MAKING TAX SIMPLER

BETTER BUSINESS TAX

AN OFFICIALS' ISSUES PAPER

Inland Revenue
Te Tari Taake

THE TREASURY
Kaitohutohu Kaupapa Rawa

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CHAPTER 1

OVERVIEW

The Government has recently announced a package of proposals to simplify business tax, and intends to introduce legislation in August.

Inland Revenue is now seeking feedback to assist with advising the Government on the implementation of this package. This issues paper discusses the technical detail of the proposals and seeks feedback on some design decisions.

BACKGROUND

All businesses benefit from an environment which gives them confidence to invest and grow. Through the Business Growth Agenda, the Government is working to create a competitive and productive economic environment which supports both export and domestically focused businesses. One way Government can help businesses is by reducing their compliance costs, saving them time and providing more opportunities to run and grow their businesses.

Inland Revenue's Business Transformation programme is part of the Government's investment in a productive environment for businesses. A well-functioning, modern revenue system should make it easy for businesses to get things right and difficult to get wrong, and reduce compliance costs.

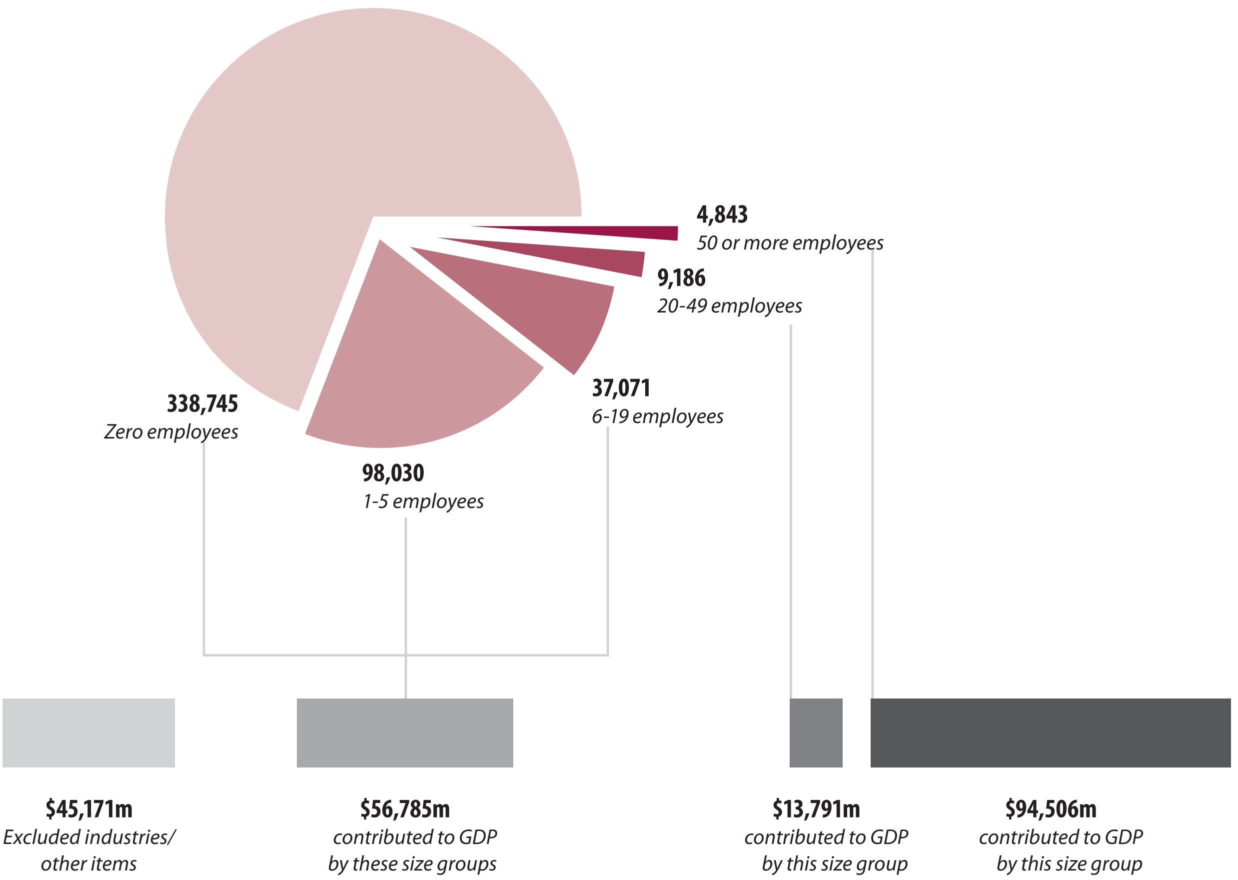
Research shows that tax compliance costs are relatively high for small businesses. It is important to consistently ask whether these costs are excessive. In particular, for small businesses, there is the question of whether 'close enough is good enough' and whether there are ways of reducing compliance costs without providing tax concessions. Of course it is important, where possible, to reduce compliance costs for all businesses.

Business in New Zealand

Approximately 97% of enterprises in New Zealand are small businesses. Small businesses, like all businesses, make a significant contribution to the New Zealand labour market. Around 597,000 people, comprising around 30% of the workforce, are employed in small businesses. These figures do not include the self-employed, which number more than 391,000.

NUMBER OF ENTERPRISES BY EMPLOYEE SIZE GROUP & THEIR CONTRIBUTION TO GDP

Data source: Statistics New Zealand, Business Demography Feb 2014 & National Accounts Mar 2012



97%

of enterprises have fewer than 20 employees (473,846 enterprises).

69%

of enterprises have zero employees.

30%

of employees in New Zealand are employed by enterprises with fewer than 20 employees (597,500).

27%

of New Zealand's GDP is estimated to be produced by enterprises with fewer than 20 employees.

96%

of enterprises with fewer than 20 employees are independent operations not owned by others.

Both small businesses and the self-employed are spread across the full range of industries.

Small businesses play a critical role in the New Zealand economy. They often provide a means of entry into business for new entrepreneurial talent and a career for those who value economic independence. Small businesses often act as specialist suppliers of parts and services to large companies. They contribute to variety and consumer choice by serving niche, rather than mass, markets. Small businesses also provide an important source of innovation and invention, something that all economies require.

A particular challenge for small businesses is the relative level of compliance costs they face. The Government has been considering measures to reduce compliance costs for all businesses, recognising that these are a particular concern for small businesses.

Making Tax Simpler

In a March 2015 public consultation document, *Making Tax Simpler: A Government Green Paper on Tax Administration (the Green Paper*), the Government sought feedback on the overall direction of the modernisation of the revenue system. A substantial amount of feedback was received about business tax, particularly about issues faced by small businesses.

Recognising the importance of small businesses to the economy, and taking into account the feedback received, the Government has announced a package of tax proposals to help businesses. The package reflects several key themes:

- Changes to provisional tax to increase certainty;
- More timely payment of provisional tax for some taxpayers;
- Self-management and integrity;
- Making the system fairer;
- Improving the operation of markets through greater tax transparency; and
- Making the system simpler.

The Government intends to introduce legislation in August to implement this package. Inland Revenue is now seeking feedback to assist with advising the Government on its implementation. This issues paper discusses the technical details of the proposals and seeks feedback on some design decisions.

With the exception of the proposals in Chapter 3, the measures all have a proposed implementation date of 1 April 2017. The new methods for paying provisional tax set out in Chapter 3 have a proposed implementation date of 1 April 2018.

SUMMARY OF ANNOUNCEMENTS

Changes to provisional tax to increase certainty

- Increase the current safe harbour threshold from use of money interest from $50,000 to $60,000 of residual income tax and extend the safe harbour to non-individual taxpayers; and
- Remove use of money interest for the first two provisional tax instalments for all taxpayers who use the standard uplift option, as long as the payments required under that option are made.

More timely payment of provisional tax for some taxpayers

- Introduction of another option for calculating provisional tax, the accounting income method, which allows some taxpayers to pay tax as they earn their income; and
- Allow a company to pay tax as agent for shareholder-employees in respect of their shareholder-employee salary with a view to reducing the impact of provisional tax on them.

Self-management and integrity

- Allowing contractors to elect their own withholding tax rate to more accurately reflect the tax payable on income earned and reduce the impact of provisional tax;
- Extending withholding tax to cover contractors working for labour-hire firms to better reflect the working arrangements with those firms; and
- Introducing voluntary withholding agreements where contractors and principals can agree to withholding tax as income is earned to reduce the impact of provisional tax on contractors.

Making the system fairer

- Removal of the incremental late payment penalty for new debt for goods and services tax, income tax and working for families tax credits.

Improving the operation of markets through greater tax transparency

- Allow the credit reporting of significant tax debts to credit reporting agencies, to provide greater transparency for other businesses; and
- Information sharing with the Registrar of Companies to assist with compliance with company laws to protect other businesses.

Making the system simpler

- Various measures designed to make tax easier to comply with and reduce compliance costs:
  - Allow small companies providing motor vehicles to shareholder-employees to make private use adjustments instead of paying fringe benefit tax;
  - Increase the threshold for taxpayers to correct errors in returns from $500 to $1,000;
  - Simplify the calculation of deductions for dual use vehicles and premises;
  - Removal of the requirement to renew resident withholding tax exemption certificates annually;
  - Increasing the threshold for annual fringe benefit tax returns from $500,000 to $1m of PAYE/ESCT; and
  - Modifying the 63 day rule on employee remuneration to reduce costs of complying with that rule.

HOW TO MAKE A SUBMISSION

You are invited to make a submission on the points raised in this issues paper by emailing *policy.webmaster@ird.govt.nz* with "Better Business Tax" in the subject line.

Alternatively, submissions can also be sent to:

Better Business Tax
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

The closing date for submissions is **30 May 2016**.

