxpayers may be entitled to slightly greater or lesser deductions than their actual expenditure however.	taxpayers as option 2, although taxpayers will not be able to opt out of it.		housing expenditure.

## ***Recommendations***

Officials recommend option 2 for premises. While the method should produce a fairly accurate measure for most taxpayers, some taxpayers will be entitled to smaller deductions under the method than their actual costs. Such taxpayers may consequently regard a compulsory measure as a cap on their deductions rather than a simplification. Introducing a new option will prompt some taxpayers to undertake both sets of calculations, in order to determine which gives the best result, and thereby undermine the compliance savings. It is unlikely though that taxpayers would do this every year as premises expenses would likely remain fairly stable and so a reassessment of the calculation options would not be necessary.

## ***Consultation***

We consulted on the options with Chartered Accountants of Australia and New Zealand (CAANZ), Corporate Taxpayer Group and Business New Zealand.. CAANZ submitted that the premises single rate method should be optional. CAANZ also suggested consideration be given to a flat deduction for dual use premises. However Officials consider that a flat deduction would be too inaccurate, given that it would not be proportionate to the size of the premises used for business purposes. Accordingly this suggestion was not included in the options above.

## **3 – Increase threshold for taxpayer self-corrections of minor errors**

### ***Status quo and problem definition***

If a taxpayer makes a minor error in their tax return with a tax effect of less than \$500, they can self-correct the error in their next tax return.<sup>10</sup> However, if the error results in more than a \$500 tax difference, the taxpayer must request the Commissioner to correct the error. This imposes compliance costs on the taxpayer in having to apply to the Commissioner for a small adjustment. It also imposes administration costs on Inland Revenue in having to manage these low value items. These costs can be high compared with the amount of tax at stake.

### ***Options and analysis***

Options for addressing the issue are to retain the status quo, to increase the self-adjustment threshold to \$1,000, to increase the threshold to \$2,000, or set the threshold as a percentage of taxpayer tax or turnover.

The option to increase the threshold to \$1000 represents a maximum adjustment of income or deductions of \$3,571 for a company, \$3,030 for an individual and \$7,667 for GST.

The option to increase the self-adjustment threshold to \$2000 represents a maximum adjustment of income or deductions of \$7,142 for a company, \$6,060 for an individual and \$15,333 for GST.

---

<sup>10</sup> Section 113A of the Tax Administration Act 1994

The option to set the self-correction threshold as a percentage of the taxpayer's tax or turnover would mean a corporate taxpayer with a \$50 million tax liability could make a \$1 million adjustment if the threshold for self-correction was set at 2% of tax. This represents \$3.57 million of income or \$7.667 million for GST.

Officials' analysis of the options is set out in the table on the next page.

<b>Options</b>	<b>Fairness and equity</b>	<b>Efficiency of compliance and administration</b>	<b>Sustainability of tax system</b>	<b>Revenue</b>
1. Status quo	Met  Generally fair.	Not met  Inefficient, as taxpayers must apply to Inland Revenue to self-correct small errors.	Met	No impact
2. Increase threshold to \$1,000	Met	Met  More efficient, as taxpayers can self-correct larger errors. The measure will affect all taxpayers who make low value minor errors.	Met  Although less Inland Revenue oversight of error correction slightly increases the potential for abuse.	No impact
3. Increase threshold to \$2,000	Met	Met  As above, except a greater efficiency increase and impact with the greater threshold.	Partially met  As above, although the impact on sustainability increases with the greater threshold.	No impact
4. Revenue percentage threshold	Not met  Unfair as large taxpayers will be able to self-correct larger errors, but arguably fair given the relative significance of the error to the business.	Met  As above.	Partially met  As above, except there could be a significant impact on sustainability for large taxpayers, as they could make significant tax adjustments without Inland Revenue oversight.	Measure may be abused  There might be an impact if large taxpayers abuse the measure to defer income; however this is not possible to estimate.

## ***Consultation***

We consulted on the proposal with Chartered Accountants of Australia and New Zealand (CAANZ), Corporate Taxpayer Group and Business New Zealand. CAANZ and Business New Zealand both supported an increase to the threshold, but considered it needed to be greater to benefit larger business. Corporate Taxpayer Group suggested setting the threshold as a percentage of tax or turnover while CAANZ suggested tiered thresholds based on turnover. Corporate Taxpayer Group also suggested including a requirement to notify Inland Revenue of any corrections made.

