

In Confidence

Office of the Minister of Revenue

Chair, Cabinet Economic Development Committee

## **PAYE Error Correction Regulations and Legislative Amendments**

### **Proposal**

- 1 This paper seeks the Cabinet Economic Development Committee's agreement to the policy settings required to establish acceptable methods for error correction in PAYE information in the context of payday reporting. It also proposes two related amendments to the Income Tax Act 2007 which I am recommending are included in the forthcoming taxation omnibus bill.

### **Executive summary**

- 2 The Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill (the Bill) is currently before Parliament. Amongst other things this Bill seeks to modernise the way employers provide PAYE information to Inland Revenue. The changed processes will be made possible by Inland Revenue's business transformation programme.
- 3 The Bill proposes that employers should generally provide information to Inland Revenue on the income they pay their employees, and the PAYE and associated deductions withheld from that income, within two to ten working days of each payday (payday reporting). This information is referred to as "employment income information", and is currently provided to Inland Revenue monthly.
- 4 Payday reporting will enable the reporting process to be integrated with employers' normal payroll cycles and will facilitate more accurate PAYE withholding. The information will be available on a timelier basis which will also lay a foundation for future improvements to the administration of income tax for individuals and social policy. However, as the Bill requires employers to report more frequently, they will have less time in which to make corrections before reporting. Unless other changes are made this is likely to result in more errors being reported to Inland Revenue.
- 5 The current PAYE error correction process is largely manual. It imposes significant administrative and compliance costs on all parties, and can involve substantial delays. A key objective of Inland Revenue's business transformation is to integrate tax requirements into business processes using business software. However, error correction processes must also cater for employers who do not use payroll software, and must ensure reasonable accuracy for the employees whose entitlements and obligations are affected.
- 6 The Bill includes a regulation-making power that enables the Governor-General, on the recommendation of the Minister of Revenue, to make regulations to provide for the correction of errors in employment income information, following appropriate consultation. Consultation was undertaken through the release of an officials' issue paper "PAYE error correction and adjustment" [CAB-17-MIN-0404].

- 7 I propose that regulations should be drafted, setting out the following approach to error correction. In some cases the proposals will allow the employer the option to correct errors in a subsequent return. This approach eliminates the need for a separate error correction process, and will reduce administrative and compliance costs. The regulations would be effective from 1 April 2019, the date at which it will become mandatory under the Bill for employers to report on a payday basis.
- Reporting errors (where the amount actually withheld and/or paid is not accurately reported to Inland Revenue) must be corrected by amending the return that contained the error. Amending the original return is necessary to ensure that the payment can be correctly processed.
  - Payroll corrections, which occur where an employee was overpaid, will be able to be made either by amending the original return or by correcting the errors in a subsequent return. Due to the principle that salary and wages are taxed when paid underpayments do not require correction.
  - Interpretation errors (where the wrong tax treatment has been applied) may be corrected in a subsequent return if PAYE on the correction is less than a threshold of 10% of the relevant employee's PAYE for the payday. The threshold is required to avoid unfair social policy impacts on the employee.
  - Payroll corrections on overpayments and interpretation errors made in one year will be able to be corrected in a return filed in a subsequent tax year. This provision will be subject to the above threshold on interpretation errors.
- 8 Two issues included in the consultation would require amendments to the Income Tax Act 2007. One issue is substantive and the other remedial. I recommend that the following issues be included in the forthcoming taxation omnibus bill.
- overpaid PAYE income that is not repaid remains taxable as PAYE income; and
  - fringe benefit tax on an interest-free loan does not arise where an employer allows an employee time to repay overpaid income (remedial).

## **Background**

- 9 Employers must withhold PAYE and other deductions from salary, wages and schedular payments<sup>1</sup>, and pay and report the amounts withheld to Inland Revenue. Employment income is taxed on a cash basis – that is, tax is withheld when the cash is received, regardless of which period the payment relates to.
- 10 When an error is made, Inland Revenue's current process requires the employer to file a correction that amends the original return. This process imposes significant compliance and administrative costs. As the Bill requires employers to report on a payday rather than monthly basis they will have less time to make corrections and there may be more returns to correct. In the absence of other change this will increase the number of errors that require correction.