Submissions should include a brief summary of major points and recommendations. They should also indicate whether the authors are happy to be contacted by officials to discuss the points raised, if required.

Submissions relating to the Accounting Income Method in chapter 3 can also be made online at *aim.makingtaxsimpler.ird.govt.nz*.

Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. You should make it clear if you consider any part your submission should be withheld under the Official Information Act.

CHAPTER 2

CHANGES TO PROVISIONAL TAX TO INCREASE CERTAINTY

While income tax liabilities are generally determined on an annual basis, most taxpayers are required to make some form of interim tax payment during the year. For businesses, the most well-known, is provisional tax. For others interim payments are made through withholding taxes.

The principle underlying interim payments is that tax should be paid as income is earned. This better aligns the payment of tax with cashflow, ensures a more even flow of revenue to the Crown, and reduces the risk of non-payment. Interim payment systems can also assist taxpayers who find it difficult to budget for tax, by providing for deduction at source (e.g. PAYE or withholding tax) or for more frequent, smaller payments, such as provisional tax.

The tax system needs to be as fair and efficient as possible in raising the revenue required to meet society's needs. New Zealand, like most other countries, faces long-term fiscal pressures stemming from an aging population, coupled with an increasing demand for high quality public services. As a result it is important to ensure high levels of tax compliance are maintained and, where possible, improved. The proposals in this chapter are intended to provide businesses with more flexibility and certainty in managing their provisional tax obligations.

PROVISIONAL TAX

Where income is earned and is not subject to any withholding taxes, or the withholding taxes are not sufficient to cover the total liability, the provisional tax rules apply if a threshold is met.[1] In practice, most business taxpayers will be subject to the provisional tax rules as there are few other options to allow businesses to pay tax as they earn their income.

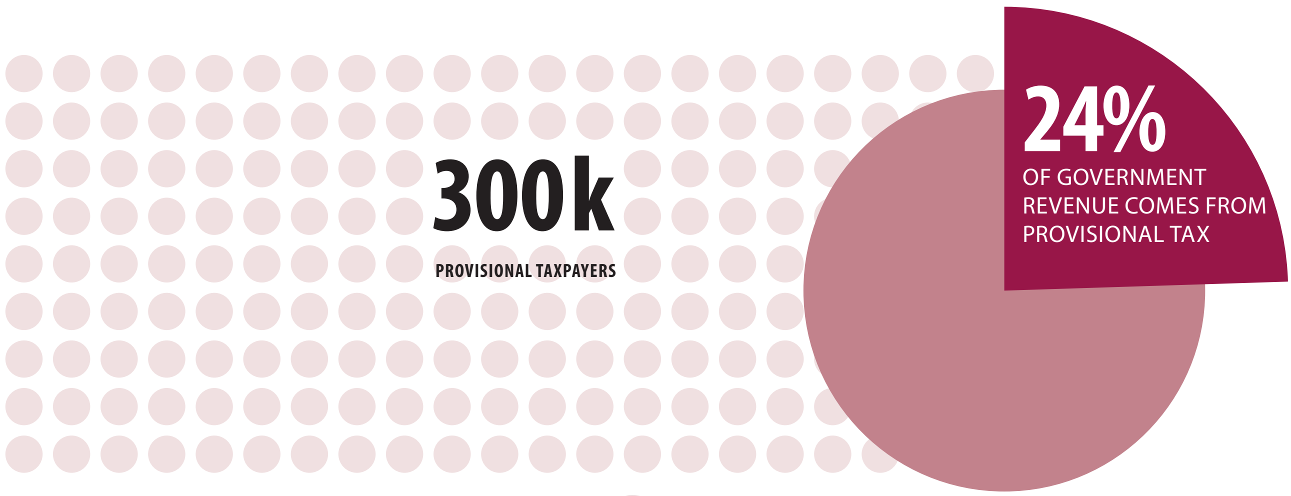
Broadly speaking, the current provisional tax rules generally require a taxpayer to meet their annual income tax liability by making three interim payments during the year. Interest applies to compensate taxpayers or the Crown in the event of over or underpayments.

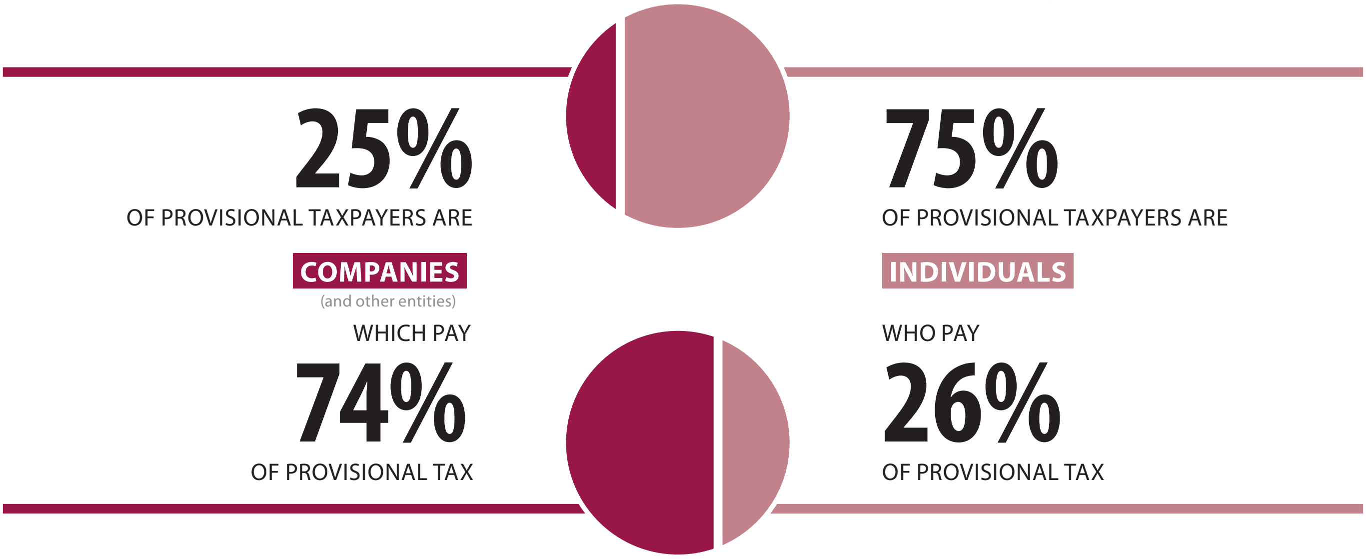
Instalments can be calculated in the following ways:

- Standard (or "uplift") method – provisional tax instalments are based on 105% of the prior year's residual income tax (RIT) or 110% of the year before the prior year if the taxpayer has not filed their prior year's tax return;
- Estimation method – the taxpayer estimates their provisional tax liability and pays instalments on that basis;[2] or
- GST ratio method – provisional tax payments are based on a ratio of residual income tax to GST taxable supplies. This method is only available to a subset of provisional taxpayers.

A significant proportion of Government revenue is collected through provisional tax, making up almost a quarter of collections.

There are approximately 300,000 provisional taxpayers, three quarters of whom are individuals. However, when considering the tax collected, three quarters of provisional tax revenue is collected from companies. The top 5% of companies represent





approximately 43% of the total provisional tax collected.

Previous feedback indicates that, while provisional tax works well for some taxpayers, for others, small businesses in particular, provisional tax is a source of stress. This is chiefly because of the uncertainty or unpredictability of income.

Use of money interest has been effective at encouraging accurate payment of provisional tax, and has allowed removal of other measures that would otherwise be necessary, such as underestimation penalties. However, submissions on the *Green Paper* make it clear that the interest and penalty rules also impose costs and stress on many taxpayers. Further, the assumptions that underlie the interest rules, such as income being evenly earned throughout the year, are often incorrect and seen as unfair.

Example 1: Mustang Limited (Mustang) is a bloodstock auction house that has one major sales event each year. Over the course of this three day sale, held in February, Mustang makes 95% of its annual taxable income. Mustang has a March balance date.

In the 2018 income year Mustang makes $1.5 million taxable income. It had estimated this exact amount for provisional tax purposes and paid $420,000 in three equal instalments of $140,000 in August, January and May. Two of these instalments were paid before Mustang had actually earned any income for the year.

While the use of money interest rules are intended to act as compensation for over or underpayments, rather than act as a penalty, they can be seen as having a penal effect. In particular, where a taxpayer has not paid sufficient tax for the year due to an unexpected or unpredictable event.

Example 1B: As in Example 1, Mustang estimated their provisional tax at $1.5 million and paid the three instalments as outlined above. However, due to an unexpectedly large price obtained for a standout colt at the sales, Mustang's taxable income was in fact $2 million for the year. Therefore instead of three instalments of $140,000, Mustang should have paid three instalments of $186,666.

While Mustang can correct its position from the third instalment, it has underpaid the first two instalments by $46,666 each. Mustang will be charged interest on these amounts until the outstanding amounts and interest have been paid. At the point that the first two instalments were required, Mustang had not yet earned any income for the year. Mustang also had no idea at that time that they would obtain such a high price for one colt at the sales.

While the Mustang example is somewhat extreme, similar issues exist for many businesses with seasonal or volatile income-earning patterns. These issues can especially impact smaller businesses that do not necessarily have the means to fund tax payments prior to earning their income.

The Government has therefore announced measures to change some of the aspects of provisional tax that cause particular stress, while maintaining the underlying principle that tax is paid as income is earned. The measures are:

- Increasing the current residual income tax limit of $50,000 before use of money interest is imposed (commonly known as the "safe harbour") to $60,000 and extending this safe harbour rule to non-individual taxpayers;
- Removing use of money interest for the first two provisional tax instalments for all taxpayers who use the standard method to calculate and pay provisional tax (commonly referred to as the "uplift method");
- Introducing an accounting income method for smaller taxpayers which uses accounting results to determine provisional tax payments; and
- Allowing a closely held company to pay provisional tax as agent of its shareholder-employees in order to remove them from the provisional tax rules.