Officials considered this option (included as option 4 in the table on the previous page), but do not recommend it. This is because it would have a significant impact on sustainability for large taxpayers, as they could make significant tax adjustments without Inland Revenue agreement.

## ***Recommendations***

Officials recommend Option 2, as it provides the best balance between meeting the objectives of fairness and equity, efficiency of compliance and administration, sustainability of the tax system and revenue.

## **4 – Remove the requirement to renew RWT exemption certificates annually**

### ***Status quo and problem definition***

Currently some taxpayers who hold a certificate of exemption from resident withholding tax (RWT) must renew the certificate annually.<sup>11</sup> Taxpayers have argued that this is creating relatively large compliance costs for those who are required to renew for relatively little value. It is also creating an administrative burden for Inland Revenue, as all the annual exemption certificates must be renewed at the same time each year.

### ***Options and analysis***

The following two options, plus the status quo, have been considered for addressing this issue.

The first option is to retain the status quo.

#### ***Option 2 – Issue certificate for an unlimited period***

This option would apply for all the available grounds of exemption, except for the taxpayer income estimation option. Inland Revenue would have the discretion to issue exemption certificates for a shorter period in exceptional circumstances.

---

<sup>11</sup> Annual renewal is currently required by Inland Revenue if the applicant is applying for a RWT exemption certificate on the grounds that it has tax losses, a refund of over \$500 RWT or estimated annual gross income of over \$2 million. Applications on other grounds (such as annual gross income over \$2 million in the prior year) do not require annual renewal.

There is an integrity concern that a taxpayer might no longer be eligible for an RWT certificate, but because they are not required to renew this is not known to Inland Revenue. We consider that this can be adequately mitigated by including a simple “tick the box” declaration on a taxpayer’s tax return. This would require the taxpayer to confirm that they are still eligible to hold their exemption certificate on the basis on which it was granted.

Taxpayers will still be required to surrender their exemption certificates when they fail to meet the basis for eligibility on which they were granted. Inland Revenue will also retain its ability to cancel an exemption certificate.

*Option 3 – Issue certificate for a period greater than a year*

This option would ensure that taxpayers did not indefinitely retain exemption certificates they were no longer entitled to. However, a large number of exemption certificates are currently issued for an unlimited period (e.g. to charities, banks and entities with annual gross income over \$2 million) and this option would not change this practice. Also a fixed period would still impose a level of compliance obligation in having to periodically reapply for the certificate.

Officials’ analysis of the options is set out in the table on the next page.



<b>Options</b>	<b>Fairness and equity</b>	<b>Efficiency of compliance and administration</b>	<b>Sustainability of tax system</b>	<b>Revenue</b>
1. Retain the status quo	Met	Not met  Inefficient, as annual applications impose compliance costs on taxpayers and administration costs on Inland Revenue.	Met	No impact
2. Issue certificate for an unlimited period	Met	Met  More efficient, as fewer taxpayers will be required to apply annually. The measure will affect taxpayers who are required to file annually, other than those applying under the income estimation method. There are currently less than 500 such taxpayers.	Met  Any integrity concerns can be addressed by requiring taxpayers to indicate in their annual returns whether they are still eligible to hold their certificates.	No impact
3. Issue certificate for fixed periods longer than a year	Met	Partially met  More efficient than option 1 but less efficient than option 2, as renewing certificates will impose compliance costs on taxpayers and administration costs on Inland Revenue.	Met	No impact

## *Consultation*

We consulted on the options with Chartered Accountants of Australia and New Zealand (CAANZ), Corporate Taxpayer Group and Business New Zealand. The Corporate Taxpayer Group supported option 2, and recommended it be expanded to other types of exemption certificate (e.g. non-resident contractors withholding tax). CAANZ also supported option 2 in conjunction with the “tick the box” declaration.

## *Recommendations*

Officials recommend option 2, as it meets the objectives and improves efficiency with no significant impact on fairness or sustainability of the tax system.

## **5 – Increase the threshold for annual FBT returns from \$500,000 to \$1 million of PAYE/ESCT**

### *Status quo and problem definition*

Most businesses are required to calculate and return fringe benefit tax (FBT) on a quarterly basis. However businesses that have combined pay as you earn (PAYE) and employer superannuation contribution tax (ESCT) obligations of no more than \$500,000 per year are currently allowed to calculate and return FBT on an annual basis.<sup>12</sup> As a smaller business becomes larger and employs more staff, it may exceed the \$500,000 threshold. Consequently the business will be required to calculate and pay FBT on a quarterly basis. This can impose compliance costs which are still significant relative to the size of the business.