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<sup>1</sup> Payments to certain non-employees (e.g. some contractors and board directors' fees), which are subject to PAYE.

- 11 The Bill includes a regulation-making power that enables the Governor-General, on the recommendation of the Minister of Revenue, to make regulations to provide for the correction of errors in employment income information, provided appropriate consultation has taken place. I consider that an officials' issues paper "PAYE error correction and adjustment", released in August 2017 following Cabinet approval [CAB-17-MIN-0404], met the consultation requirement. The consultation feedback is summarised in Appendix A to this paper and is reflected in the proposals. Some proposals continue current practice; these will be included in the regulations for completeness.

## Comment

### Regulations

- 12 The following table sets out different types of errors and adjustments, and the proposals to be included in regulations. Except as noted submitters supported these proposals. Submitters also generally supported the provision of options which, for some error types, will allow employers to choose the approach that works best for them.
- 13 It is possible that some employers may see the proposals as overly complex. However, an employer who wanted a simple approach could elect to correct all errors by amending the previously filed returns, in the same way that they can under current settings. Although this might involve higher compliance costs, it would eliminate the need to categorise the reasons for correction.

Error type	Proposed correction mechanism
<b>Reporting error:</b> the pay and tax were correct but the amounts were wrongly reported.	The original return must be corrected by submitting an amendment. This is necessary because a processing error can occur if the amount reported does not match the amount paid to Inland Revenue. This recommendation continues current practice..
<b>Payroll corrections:</b> consequential changes to PAYE and other deductions when an employee was under or overpaid.	<p><b>Underpayments</b></p> <p>No correction is required for underpayments – this reflects the principle that salary and wage earners are taxed when the payment is made. This is current practice.</p> <p><b>Overpayments</b></p> <p>Overpayments, may be corrected by:</p> <ul style="list-style-type: none"> <li>• amending the original return(s); or</li> <li>• by recalculating the amounts in the original period(s) but reporting the error by netting it off the values in a subsequent return. Permitting employers to adjust for the error in a subsequent return represents a relaxation of the current requirements. The proposed method is consistent with the approach used in payroll software.<sup>2</sup></li> </ul> <p>Negative values arise when the overpayment, or any of the</p>

<sup>2</sup> For management accounting reasons payroll software typically recalculates the salary and deductions back in the original pay periods but then 'rolls the resulting change forward' and nets it off the values in the current return.

<b>Error type</b>	<b>Proposed correction mechanism</b>
	<p>related deductions, exceeds the relevant amount in the subsequent return. Initially, Inland Revenue will be unable to accept an adjustment in a subsequent return that contains a negative value and employers must correct these errors by amending the original return(s). It will be possible to file negative values once PAYE and related social policies are processed in Inland Revenue's new computer system (expected in 2020). This will reduce compliance costs.</p> <p>Submissions indicate that employers with small payrolls may correct an overpayment by reducing the gross income paid in a future period by an offsetting amount. This approach eliminates the need to correct the previously submitted information but is only legal provided it does not breach the Minimum Wages Act 1983 and provided the employee has agreed in writing to the reduced income.</p>
<b>Errors made in a previous tax year</b>	<p>Where the error occurred in a previous tax, year employers will have the option to make an adjustment in a subsequent return. This approach means that the employee's record of income, which is used for social policy purposes, will better reflect their available income because the reduction will be reported when repayment(s) is made.</p>
<b>Interpretation error:</b> where the wrong tax treatment has been applied, for example accommodation was treated as tax free in circumstances where it should have been treated as taxable.	<p>It is proposed that employers will have the option of correcting errors of this type in a subsequent return, if PAYE on the error is less than 10% of the relevant employee's PAYE for the payday in which the correction is made. Larger errors must continue to be corrected by amendment to the original return. This is a voluntary disclosure.</p> <p>Some submitters proposed that the 10% employee threshold should be higher. However I am satisfied that the threshold is appropriate. It will ensure that correction of a significant error does not materially increase an employee's reported earnings in a single pay-period in circumstances where the employee has no increase in available cash. This is necessary to avoid the potential for unfair impacts on social policy obligations and entitlements.</p> <p>There is no current ability under the law to amend this type of error in a subsequent return. Although this proposal should reduce compliance costs, it is thought that some employers already correct small errors of this type in this way.</p> <p>The issues paper originally proposed a double threshold. In addition to any change being less than 10% of the employee's PAYE an employer threshold was proposed. Respondents strongly opposed this threshold because it would have required manual tracking.</p> <p>Due to the relatively low employee level threshold I am satisfied that not proceeding with the employer threshold does not impose a risk to the integrity of the tax system and I therefore recommend that the employer level threshold not be included in the regulations.</p>