The remainder of this chapter discusses the first two measures. The accounting income method and paying tax as agent measures are discussed in Chapter 3.

EXTENDING AND INCREASING THE CURRENT SAFE HARBOUR

By far the most popular method for calculating provisional tax is the standard method, which is used by approximately 92% of provisional taxpayers. It is the most straightforward method, however, it can result in outcomes that can be seen as adverse. The most obvious is where the method underestimates the final liability and the taxpayer is subject to use of money interest. It can also result in taxpayers paying too much or having to pay before they have earned any income (the seasonal fluctuations as in examples 1 and 1B).

Use of money interest applies to both the standard and estimation methods. It applies from the first instalment date where the payments made do not equal those that should have been made based on the taxpayer's total liability for the year.

Example 2: Viper Limited (Viper) has residual income tax for the 2016 year of $200,000. Viper bases its 2017 provisional tax payments on 105% of the 2016 liability ($210,000) and makes three payments of $70,000 during the 2017 year.

On completing its 2017 tax return, Viper calculates its actual liability at $300,000 and as a consequence should have made three payments of $100,000. Viper will be liable for use of money interest on the shortfall of $30,000 from each provisional tax payment date until the tax and use of money interest is paid.

A key simplification measure, that has previously been introduced to the provisional tax rules, is the inclusion of a safe harbour rule to remove smaller taxpayers from the application of use of money interest, provided they use the standard method to calculate their payments. This safe harbour rule[3] provides that where a taxpayer:

- Is a natural person, other than in their capacity as a trustee;
- Has residual income tax of less than $50,000 for the tax year;[4]
- Has not estimated their residual income tax for the tax year;
- Has not used the GST ratio method for the tax year; and
- Has not held, at any time during the tax year, a RWT certificate of exemption;

their provisional tax is deemed to be due and payable in one instalment, on their terminal tax date. Therefore use of money interest will not apply to that taxpayer, unless they do not pay by the terminal tax date, in which case use of money interest will apply from that date.

The safe harbour was restricted to individuals, due to concern about taxpayers switching income between related parties to eliminate paying use of money interest and provisional tax altogether.

Example 3: Challenger Limited (Challenger) is a consulting firm owned by Reginald Dodge. Reginald undertakes all the work for Challenger as a shareholder-employee and payments from Challenger to him are not subject to PAYE. In the 2016 year Challenger has residual income tax (RIT) of $45,000 as all the income was held in the company that year. Reginald had no residual income tax.
Over the next two years, assuming the same income level, but shifting it between Challenger and Reginald, and alternating provisional tax calculation methods, no provisional tax is paid by either party, and there is no exposure to use of money interest:

Year	**2017**			**2018**		
	Method	**Provisional amount**	**RIT**	**Method**	**Provisional amount**	**RIT**
Challenger	Estimate	Nil	Nil	Standard	Nil	$45,000
Reginald Dodge	Not liable	Nil	$45,000	Estimate	Nil	Nil

Therefore any extension of the safe harbour rule to include non-individuals will require some safeguards [see pages 17 to 20].

The Government will extend the safe harbour rule by:

- Increasing the threshold from $50,000 to $60,000; and
- Allowing non-individuals to use it.

This will mean that all taxpayers, whether they are an individual, company, trust, or other entity, who calculate and pay provisional tax using the standard method, will not be subject to use of money interest, provided they have residual income tax below $60,000 and meet the other criteria listed [see page 15]. For these taxpayers, any use of money interest will apply from their terminal tax date. This change is expected to remove approximately 67,000 taxpayers from the use of money interest rules, at least 63,000 of which are non-individuals.

SAFE HARBOUR FOR ALL TAXPAYERS USING THE STANDARD METHOD

Currently taxpayers who use the standard method but exceed the safe harbour threshold are liable to comprehensive use of money interest applied to any over or underpayments. This applies from the first instalment date where the amount paid differs from the amount of residual income tax subsequently calculated.

The Government considers that this may not provide taxpayers with certainty. A taxpayer who bases their current year provisional tax payments on the previous year's tax amount for simplicity, should not be subject to use of money interest when, by chance, that turns out to have resulted in an underpayment of tax.

Taxpayers who fall outside the safe harbour are generally larger and more sophisticated, and therefore have a better understanding of their tax position at any point in time. It is highly likely that by the date of the last provisional tax instalment, which is after their balance date, these taxpayers will be well placed to more accurately work out their total tax payable for the year. This should allow them to compare the actual liability to the provisional payments already made and make up any shortfall to avoid any use of money interest.

The Government has therefore announced that it will introduce legislation to apply use of money interest only from the last instalment date for taxpayers using the standard method and falling outside the new $60,000 safe harbour.

Taxpayers using the standard method are committing to making a minimum level of provisional tax payments during the year. It may be that these payments are ultimately more or less than their actual final liability, but this will depend on factors that may be outside the taxpayer's control. The standard method is designed to approximate a taxpayer's current liability using the best information available (other than a comprehensive estimate by the taxpayer). A taxpayer who wishes to, can use the estimation method where they consider the standard method does not produce a reasonable approximation of their liability for the year.

Applying use of money interest only from the final instalment date will allow a taxpayer to pay all their tax without use of money interest being imposed.

Example 4: Thunderbolt Limited (Thunderbolt) a manufacturer of clapping devices for sports fans, has residual income tax of $250,000 in the 2016 year. Thunderbolt has trouble estimating its provisional tax due to volatility in its income. Sales volumes are highly dependent on the success of local sports teams – the more successful the teams, the more clapping devices are sold. Therefore Thunderbolt decides to use the standard method to calculate its provisional tax payments, reducing the risk of use of money interest applying if it estimates and the estimate is incorrect.

For the 2017 year Thunderbolt makes two provisional tax payments of $87,500 per payment. At the third instalment date Thunderbolt has calculated that its actual annual liability is $300,000, due to the success of the local football team, the Fords.

Thunderbolt could now either pay a third instalment of $87,500 or pay the full year balance of $125,000. If Thunderbolt pays the full $125,000 it will have satisfied its income tax obligation for the year and will not be subject to any use of money interest. If Thunderbolt pays $87,500, it will incur use of money interest on the shortfall of $37,500 from the third instalment date until the outstanding tax and interest is paid.

When a taxpayer has overpaid their liability using the standard method, use of money interest will apply to any overpaid balance at the third instalment date until that tax is refunded or otherwise applied.

Example 4B: Returning to the Thunderbolt example, but assuming the Fords have a poor season, resulting in Thunderbolt's residual income tax for the 2017 year being $230,000. Thunderbolt could pay the final instalment of $87,500 and be paid use of money interest from the third instalment date until the amount was refunded, or it could make a final payment of $55,000 with no use of money implications.

Consistency requirements

The measures announced by the Government are intended to reduce the potential negative impacts of the current provisional tax and use of money interest rules. However, in attempting to address these issues and provide taxpayers with greater certainty there is the potential for people to take advantage of the rules.

As detailed in example 3, extending the safe harbour to non-individuals could lead to some undesirable practices such as switching income between parties and switching between the estimation and standard methods. This could result in no provisional tax payments being made by these taxpayers. In addition, it will be important to ensure that taxpayers pay the instalments required under the standard method.

Officials consider rules to reduce the ability of taxpayers to switch between methods could address the first issue. Taxpayers would still be permitted to switch methods during and between years, but some restrictions will apply.

Switching income between parties

Related parties would be required to use the same method of calculating provisional tax within an income year (with the exception of taxpayers using the GST ratio method). This will apply to companies in a group of companies[5] and to companies and shareholder-employees who do not have PAYE deducted from payments of salary.

Example 5: Charger Limited (Charger) is owned equally and run by its two shareholders Macintyre and Alistair Craig. Both draw shareholder-employee salaries from the company from which no PAYE is deducted. Charger chooses to use the standard method to calculate provisional tax.

Macintyre and Alistair will be required to use the same provisional tax calculation method as Charger for that income year

Example 6: Coronet Super Bee Limited (CSBL) produces honey from a special breed of bee. It has two subsidiary companies, Hummer Limited (Hummer) that operates the hives and Bel Air Limited (Bel Air) that bottles the honey. Hummer is 100% owned by CSBL but Bel Air is only 50% owned by CSBL with the other 50% owned by Pacer Limited, another honey producer who is unrelated to CSBL.

CSBL and Hummer would be required to use the same provisional tax calculation method during a year.

The requirement for related parties to use the same method to calculate provisional tax should largely prevent switching income between parties. However, it is proposed that a specific anti-avoidance provision be included within the rules to ensure that taxpayers cannot manipulate incomes to avoid being subject to the provisional tax rules.

The result of such an anti-avoidance provision being applied will be that the taxpayers will be deemed to be estimated taxpayers and subject to full use of money interest for the period of the manipulation. In addition, officials envisage that the general anti-avoidance provision will also apply to any manipulation of income to avoid the application of the provisional tax rules.

Switching between methods

A taxpayer who has chosen the standard method could subsequently switch to the estimation method within an income year. However, any related parties would also be deemed to have switched. A taxpayer choosing to switch will be subject to use of money interest from the first instalment – the same treatment as under the current rules.

If a taxpayer selects the standard method but does not make the minimum payments, use of money interest will apply to the lower of the difference between the amount paid and the required standard method instalment or one third of the taxpayer's RIT for the year. They will also be liable for late payment penalties on the same basis. This rule will also apply to taxpayers falling within the expanded $60,000 safe harbour.