### *Options and analysis*

Three options have been considered for addressing this issue, namely; retain the status quo, or to increase the threshold for annual FBT returns from \$500,000 to \$1 million of PAYE/ESCT or from \$500,000 to \$2 million of PAYE/ESCT.

Officials’ analysis of the options is set out in the table on the next page.

---

<sup>12</sup> Sections RD 60 and RD 61 of the Income Tax Act 2007

<b>Options</b>	<b>Fairness and equity</b>	<b>Efficiency of compliance and administration</b>	<b>Sustainability of tax system</b>	<b>Revenue</b>
1. Status quo	Met	Not met  Inefficient, as quarterly filing imposes a significant compliance cost compared with the amount of FBT.	Met	No impact
2. Increase threshold to \$1 million	No impact on fairness	Met  More efficient, as only annual filing is required. This will affect 1,500 taxpayers.	Met  The same amount of FBT will be payable. However the payment of FBT will be a deferral as it will be payable in a lump sum rather than 4 quarterly instalments.	Small fiscal cost  The fiscal cost of this for close companies is estimated to be \$0.5 million over four years. Other taxpayers will still pay their FBT in the same fiscal year.
3. Increase threshold to \$2 million	No impact on fairness	Met  More efficient, as only annual filing is required. This will affect 2,100 taxpayers.	Met  Same as option 2.	Small fiscal cost, greater than option 2.

## ***Consultation***

We consulted on the options with Chartered Accountants of Australia and New Zealand, Corporate Taxpayer Group and Business New Zealand. They did not have any comments.

## ***Recommendations***

Officials recommend option 2, as it meets the objective without a significant fiscal cost. Officials do not recommend option 3, as officials consider a business with combined PAYE and ESCT obligations of over \$1 million is sufficiently large to be subject to the standard quarterly filing requirement.

## **6 – Modify the 63 day rule on employee remuneration**

### ***Status quo and problem definition***

There is a special deduction and timing rule for the deferred payment of employee remuneration. Currently, in order to comply with this deferred payment rule, taxpayers need to work out what employee remuneration has been paid during the 63 day period that relates to the previous income year. This creates an additional compliance burden for taxpayers because they need to track payments accrued at year end and paid within 63 days of the end of the income year.

### ***Options and analysis***

The following options have been considered for addressing this issue.

The first option is to retain the status quo.

#### ***Option 2 – Make the 63 day deferred payment rule optional***

If taxpayers did not want to apply the deferred payment rule, then they would deduct an amount for all employee remuneration on an “incurred and paid in an income year” basis. This would mean that taxpayers would not need to track employment remuneration payments made within 63 days of the end of the income year and could use the accruals in their financial accounts as a basis for working out the amount of their deduction for employee remuneration.

#### ***Option 3 – Taxpayers choose which employee remuneration is subject to the 63 day rule***

Taxpayers could choose which types of employee remuneration are subject to the 63 day rule and which types are subject to the ordinary incurred and paid test. Types of employee remuneration include salary and wages, holiday pay and bonus payments.

Officials’ analysis of the options is set out in the table on the next page.

Officials' analysis of the options is set out in the table below.

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax system	Revenue
1. Status quo	Met  Existing rule applies to all taxpayers.	Not met  Inefficient to comply with, due to the need to track employee payments paid within 63 days of end of income year.	Met  The rule is well-established. However actual calculation can be time-consuming particularly for large employers.	No impact
2. Optional 63 day rule	Met  Taxpayers will choose whether to apply the existing deferred payment rule or not. Taxpayers will weigh up increased deductions under the existing rule against the compliance costs associated with the existing rule.	Met  More efficient as taxpayers will have a choice whether to continue applying the existing rule or use the information in their financial accounts. Administratively Inland Revenue will not monitor what option taxpayers elect.	Met  Taxpayers wanting to continue with the existing rule will not be affected and those not wanting to do the calculation required under the existing rule can apply the simpler rule.	Small upfront gain  No change to overall amount of deduction over time.
3. Optional 63 day rule for different classes of employee remuneration	Met  Taxpayers will choose whether to apply the existing deferred payment rule to different classes of employee remuneration. Taxpayers will weigh up the benefit of an increased deduction under the existing rule against the compliance costs associated with the existing rule.	Partly met  Taxpayers will have a choice whether to continue applying the existing rule or use the information in their financial accounts for different types of employee remuneration. Administratively Inland Revenue will not monitor what option taxpayers elect.	Met  Same reasons as above, except that taxpayers will be using different timing rules and deductibility for the same type of expenditure.	Small upfront gain  No change to overall amount of deduction over time.