- 14 Employers using payroll software should generally be able to use their payroll software to generate the error correction information required by the above proposals. Employers not using software will have the option of making corrections through Inland Revenue's secure online portal (myIR), on paper, or, for simple corrections, over the telephone.
- 15 The proposals set out above are consistent with Inland Revenue's business transformation objective of making the tax system simpler and more certain by integrating tax obligations into normal business processes. As the changes will reduce the time it takes for PAYE corrections to be integrated into an individual's record of earnings the above proposals will improve Inland Revenue's ability to help individuals get their tax obligations right.
- 16 The more timely availability of accurate information also will increase the value of information sharing across the public service, and will create a better foundation for future changes to social policy. The proposed approach to error correction aligns with the approach to correcting minor errors recommended for the Tax Administration Act 1994. Although the thresholds differ, reflecting differences in the amount of money at stake, both proposals will generally allow minor errors to be corrected in a subsequent period.

#### *Legislative amendments*

- 17 The recommended responses to two matters covered in the consultation will require amendments to the Income Tax Act 2007. The first is a substantive change and concerns the status of overpaid income where the employee does not repay the amount to the employer.
- 18 The repayment of an overpayment generally requires the employee's agreement<sup>3</sup> or a court order. For a variety of reasons, employers do not always succeed in recovering the net amount from the employee. Inland Revenue's legal view is that overpaid PAYE income is generally not taxable, as it is not paid pursuant to the employment agreement and is not income under normal concepts. It can be taxable if the employee obtained it fraudulently, if the employer turns it into a bonus, or if it becomes debt remission income.
- 19 Once advised by the employer that an overpayment has been made, Inland Revenue refunds the PAYE and other deductions to the employer.
- 20 The individual employers who responded to the consultation and others, with whom Inland Revenue has discussed this matter, currently treat all overpayments as subject to tax. They do not seek a refund of PAYE until and unless they have secured an agreement that the amount will be repaid and, in some cases, not until after it has been fully repaid.
- 21 If an employer is unable to recover an overpayment, for example because the employee has left their employment and is untraceable, then the debt will eventually become unrecoverable through the passage of time. At that point it may be debt remission income and if so, would be taxable. However the employee is unlikely to be aware of this requirement and Inland Revenue is poorly placed to ensure compliance. If the overpaid income were subject to PAYE, it is much more likely that this tax would be paid.

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<sup>3</sup> There are limited circumstances under the Wages Protection Act 1983 where agreement is not required and it is not required for overpayments made by MSD and ACC.