Example 7: Camaro Limited (Camaro) elects to use the standard method for its 2017 provisional tax calculation. Camaro's residual income tax for the 2016 year was $450,000 and therefore its 2017 liability will be three instalments of $157,500. On each instalment date Camaro only pays $100,000.

If Camaro's RIT for the 2017 year was $330,000, three provisional tax instalments of $110,000 should have been paid. Camaro will be liable for use of money interest and late payment penalties on $10,000 for each instalment (the difference between Camaro's RIT "instalments" and the payment made).

If Camaro's RIT for the 2017 year was $600,000, then three instalments of $200,000 should have been paid. Camaro will be liable for use of money interest and late payment penalties on $57,500 for each instalment (the difference between the required standard instalment and the payment made).

Another issue that could arise is switching between methods, to extend the period use of money interest is payable to the taxpayer when an overpayment has been made. Under the current rules, interest is payable from the first instalment date under either method. However, under the new rules a taxpayer who subsequently discovers they have overpaid using the standard method might seek to switch to the estimation method to maximise the use of money interest payable.

Example 8: Caballero Limited (Caballero) manufactures staple removers. In the 2016 income year its residual income tax was $350,000. Caballero decides to pay its 2017 provisional tax using the standard method. Under this method it is required to pay three instalments of $122,500.

After paying the first two instalments, and due to a downturn in people using paper, Caballero now believes it will only have a total tax liability of $100,000 for 2017. This is less than the provisional tax instalments already paid.

Caballero's accountant, Mr Edsel, suggests that Caballero switch to the estimation method to calculate *provisional tax. This would enable them to earn use of money interest on the overpaid amount back to the first instalment date, instead of only from the third instalment date under the standard method.*

This defeats the intention of simplifying and reducing the application of the use of money interest rules. Therefore a restriction to prevent this form of switching is required.

Officials suggest that taxpayers can only switch from the standard method to the estimation method prior to the payment of the second provisional tax instalment.

Reassessments

From time to time it is necessary for reassessments of a particular year or years to be made. Under the current rules, use of money interest would apply back to the first instalment of provisional tax for the year subject to the reassessment. Removing use of money interest for those who use the standard provisional tax calculation method raises a question about how to apply interest to reassessments.

There are two options:

- Continue to apply use of money interest to reassessments as is currently the case (i.e. from the first instalment date); or
- Apply use of money interest on the basis it would have been applied had the reassessed amount been correctly accounted for in the year concerned.

The first option, applying use of money interest in full, recognises that there is a cost to the government in not having the right amount of tax in the right period.

The second option would mean that if a taxpayer had calculated and paid their provisional tax using the standard method, use of money interest (if any) would only have applied from the final instalment date for the year in question. If a taxpayer had used the estimation method, use of money interest would apply from the first instalment date.

It is proposed that the second option is adopted. This recognises that taxpayers have still, during the relevant year, made the provisional tax payments they were required to under the standard method. If anything, the only provisional tax amount that would have been underpaid was the final instalment which should have captured the amount of the reassessment. Therefore use of money interest should only apply from that date.

Example 9: Escalade Limited (Escalade) is a furniture retailer. Escalade calculated and paid its 2017 provisional tax using the standard method. In November 2017 Escalade discovered that it had omitted to include, in its closing stock, some stand up desks with built in treadmills that were being stored offsite. This resulted in a tax shortfall for the 31 March 2017 year of $30,000.

Escalade makes a voluntary disclosure and is reassessed for the 2017 year. Escalade will be subject to use of money interest on the $30,000 shortfall from the last instalment date of the 2017 income year (7 May 2017) until November 2017 when they pay the shortfall (plus interest and any shortfall penalties).

For taxpayers who fall within the new "under $60,000 safe harbour" rule and who receive a reassessment, officials consider that use of money interest should apply in the same way as it would have had the reassessment been dealt with in the year in question. If a reassessment places a taxpayer above the safe harbour limit of $60,000, the interest position will default to the standard safe harbour rule. That is, use of money interest will apply from the third instalment rather than the terminal tax date.

Example 10: Caprice Limited (Caprice) is a small business that advises corporate clients on integrating pets within the workplace. They have used the standard method and have residual income tax of $50,000 for the 2017 year. Caprice met all the other requirements to qualify for the under $60,000 safe harbour, therefore use of money interest, should it apply, will not apply until the terminal tax date.

In 2019 Inland Revenue audits Caprice and finds that they did not declare income of $50,000 from a client who was invoiced in the 2017 year but did not pay until the 2018 year. Inland Revenue reassess Caprice for an additional $14,000 tax in the 2017 year. Caprice's residual income tax now exceeds the $60,000 limit for the safe harbour to apply. However, because Caprice used the standard method to calculate and pay its provisional tax, it would have been eligible for the standard method safe harbour. Therefore use of money interest will only apply from the third instalment date for the 2017 year.

Tax pooling

Currently many taxpayers use tax pooling intermediaries as a way to reduce their exposure to use of money interest. Tax pooling intermediaries are able to reduce the amount of use of money interest incurred by taxpayers by offsetting these tax shortfalls with surplus payments by other taxpayers within the "pool".

Taxpayers who have surplus payments can also derive higher credit interest where that surplus can be "sold" to another member of the pool.

The new safe harbour rule will reduce the impact of use of money interest on taxpayers. However, taxpayers may wish to continue using pooling intermediaries to make tax payments.

Tax pooling will continue to be available for taxpayers who wish to use the new safe harbour option.

Tax payments within group companies

It is common in a group of companies for one entity to make all the tax payments for all members of the group, and then transfer those payments once the group's tax returns are completed.

One issue that arises with the proposed safe harbour rule is that, although in total the group may have paid provisional tax instalments based on the standard method, individual entities may have short paid as they make no provisional tax payments during the year.

It is proposed that group companies continue to be able to make tax payments in one entity within the group and be able to make transfers to other group members at the end of the year.

[1] For a taxpayer to be subject to provisional tax they must have had a residual income tax (RIT) liability of greater than $2,500. RIT is calculated by subtracting any tax credits and PAYE which have been deducted during the year from the total tax liability.

[2] A taxpayer is able to re-estimate during an income year and alter their instalments as required.

[3] Section 120 KE of the Tax Administration Act 1994.

[4] The safe harbour rule was increased from $35,000 to $50,000 with effect from 1 April 2009, for the 2009-10 income year. When the safe harbour was reconsidered in 2007, lifting the threshold to $50,000, meant about 243,000, or 97% of all individual provisional taxpayers, could potentially rely on the use of money interest safe harbour threshold. See Reducing tax compliance costs for small and medium-sized enterprises: a Government discussion document (2007) at paragraph 2.33.

[5] As defined in section IC 3 of the Income Tax Act 2007.

CHAPTER 3

MORE ACCURATE AND TIMELY PAYMENT OF PROVISIONAL TAX

A key principle underlying the tax system is that generally taxpayers should pay tax as their income is earned. Pay as you earn (PAYE), resident withholding tax (RWT) and withholding taxes are examples of this principle. Provisional tax aims to ensure those who do not have tax deducted at source also pay tax as income is earned, although it starts with the presumption that income is earned evenly over the year.

This presumption does not work well for businesses with seasonal or volatile incomes, as demonstrated in the extreme example of Mustang Limited (see Example 1 in Chapter 2). The Government has therefore announced two new methods for paying provisional tax that seek to better deal with seasonality and volatility by allowing income tax to be paid on a more 'pay as you go' basis:

- An 'Accounting Income Method'; and
- Paying provisional tax on behalf of related parties.

These two proposals also simplify the taxation of the total income of closely related parties by removing some parties from provisional tax and allowing more freedom around balance dates.

THE ACCOUNTING INCOME METHOD (AIM)

More information and detailed questions relating to AIM can also be found online at *aim.makingtaxsimpler.ird.govt.nz*.

Use of cloud based software

Indications are that greater numbers of small and medium enterprises (SMEs) are ensuring that they have up-to-date accounting information to enable them to make sound business decisions based on their trading history and current position. This is particularly evident in the increasing take-up of digital business systems, including accounting software systems. Integration between accounting software and Inland Revenue's systems and processes has been requested by taxpayers.

SMEs use tools, like their accounting software, often in conjunction with a professional advisor, to track how their business is performing at various times during the year. The timing of these interactions are often driven by outside events such as preparing GST returns. This same information might, therefore, also be used to make provisional tax payments on an actual results basis.

The AIM measure announced by the Government proposes that, accounting information prepared by a taxpayer for a period, be used as a basis for calculating the tax liability of the business for that period. The resulting amount would be payable by the taxpayer as a provisional tax instalment.

AIM payments will be generated by the accounting software and authorised by the user, whether a business or its advisors. The user will confirm the amount to pay and then activate the payment for both GST and provisional tax. The calculation and payment of provisional tax will become part of running the business instead of an extra process.

For accounting income to be the basis for provisional tax calculations, accounting information would need to be regularly updated, including clarification of the tax treatment of some transactions. Some users are already operating on this real-time basis, whereas others may need to update their records more regularly.

Eligibility criteria for AIM

The AIM method will be available to all provisional taxpayers with a turnover of $5 million or less.

AIM is most likely to suit the SME market rather than larger corporate taxpayers because of the size and nature of tax adjustments required to accounting profits in the large corporate market.

While the Government has restricted the use of AIM to SMEs, officials are interested in submissions from larger taxpayers on whether they would consider using this method and whether they would be willing to make the required tax adjustments throughout the year by, for example, completing monthly tax calculations.

Calculation methods

An interim tax calculation is needed to calculate provisional tax payments under AIM. This would be done through accounting software by either using the information prepared for GST returns and making some adjustments for non-GST items such as wages and salaries, interest and tax depreciation; or using a “tax” profit and loss statement for the period as the basis for a provisional tax instalment.