## ***Consultation***

We consulted on the options with Chartered Accountants of Australia and New Zealand (CAANZ), Corporate Taxpayer Group and Business New Zealand. CAANZ were supportive of the proposal whilst the Corporate Taxpayer Group suggested that the 63-day period should be increased to 90 days. A change to the existing 63-day period has not been considered as part of this proposal because the proposal is a simplification measure. Increasing the day period to 90 days whilst it may increase the deduction amount, does not simplify the calculation.

## ***Recommendations***

Officials recommend adopting option 2 – optional 63 day rule. This option will achieve the objective of providing compliance savings while also improving the efficiency by providing taxpayers with a choice. This option also has no disadvantages in terms of fairness, equity and sustainability of the tax system because the same rule is being applied to all types of employee remuneration rather different rules for different types of employee remuneration as proposed under option 3.

## **7 – Simplification of fringe benefit calculation for close companies**

### ***Status quo and problem definition***

Close companies that provide their shareholder-employees with a motor vehicle for private use are required to register and pay FBT for that benefit, subject to certain exemptions. Sole traders and partners in a partnership who use a motor vehicle in a similar way are not required to register and pay FBT. Instead these taxpayers apportion their motor vehicle expenditure between the business and private use using special motor vehicle expenditure rules. These differences in treatment for what is essentially the same benefit (i.e. the private use of a motor vehicle) arise because of the different entities involved.

### ***Options and analysis***

The following options have been considered for addressing this issue.

The first option is to maintain the status quo.

#### ***Option 2 – Use motor vehicle expenditure rules instead of paying FBT***

This option will allow close companies who pay their FBT on an income year basis to use the motor vehicle expenditure rules instead of paying FBT. These companies could choose not to pay FBT for a motor vehicle being available for private use for shareholder-employees. Instead they would measure the business and private use of the motor vehicle and then make an adjustment to the amount of motor vehicle expenditure deducted. The option is available where the only benefit provided is 1 or 2 motor vehicles for private use to shareholder-employees.

Officials' analysis of the options is set out in the table below.

<b>Options</b>	<b>Fairness and equity</b>	<b>Efficiency of compliance and administration</b>	<b>Sustainability of tax system</b>	<b>Revenue</b>
1. Retain the status quo	Not met  Existing rule treats close companies like other companies who provide benefits to their employees. However close companies are often similar to sole traders and partnerships that use different rules.	Not met  Inefficient to comply with due to having to register and pay FBT when close companies provide sole benefit to their shareholder-employees.	Not met  Generally sustainable as the existing rule treats close companies like other companies that provide fringe benefits. However close companies can structure motor vehicle arrangements to minimise or avoid FBT liability.	No impact
2. Option for close companies to use motor vehicle expenditure rules	Met  Provides an option to enable close companies to be treated the same way as a sole trader when accounting for the use of a motor vehicle.	Met  More efficient as close companies will have a choice whether to register for and pay FBT or use the motor vehicle expenditure rules.	Met  Generally sustainable as provides a choice for close companies as to how they account for the private use of a motor vehicle by their shareholder-employees.	Small fiscal cost  Attributable to a reduction in FBT paid over time.

### ***Consultation***

Limited consultation with a small number of tax advisers indicates that option 2 would be well-received and would assist with addressing the perceived mismatch in treatment between a sole trader using a motor vehicle for private use and a shareholder-employee in a close company using a vehicle for private use. It was also suggested that this option would increase compliance as it will be viewed as a simpler basis for calculating the private use of the motor vehicle.

### ***Recommendations***

Officials recommend adopting option 2 – option for close companies to use motor vehicle expenditure rules. This option will achieve the objective of providing compliance savings while also improving compliance overall. This option also has no major disadvantage in terms of fairness, equity and sustainability of the tax system.