- 22 Employers have advised Inland Revenue that, if employees know that their record of income with Inland Revenue will not be corrected until they (agree to) repay the overpayment, this acts as leverage to secure repayment<sup>4</sup>. Further, it can be seen as inequitable if two employees who received the same overpayment are treated as having the same income for social policy purposes despite one having repaid the overpaid income and the other not having done so.
- 23 For the above reasons and because some employers consider an over-payment to be more 'salary and wages' than a windfall, they believe that overpayments that are not repaid should be subject to PAYE and associated deductions, even though that position denies them the refund from Inland Revenue that would be available if such overpayments were not taxable.
- 24 If overpaid PAYE that is not repaid remains taxable, where an employer advises Inland Revenue of the overpayment when an agreement to repay is reached, and the employee subsequently defaults on the repayment, the employer would be required to return a further adjustment and pay PAYE on the outstanding amount.
- 25 Most employers and payroll software providers who responded to the consultation were in support of a change to the law to deem overpaid PAYE income subject to PAYE. However the proposal was opposed by the Corporate Taxpayers Group and Chartered Accountants Australia New Zealand (CA ANZ). The Corporate Taxpayer's Group submitted that such a change would disadvantage employers because it denies them a refund of PAYE on the overpaid amount. CA ANZ submitted that repayment is a private matter between the employer and employee and should only be taxable if it is debt remission income.
- 26 The Ministry of Social Development (MSD) and the Accident Compensation Corporation (ACC) do not need the client's agreement to recover overpayments of taxable benefits, New Zealand superannuation or accident compensation. In addition an overpayment that is not fully recovered during one period of assistance can subsequently be recovered if the person receives assistance in a future period. This generally makes it difficult for these agencies to categorise an overpayment as 'not repaid'.
- 27 The objectives for the proposed change to the definition of PAYE income include avoiding an increase in compliance costs and protecting the integrity of the tax system. Withheld under section 9(2)(f)(iv) of the Official Information Act 1982  

- 28 As the amendment supports the integrity of the tax system and accords with current employer practice, I recommend that the amendment be included in the next taxation omnibus bill so that overpaid PAYE income that is not repaid remains subject to PAYE. This Bill is likely to also contain other business transformation related proposals, so it is an appropriate place for Parliament to consider this issue.
- 29 The second proposed amendment to the Income Tax Act 2007 is remedial in nature. If an overpayment is significant, an employer and employee will often agree that the employee can spread the repayments over a number of pay periods. Technically this could give rise to a liability for fringe benefit tax on an

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<sup>4</sup> Until it is corrected an overpayment will reduce social policy support and increase child support obligations.

interest-free loan. This was not the policy intent and I propose that a remedial amendment to clarify this matter is included in the forthcoming taxation omnibus bill.

#### *Other matters*

- 30 Under tax law, a lump sum payment of employment income (including ACC weekly compensation), which covers a number of years is subject to PAYE (income tax) when it is paid. This can lead to over-taxation compared to the amount of tax that would have been payable if the income was taxed in the years to which it related. It is seen as unfair by recipients of such payments. My officials have provided some initial advice of the matter and I am looking at including this matter in the Government's tax policy work programme.
- 31 A number of issues, some operational and some legislative, relating to the tax treatment of non-resident employees and non-resident contractors were raised in feedback on two documents issues by the previous Government - *Making Tax Simpler – A Government green paper on tax administration* and *Making Tax Simpler – Better administration of PAYE and GST*. The issues paper on PAYE error correction did not propose any special rules relating to these taxpayers, and no specific regulatory responses are proposed at this time. However, a number of operational concerns are being worked through separately and some legislative issues have been identified for inclusion in the Government tax policy work programme.
- 32 The issues paper also contained a proposal that employer superannuation contribution tax (ESCT) should be reported at an employee level rather than as the total per employer. This change will make it easier for an employer to obtain a credit or refund of ESCT when an overpayment is corrected. Respondents who commented on this proposal universally supported it, and the Commissioner of Inland Revenue intends to use her power to prescribe forms to obtain ESCT information on this basis.