Example 11: Road Runner Industries Limited (Road Runner) manufactures the Coyote rod - an integral part in electric cars. It files GST on a two monthly cycle and this is its first GST return for the year. Since it prepares this information for GST purposes anyway it decides to pay provisional tax using AIM. Road Runner prepares a taxable income figure from its accounting system for the two month period based on the transactions included in its GST return and makes adjustments for capital asset purchases, wages and salaries paid (excluding shareholder salaries), interest and tax depreciation as follows:

GST taxable supplies (excl. GST)	*$200,000*	
GST expenditure (excl. GST)	*$100,000*	
Net of GST "income"	*$100,000*	
Add back:		
Assets purchased during the period	*$50,000*	*(excl. GST)*
Deduct:		
Wages and salaries (excl. s/h salaries)	*$30,000*	
Interest for period	*$10,000*	
Tax depreciation on assets[6]	*$25,000*	
Net "taxable" profit	*$85,000*	
Tax on net profit (28%)	*$24,000*	

Alternatively, if Road Runner is not registered for GST or its accounting system can create a profit and loss schedule based on actual results adjusted for tax depreciation and interest, it could use those figures to calculate the "taxable income" for the period as follows:

Gross sales	*$200,000*
Less:	
Rent	*$30,000*
Wages and salaries (excl. s/h salaries)	*$30,000*
Interest	*$10,000*
Tax depreciation on assets[6]	*$25,000*
Other expenses	*$20,000*
Net profit before tax	***$85,000***
Tax on net profit (28%)	*$24,000*

Under either calculation method Road Runner pays tax of $24,000 for the period to Inland Revenue as a provisional tax instalment.

Making provisional tax payments more frequently

For those using AIM, provisional tax payments will be made monthly for businesses registered for monthly GST returns. Payments will be made two monthly for businesses on a two-monthly or six-monthly GST filing option, and for those not registered for GST.

The Government expects more regular payments of provisional tax will enable a better fit between when income is earned and tax paid, while assisting with financial planning and budgeting. Small businesses are generally very aware of their tax liability and it is often a source of stress for them. Consultation indicates that being able to pay tax on a more regular basis will reduce this stress.

Seasonal and Volatile businesses

AIM is intended to help businesses with seasonal or volatile incomes as it allows them to pay tax as income is earned rather than in equal instalments spread across the year.

Example 12: Consider a ski field, Rubicon Limited (Rubicon) which earns all its income over the winter period. Rubicon has a 30 September balance date and decides to use AIM for calculating provisional tax to better reflect the seasonality of its income. There would be no payments during the start of the year, with payments only at the end of the year.

DATE	30 NOV	31 JAN	31 MAR	31 MAY	31 JUL	30 SEP	TOTAL
Net income (loss)	*(1,000)*	*(1,500)*	*(500)*	*(2,500)*	*(2,000)*	*10,000*	*2,500*
Cumulative income (loss)	*(1,000)*	*(2,500)*	*(3,000)*	*(5,500)*	*(7,500)*	*2,500*	—
Tax payment (refund)	—	—	—	—	—	*705*	*705*

Software program development

Currently software programs do not calculate provisional or income tax, or generate income tax payments to Inland Revenue. Officials understand that software companies want to offer this to the market place. Inland Revenue will work with software providers to develop an acceptable calculation method that gives both Inland Revenue and taxpayers confidence in the calculation of their tax liability.

Inland Revenue will develop the basic specifications it requires from a software program before this service can be offered to the market place.

The specifications might include the following:

- Meets minimum prescribed accounting requirements;
- Can file electronically to Inland Revenue;
- Can accurately map a trial balance to the prescribed IR10[7] style form;
- Can calculate profit figures on a regular basis;
- Has the ability to calculate a tax liability (including tax adjustments); and
- Supports the relationship between the tax advisor and client through shared communication, alerts and dual access.

The calculation of provisional tax payments will not be an additional workload for taxpayers. There is additional work to input and code data on a more regular basis. The software will pull relevant accounts into the tax calculation, so taxpayers will need to code their income and expenses to the right accounts (i.e. profit and loss or balance sheet accounts).

The software will use up-to-date figures where they are available, and a mix of prior year figures and current year estimates where this is not the case. For example, home office expenses are traditionally steady so software will use last year's amount and apportion it over the current year until any corrections are made at year end.

As the amounts paid are on a cumulative basis, any corrections to prior provisional tax periods can be reflected by the software in the current payment. Therefore a tax advisor can make adjustments retrospectively and the software will reflect this for the current period and remember this treatment for next time (for example, if a percentage of an expense relates to private non-deductible use, then the software will apportion and remember this for the future).

Ultimately, under a self-assessment model, the taxpayer is always responsible for calculating and assessing their tax liability. Software is a tool to assist a taxpayer, however, self-assessment will continue to require them to turn their mind to the liability calculated by the software.

Submissions are invited on the ability of software providers to build this capability. Officials also seek submissions on what specifications software developers consider appropriate to ensure Inland Revenue and small businesses can have confidence in the provisional tax payments.

Submission of information to Inland Revenue

Taxpayers using AIM will be required to submit information with their provisional tax payments to enable the calculation to be verified. The option being considered is a subset of the information in the IR10 (an "interim 10"), provided electronically. This would include information that supports the calculation of provisional tax (for example, cost of goods sold) but not information that can wait until end of the year (for example, rates). It may include GST related information so that the two payments can be cross-referenced.

Software packages will automatically map this information and forward it to Inland Revenue at the time of the provisional tax payment. Inland Revenue will not access the raw data held within the software itself. More regular provision of information during the year may also provide opportunities to simplify the end of year tax return process in the future.

Submissions are invited on what level of financial information should be submitted, and whether there is interest in exploring options to further reduce the end of year tax return process.

Taxpayers not using software

Although the use of software is increasing, there will be taxpayers who prefer to use their own software or not to use software at all, for example, a spreadsheet or manual cashbook.

As actual trading results are used to calculate the provisional tax payment it would be necessary to have minimum accounting requirements for taxpayers opting to use AIM manually. A standard of reasonable care would be expected to be taken when calculating provisional tax. At a minimum to use AIM officials anticipate that a taxpayer should maintain a double entry accounting system.

Officials are interested in whether AIM should be available to those using a manual system and, if so, what minimum accounting requirements should be expected. Officials are also seeking views on what level of accuracy would be considered acceptable for tax adjustments, and whether a spreadsheet or manual cashbook would be suitable (as long as there is some reconciliation between the business bank account and the accounting records).

Potential issues with the use of AIM

Loading income in latter part of year

To protect the tax base and the integrity of the tax system in general, consideration must be given to the possibility of taxpayers manipulating the timing of tax payments. GST returns create a natural audit trail, however, there is a risk that a taxpayer could seek to load income into the latter part of the income year even though the income may actually be earned earlier.

It is possible there could be slippage from one payment period for income and/or expenses. Where these correct themselves within two periods it is likely this would be considered reasonable.

Inland Revenue expects a taxpayer to take reasonable care in entering and coding their income and expenses to calculate their AIM payments. If a taxpayer is found to have deliberately manipulated the timing of their income and tax payments, they would no longer be eligible to use AIM. Instead, they would be placed into the estimate method where penalties and use of money interest apply.

Shareholder-employee payments

There is the risk that accounting income could be manipulated through shareholder-employee payments. The calculation of AIM payments will be based on accounting income before shareholder salaries are paid, and deductions for such payments can only be taken if the salary is paid within the period that the tax payment relates to. Overpayments of tax that relate to shareholder salary accruals can then be transferred to meet the shareholders' tax liability at the end of the year.

Use of Tax Pooling

Provisional tax pooling was introduced to manage taxpayers' uncertainty around provisional tax payments and their exposure to use of money interest. Consistent with this objective, pooling is not currently available for payments of tax types where a taxpayer has certainty of their liability at the time of payment (for example, GST). As the payments made under AIM are calculated on actual accounting income, taxpayers will have certainty about their payments. Therefore it is not appropriate to allow pooling for provisional tax payments based on AIM.

Fluctuations between income and loss

Although AIM does provide an actual results-based pay as you go system for businesses, unlike salary and wage payments, business income can fluctuate. If income is always positive, the cumulative tax position will always be positive, however, where income fluctuates between profit and loss for particular periods, issues may arise with using AIM. This is most likely to be an issue where profits are earned at the beginning of an income year and losses are incurred at the end. In some situations this issue could be resolved by a change in balance date.

Example 13: Atlanta Limited (Atlanta) is a commercial breeder of falcons. It sells these falcons to farmers to help eliminate rabbits on farms. Due to the breeding cycle of a falcon Atlanta sells all its falcons in the month of June. Atlanta has a 31 March balance date and decides to use AIM to calculate provisional tax to attempt to better reflect the seasonality of its income. Atlanta has the following calculation of income for each two month period:

DATE	31 MAY	31 JULY	30 SEP	30 NOV	31 JAN	31 MAR	TOTAL
Net income (loss)	*(2,000)*	*10,000*	*(1,000)*	*(1,500)*	*(500)*	*(2,500)*	*2,500*
Cumulative income (loss)	*(2,000)*	*8,000*	*7,000*	*5,500*	*5,000*	*2,500*	–
Tax payment (refund)	*0*	*2,240*	*(280)*	*(420)*	*(140)*	*(700)*	*700*

Using AIM, Atlanta would significantly overpay its annual tax liability in the second period and gradually receive that back as refunds over the remaining periods. However, if Atlanta were to adopt a June balance date, to fit with the natural cycle of falcon breeding, AIM might better fit its business.

Overpayments of tax may also occur where a taxpayer's income profile fluctuates between profit and loss multiple times throughout an income year, albeit over a shorter period than in the example of Atlanta above.

Example 14: The Pitt Company Limited (Pitt) manufactures steel components of wind turbines. As their income fluctuates throughout the income year they want to adopt AIM to more closely match their tax payments to their income earning cycle. Pitt has a 31 March balance date.

Pitt has the following income profile for a year:

DATE	31 MAY	31 JULY	30 SEP	30 NOV	31 JAN	31 MAR	TOTAL
Net income (loss)	*150,000*	*(50,000)*	*300,000*	*(60,000)*	*250,000*	*100,000*	*690,000*
Cumulative income (loss)	*150,000*	*100,000*	*400,000*	*340,000*	*590,000*	*690,000*	—
Tax payment (refund)	*42,000*	*(14,000)*	*84,000*	*(16,800)*	*70,000*	*28,000*	*193,200*

Although not as prominent as the Atlanta example above, Pitt does end up overpaying tax in two of the six two-monthly instalments because of the way the income of the company fluctuates throughout the year, however, these "overpaid" amounts are required to be repaid later in the same year.
This method would still provide a better outcome for Pitt than the current provisional tax rules, which would see them pay three even instalments of $64,400 each in August, January and May.

Refunds

Using AIM when a business fluctuates between profit and loss throughout a year may require Inland Revenue to refund amounts of overpaid tax in some periods, much the same as is currently the case for GST. A taxpayer would be given the option of not having that amount refunded. Where a taxpayer would need to pay these amounts back to Inland Revenue in the following period (i.e. have a profit in the next period), they might choose not to take the short-term refund.

If a taxpayer did wish to receive a refund, the process would be similar to the current GST refund process. This would be an automated process. The ability to have overpaid tax refunded is a significant advantage over the current system.

Officials are interested in submitters' views on this mechanism and whether they would use it. Would submitters consider options to refund and/or transfer excess provisional tax paid to GST, and are there other approaches that would deal with these situations.

Use of money interest and penalties

If a business, using AIM to calculate and pay provisional tax, does not pay its full annual liability during the year, it will not be subject to use of money interest unless it has failed to pay the full instalments calculated under AIM. It is expected that taxpayers who use AIM will either no longer have terminal tax liabilities (as their tax payments will be made in near real-time, and based on actual results), or have very small variations to their tax liability for the year. Continuing to have the last tax instalment after balance date should allow any shortfall to be identified and paid by the final instalment.

However, if a taxpayer pays less than the amount prescribed by the software for any instalment, use of money interest will apply from the relevant payment dates. Late payments of tax may also attract late payment penalties.

Inland Revenue expects reasonable care to be taken in calculating AIM payments. If Inland Revenue considers that reasonable care hasn't been taken, then the taxpayer could be liable for penalties of 20% of the resulting tax shortfall.

A taxpayer will be removed from AIM when they do not provide the information required in the interim 10. The consequence of this will be that a taxpayer will be placed back into an estimate method, with the usual use of money interest and penalties applying.

Suitability of AIM for different types of taxpayers

The list below outlines the types of taxpayers best suited to AIM, along with some groups of taxpayers to whom it may not be well suited.

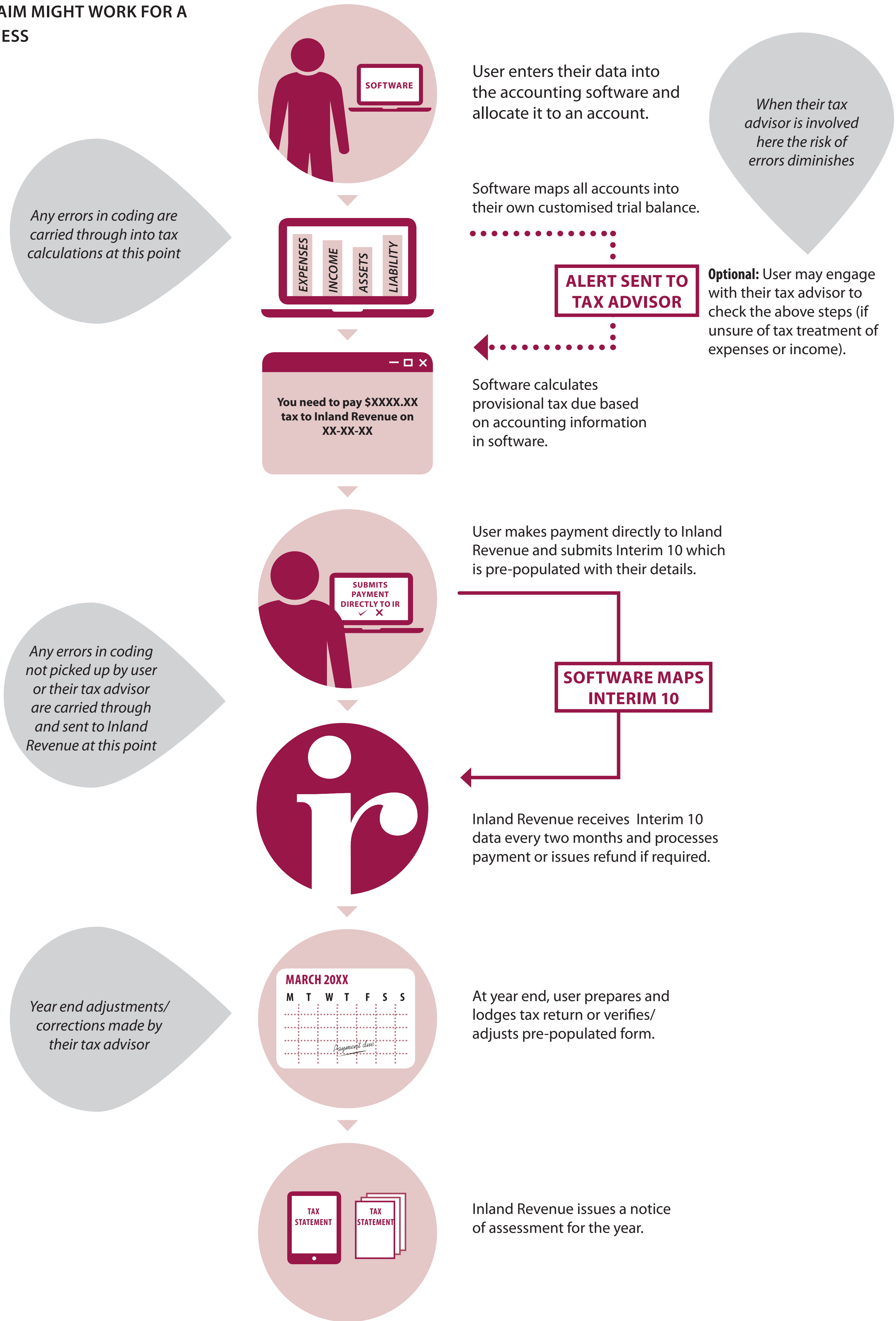
AIM may suit:

- Taxpayers who update their cloud based software accounting systems to manage their business throughout the year.
- Taxpayers whose income does not fluctuate significantly.
- Taxpayers with income concentrated in the latter part of the income year.
- Taxpayers with an annual steady accumulating income (that is, the business continues to make profit month to month, rather than fluctuating between profit and loss).

AIM may not suit:

- Taxpayers who do not have robust accounting processes (using software, spreadsheets or manual accounting records).
- Taxpayers with seasonal income concentrated in the beginning of an income year.
- Taxpayers with large amounts of overseas income resulting in large end of year income adjustments.
- Taxpayers with complex tax adjustments that require year end calculations.

HOW AIM MIGHT WORK FOR A BUSINESS



QUESTIONS FOR READERS

Officials invite submissions on the AIM proposal, in particular:

- How often records are updated in accounting software;
- Whether larger taxpayers would be interested in using AIM;
- With regard to tax calculations, what level of accuracy taxpayers can expect from software such as in the treatment of tax adjustments;
- What software specifications are appropriate to ensure Inland Revenue and small businesses can have confidence in the provisional tax payment calculations;
- What level of financial information should be submitted in the interim 10;
- Whether there is interest in further exploring options to reduce the end of year tax return process;
- Whether AIM should be available to businesses using manual systems and, if so, what minimum accounting requirements should be required;
- Whether submitters see any issues with how use of money interest might apply to AIM;
- Whether submitters would use the options to refund and transfer excess provisional tax paid to GST payments; and
- Any other technical issues that submitters wish to raise.

PAYING TAX AS AGENT FOR SHAREHOLDER-EMPLOYEES

The second measure the Government has announced to provide for more accurate and timely payment of provisional tax, is to allow a company which does not use AIM to make tax payments on behalf of shareholder-employees. This will potentially enable these shareholder-employees to be removed from provisional tax. In some instances an entity making payment to a taxpayer has a close relationship with that taxpayer. In these cases it may be possible to have the entity pay tax on behalf of the associated parties to minimise compliance costs.

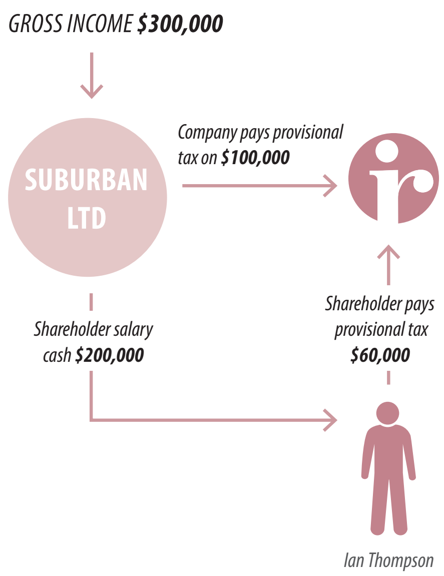
An example of a close relationship providing a low cost tax payment system is a trustee and a beneficiary. Currently, a trustee can pay provisional tax on the total income of the trust (that is, both trustee and beneficiary income). At the end of the year the provisional tax paid by the trustee can be allocated, along with beneficiary income, to the beneficiaries of the trust as part of the trust's tax return process. If the tax paid is sufficient, the beneficiaries have no provisional tax liability for that income. Without this process, beneficiaries, with no other non-source deducted income, could end up within the provisional tax rules.