#### *Compliance and administrative costs*

- 33 The proposals in the issues paper, relating to automating error correction and allowing corrections to be made in subsequent returns, are expected to reduce compliance and administrative costs. The full benefits will, however, not be realised until PAYE is fully processed within Inland Revenue's new computer system. This is not expected until 2020.
- 34 Although it is anticipated that the proposed changes will be received positively it is possible that the delay - between the imposition of mandatory payday reporting in 2019 and the full benefits of modernised error correction processes in 2020 - may occasion negative comment. However as this delay arises from a decision to manage risk and minimise the overall impact on customers (by having PAYE transition from the old to the new computer systems over several releases) I am satisfied that it is justified.

## **Consultation**

- 35 Before the release of the issues paper officials discussed PAYE error correction and adjustment with the Corporate Taxpayers Group, CA ANZ, a number of payroll software developers, a group of employers with complex payrolls, including the Ministry of Education, in respect of the teachers' payroll, a bookkeeper and a firm of tax advisors. The issues paper was released through Inland Revenue's RSS feed and in addition was sent to members of the Payroll Practitioners' Association, to payroll software developers and to approximately 30 employers who had expressed interest in the subject. Thirteen submissions were received on the issues paper and a summary of the submissions appears at Appendix A.
- 36 The MSD, ACC, the Ministry of Business, Innovation and Employment, and the Treasury have also been consulted. The Department of the Prime Minister and Cabinet and the Parliamentary Counsel Office have been informed.

## **Financial implications**

- 37 Currently if an employer corrects an overpayment error by amending the earlier return and the amount is over \$100, Inland Revenue pays interest. To the extent that employers choose to report overpayments in a subsequent return Inland Revenue will pay less interest.
- 38 Employers can be liable for interest and penalties on interpretation errors. Employers usually have thirty days before late payment penalties are imposed, and the change is not expected to affect the incidence of late payment penalties. Enabling employers to correct small interpretation errors in a subsequent return may however slightly reduce the overall interest employers would otherwise pay on reassessed PAYE.
- 39 It is expected that the proposal to allow increased correction of PAYE errors in a subsequent return will result in a small reduction in the amount of interest paid by Inland Revenue on overpaid PAYE and in a small reduction in the amount of interest paid by employers on interpretation errors.
- 40 The proposed changes to the Income Tax Act 2007 are not expected to have material fiscal implications as the recommended changes will bring the legislation into line with what is understood to be widespread employer practice. These changes would deem overpaid PAYE income not repaid as liable for PAYE, and would clarify that the time allowed to repay overpaid income does not give rise to a liability for fringe benefit tax on an interest free loan.
- 41 Overall officials consider that the proposals in this paper will have a minimal impact on revenue baselines which cannot be quantified.
- 42 The cost of implementing the changes will be met as part of Inland Revenue's business transformation programme.

## **Human rights**

- 43 I consider that the recommendations in this paper are not inconsistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

## Legislative implications and application date

44 Legislation is required to implement these proposals. I am seeking approval to have regulations drafted pursuant to proposed section 23M of the Tax Administration Act 1994. This section is included in Clause 200 of the Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill which is currently before Parliament. These regulations will be submitted to Cabinet Legislation Committee once the Bill, including the empowering section, is enacted.

45 Withheld under section 9(2)(g)(ii) of the Official Information Act 1982



46 I recommend that the following amendments are included in the next taxation omnibus bill:

- overpaid PAYE income that is not repaid, remains taxable as PAYE income, and
- fringe benefit tax on an interest free loan does not arise where an employer allows an employee time to repay overpaid income.

47 I propose that the regulations and legislative amendments should have an application date of 1 April 2019. That is the date at which payday reporting of employment income information will become mandatory under the changes in the Taxation (Annual Rates 2017–18, Employment and Investment Income, and Remedial Matters) Bill.

## Regulatory impact analysis

48 The Regulatory Impact Analysis (RIA) requirements apply to some of the proposals in this paper. A Regulatory Impact Statement (RIS) has been prepared and is attached. The Quality Assurance reviewer at Inland Revenue has reviewed the Modernising the correction of errors in PAYE information RIA and considers that the information and analysis summarised in it meets the quality assurance criteria of the Regulatory Impact Analysis framework.