The Government has announced that this mechanism will be extended to cover companies. Under this approach shareholder-employees in a company could be removed from the provisional tax rules for their salaries from the company. Tax credits would be received by the shareholder-employees to meet their tax liability.

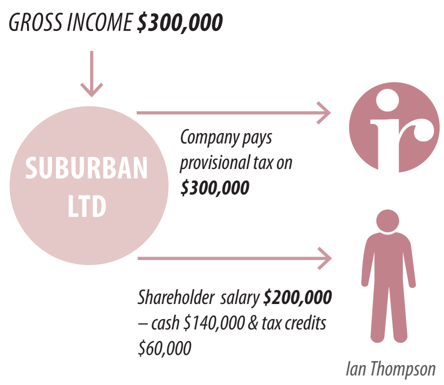
Tax payments made on behalf of the shareholder-employees would be paid on the company's provisional tax dates, not any provisional tax dates the shareholder-employees might have had.

The diagram below shows the current and future state for a company electing to pay tax as agent for its shareholder-employees.

CURRENT STATE



FUTURE STATE



Example 15: Suburban Ltd (Suburban) is a consulting business which has one shareholder-employee, Ian Thompson. At the beginning of the 2018-19 year they both elected that Suburban would pay tax on Ian's behalf.

Suburban has gross income of $300,000 and no expenses during 2018-19. During the course of the year, Ian took $140,000 in cash out of the company by way of drawings debited to a current account, and Suburban made provisional tax payments of $90,000.

At the end of the year:

- *Suburban pays Ian a salary of $200,000 by crediting the current account for $200,000, $140,000 cash and $60,000 of its provisional tax payments to Ian as a tax credit. The $60,000 tax credit meets Ian's tax liability on the $200,000 income, and he has no further liability.*

- *After payment of Ian's salary of $200,000, Suburban's net income for the year is $100,000. It has $30,000 remaining in its provisional tax account after the transfer to Ian. That amount of $30,000 meets its tax liability on its net income[8].*

This measure is intended to reduce business compliance costs by removing shareholder-employees from provisional tax. However, tax calculations, similar to provisional tax calculations made now, will still be required to be made to enable companies to pay the right amount of tax on behalf of their shareholder-employees.

Use of this method

Paying tax on behalf of shareholder-employees in relation to their salaries will be optional. It would also only be practical when the same person deals with tax for the entity and the owners – although this is a decision for those involved to make.

As with the standard method safe harbour [see pages 17 to 20], rules will be required to prevent entities from switching in and out of this option in alternate years to avoid the on-going obligations of provisional tax.

Proposed mechanism

A company and its shareholder-employees would be required to elect to have the company paying tax as agent by the company's first provisional tax payment date. The following rules would then apply:

- During the course of the year, the company would be expected to add to its own provisional tax payments, amounts equal to any provisional tax the shareholder-employees would have had in relation to their salaries, if they had not elected into paying tax as agent.

- At the end of the income year the various tax returns will be prepared for the company and its shareholder-employees. At this stage the company will be able to look at the total provisional tax paid, and allocate these amounts between the company's tax liability and the shareholder-employees. This allocation may differ from the initial calculation.

- From a shareholder-employee's point of view, amounts allocated to them will be treated as a tax credit (just like a tax credit for PAYE or RWT). The ordinary rules will then apply – if that tax credit (along with any other tax credits and amounts paid) are less than the shareholder-employee's total tax liability, the shareholder-employee will have a terminal tax liability and potentially an interest liability. If the total amount of tax credits and other payments exceeds the shareholder-employee's total tax liability, then a refund will be available.

Rate of tax paid on behalf of shareholder-employees

Where the company uses the uplift basis, no rate calculation is required – the company's obligation is simply to pay uplift amounts on shareholder-employees' salaries as well as on its own income. However, where the company uses the estimation method, the company will need to reflect the shareholder-employee's tax rate in the amount it pays on the shareholder-employee's behalf, not the company rate. For shareholder-employees for whom their salary is their primary income it will be their average tax rate; for shareholder-employees for whom it is a smaller part of their income, it may be their marginal rate. This is the same calculation which is made now for shareholders who pay provisional tax using the estimation method.

Other types of income, and other types of taxpayer

The main source of income paid without source deduction to related parties is the payment of salaries to shareholder-employees at irregular intervals, where the PAYE rules do not apply. This proposal is initially intended to be available for these transactions.

However, a progressive extension to other forms of income subject to tax at source could be considered if this proposal is popular with taxpayers. One possibility would be to allow companies to use it where they make other payments where no tax is deducted at source to related parties. The payment of rent is a prime example. This would allow a further group to be removed from provisional tax.

A second possibility would be to allow it to be used in place of resident withholding tax (RWT) for those companies liable to pay it on interest and dividends paid to related parties. This would simplify compliance by removing the need for a company to comply with RWT requirements.

This proposal could also be made available to partnerships. Payment of partnership profits from a partnership out to its partners is not subject to deduction of tax at source. Under current rules each partner is likely to be subject to provisional tax on

QUESTIONS FOR READERS

Officials invite submissions on the paying tax as agent proposal, in particular:

- Whether submitters who are involved in companies that pay salaries to shareholder-employees would use this measure;
- Whether it would be useful to extend this measure to other income paid by companies to related parties, such as rents, and interest and dividends (in place of RWT);
- Whether this measure could be usefully extended to partners in partnerships;
- Whether increased availability of early balance dates to businesses which used this measure would be valuable; and
- Any other comments or concerns on the implementation of this measure.

their share of partnership income. A partnership could pay tax for each of its partners so they would no longer be subject to provisional tax.

Suitability of paying tax as agent to different types of taxpayers

The list below outlines the types of taxpayers to whom paying provisional tax on behalf of related parties may be best suited.

May be suited to:

- Taxpayers where a single person prepares returns for both the company and its shareholder-employees.

May not be suited to:

- Companies with a large number of shareholder-employees who have different people preparing their tax returns.
- Companies where the shareholder-employees have significant other non-source deducted income and are subject to provisional tax anyway.

Potential use of this measure to provide greater balance date flexibility

While most businesses have a balance date of 31 March, Inland Revenue can allow businesses to have a different balance date. A high threshold applies to allowing companies to have early balance dates because it can be used as a tax deferral mechanism. Where income is initially derived in a company with an early balance date and then paid out to its standard balance date shareholder-employees by way of salary, tax will be paid on the shareholder-employees' later provisional and terminal tax dates.

The high threshold for allowing early balance dates can disadvantage companies that would benefit from one, and accountants whose workload is unevenly spread.

Allowing a company to pay tax on behalf of its shareholder-employees could be used to enable a greater proportion of companies to have early balance dates without fiscal risk. A company that wished to have an early balance date would be required to pay tax on behalf of its shareholder-employees on its own provisional tax dates, so ensuring that the early balance date was being used for genuine business reasons and not as a tax deferral mechanism.

Officials invite submissions on whether this proposal should be used to enable greater availability of early balance dates. It would be helpful if these submissions discussed how important balance date flexibility is.

[6] For this example it is assumed that Road Runner uses the Commissioner's economic rates of depreciation for accounting and tax purposes. For businesses that have separate accounting and tax depreciation rates an adjustment would be required to substitute accounting with tax depreciation. We understand it is reasonably common for SMEs to use tax depreciation rates for accounting purposes.

[7] The *Financial statements summary (IR10)* form is designed to collect information for statistical purposes and to assist in the administration of the tax system. It isn't designed to replace financial records. The form is a general summary of information relating to the customer's business and operations that is filed with a company tax return.

[8] Numbers rounded up for simplicity – in fact Suburban has more tax than it needs to meet its liability, and would be entitled to a refund.

CHAPTER 4

SELF-MANAGEMENT AND INTEGRITY

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 provisional tax obligations or at least reduce them to a level where safe harbour from use of money interest 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.