## Publicity

49 I propose to make an announcement about these measures and publicly release an anonymised summary of submissions on the issues paper, once the regulations have been made. Inland Revenue will communicate the changes to affected stakeholders.

## Recommendations

50 The Minister of Revenue recommends that the Cabinet Economic Development Committee:

## *Background*

- 1 **Note** that the Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill includes a regulation making power that enables the Governor-General, on the recommendation of the Minister of Revenue, to make regulations to provide for the correction of errors in employment income information, provided appropriate consultation has taken place.
- 2 **Note** that in August 2017 the Cabinet Economic Growth and Infrastructure Committee approved the release of PAYE error correction and adjustment – an officials' issues paper, which consulted on the correction of errors in employment income information.

## *Outcome of Consultation*

- 3 **Note** that most respondents supported the proposals including the flexibility to allow employers to adjust errors in the manner that works best for their system/processes.
- 4 **Note** that as a result of the consideration of submissions, the proposed annual threshold preventing an employer from correcting interpretation errors in a subsequent return, if they have already made upward reassessments exceeding a threshold, will not proceed. The employee level threshold remains.

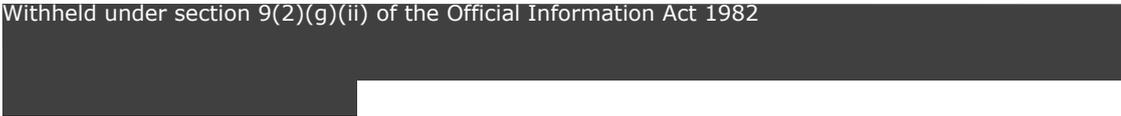
## *Proposed requirements regulations*

- 5 **Agree** that employers should continue to be required to correct reporting errors by amending the original returns.
- 6 **Note** that because wages and salary earners are taxed when they are paid underpayment errors do not require the employer to correct previously submitted information.
- 7 **Agree** that employers should be able to correct overpayment errors by:
  - 7.1 amending the original returns in which the error occurred; or
  - 7.2 recalculating the original pays but netting the changes off against the values in a subsequent return. This option will be subject to a restriction preventing employers from lodging negative values until PAYE is entirely managed within Inland Revenue's new computer system.
- 8 **Note** that if employers 'correct' an overpayment by reducing the employee's gross income in a subsequent pay period there is no requirement to correct previously submitted information. This this approach requires the employee's written agreement and cannot contravene the Minimum Wage Act 1983.
- 9 **Agree** that employers should have an option to correct interpretation errors in a subsequent period provided PAYE on the error is less than 10% of the relevant employee's PAYE for the payday in which the correction is made.
- 10 **Agree** that employers should have the option to correct overpayment and interpretation errors (subject to the employee threshold) from a previous tax year in subsequent year.

*Proposed requirements legislation*

- 11 **Agree** that an amendment providing that overpaid PAYE income that is not repaid remains taxable as PAYE income should be included in the next taxation omnibus bill.
- 12 **Agree** that an amendment, providing that no liability for fringe benefit tax arises when time is allowed for an employee to repay overpaid PAYE income, should be included in the next taxation omnibus bill.

*General*

- 13 **Note** that the Minister of Revenue proposes to publicly release an anonymised summary of submissions when the regulations have been made.
- 14 **Invite** the Minister of Revenue to issue drafting instructions to the Parliamentary Counsel Office for the Orders in Council required to give effect to recommendations 5 – 10.
- 15 Withheld under section 9(2)(g)(ii) of the Official Information Act 1982  

- 16 **Invite** the Minister of Revenue to issue drafting instructions to Inland Revenue for the amendments to give effect to recommendations 11 and 12 for inclusion in the next tax omnibus bill.

Authorised for lodgement

Hon Stuart Nash

Minister of Revenue