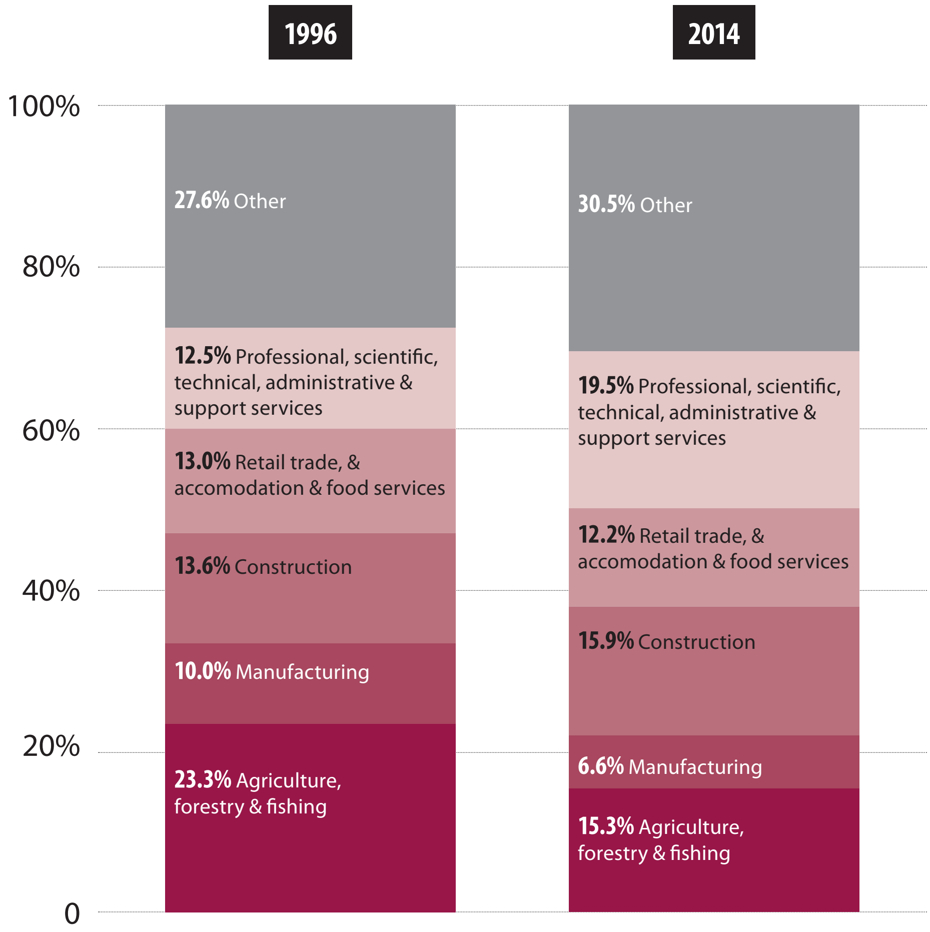
New Zealand has a number of domestic withholding taxes, most notably PAYE and RWT. The "schedular payments" rules are another example of withholding, however they have significant issues.

They are neither comprehensive in scope nor simple to apply, and require a flat rate withholding tax to be deducted from certain classes of payments which are not salary or wages but are largely payments for services (rather than goods).

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 industries they work in have changed. There has been a decrease in those working in industries such as agriculture and manufacturing, and an increase in the construction, professional, scientific, technical and administrative and support services, as shown in the diagram below. This means more self-employed people are working in industries not covered by the withholding tax rules.

PROPORTION OF SELF-EMPLOYED BY INDUSTRY

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.



In addition, using a company structure has become increasingly popular with contractors as shown in the diagram on page 40. Payments to companies are generally not subject to withholding tax under the schedular payments rules.[10]

As the current rules are both out-of-date and narrow in application there may be opportunities for SMEs to supress income and operate totally or partially in the hidden economy. Such businesses will have a competitive advantage over those who are compliant with their tax obligations. This tax advantage may also impact on small business hiring decisions.

BUSINESS VEHICLE OF CHOICE

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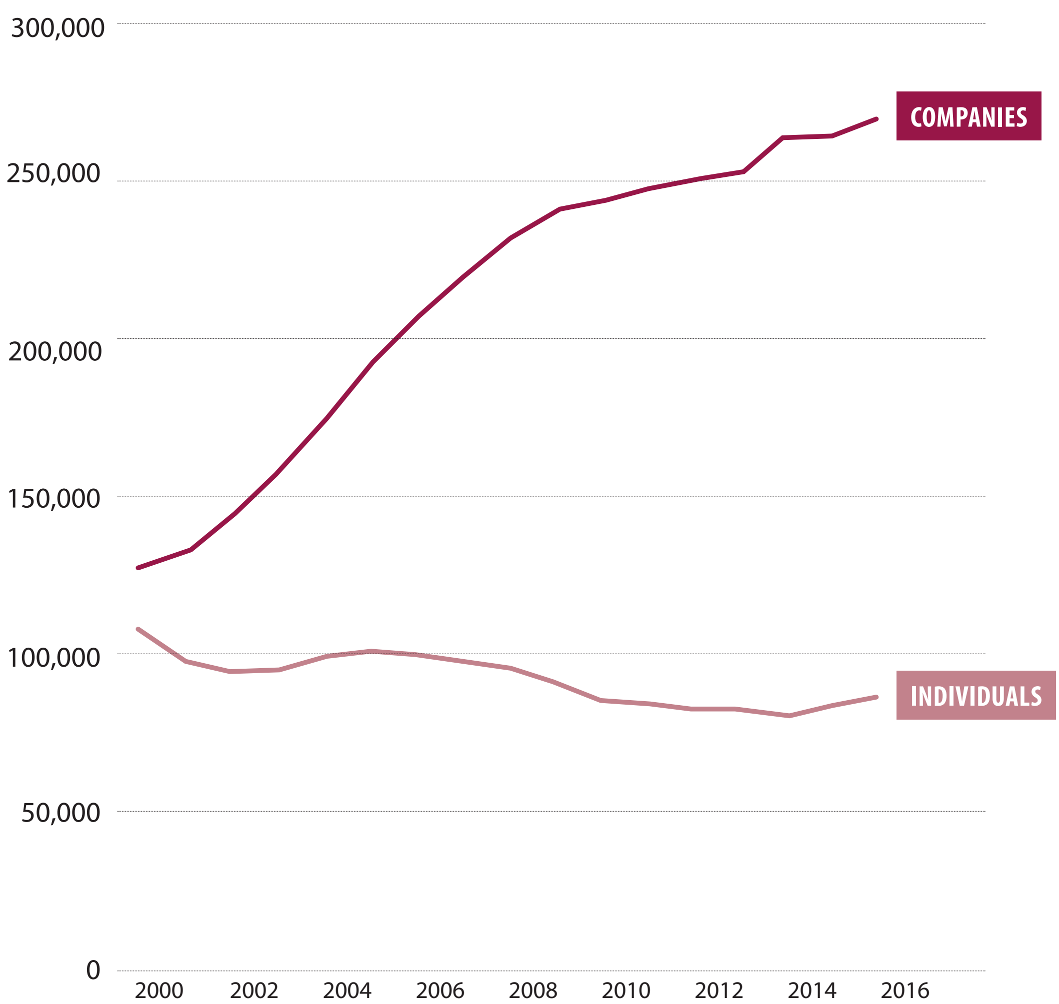


Example 16: Sandra is a Management Consultant. She was a salaried employee until 2009 when she started working as an independent contractor and worked for several large organisations from 2009-2010.

Inland Revenue commenced an audit of Sandra which revealed that she had only declared a small proportion of her contracting income and that she was charging GST but not filing GST returns. Sandra now has a tax debt of $360,000.

Many workers are moving from being employees to being self-employed and operating through a company structure. This means that payments to them are made without PAYE or withholding tax applying. This can create issues for those individuals who are not used to dealing with their tax obligations directly and have previously relied on their employer to deal with those obligations. In addition, the current rules are not designed to make it easy for people to self-manage their affairs.

Example 17: Candytasters Limited employs five people to test new types of confectionary. Willy, the owner of Candytasters, tells his employees he wants them all to become contractors and work through company structures. The five employees do this.

Candytasters Limited no longer has to deal with PAYE and other deductions on behalf of the individual tasters. The tax obligations have shifted to people who may never have had to look after their own tax obligations other than as an employee.

Enforcement of the employee-contractor boundary is also an inefficient mechanism to bring contractors into the withholding rules. Audit activity in this area can be expensive, as it is generally determined on an individual contractor basis, rather than for groups of taxpayers.

Example 18: Codeit Limited is a large New Zealand company that designs software. It has a workforce of programmers who are all contractors. Within this group there are 15 contractors who exhibit the characteristics of being employees. To challenge this Inland Revenue needs to work through each employee and apply the tests to determine their employment status for tax purposes.

SELF-MANAGEMENT FRAMEWORK

Both individuals and businesses live and operate in often complex environments. Meeting various tax obligations can also be complex. Historically the tax system has not allowed a high degree of flexibility to enable people to address these complexities and manage their obligations in a way that works for them.

The goal of the future is to design a system where people are empowered to self-manage. This involves providing more flexibility for businesses and minimising the degree of complexity in managing their tax affairs so that it is easy for businesses to get their tax affairs right. At the same time the system should make it hard for people to get their tax affairs wrong and Inland Revenue should have the ability to quickly identify areas of concern and take action to ensure things get back on track.

MODERNISING THE WITHHOLDING RULES

The schedular payment withholding rules need modernising to ensure that they keep pace with modern society, make it easy for people to comply and self-manage their obligations, and to minimise costs to the system. The Government has announced a first step towards modernising the rules, providing increased flexibility and addressing an area where compliance issues have arisen.

The measures announced are:

- Pay as you go for contractors – electing own withholding rate;
- Pay as you go for contractors – labour-hire firms; and
- Voluntary withholding agreements.

The initial measures provide a foundation for future reform. A wider review of the rules is necessary to address the issues outlined at the start of this chapter more comprehensively, and is likely to be included in a later discussion document on improving the tax system for businesses.

ELECTING OWN WITHHOLDING RATE

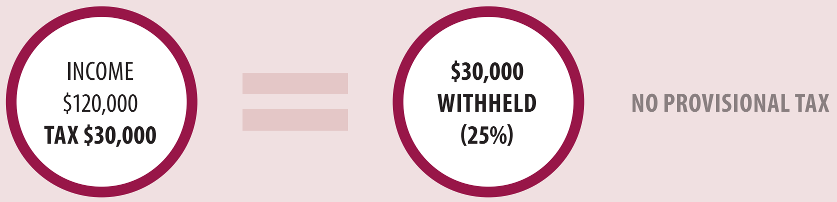
Electing your own withholding rate aims to assist contractors to better match their tax payments to their income. The current rules specify flat rates of withholding. This will often not accurately match the contractor's actual income tax liability. Contractors can obtain a special tax code to alter their rate, however the process can be cumbersome, requiring them to apply to Inland Revenue and provide supporting information.

The Government has announced it intends to amend the rules, to allow contractors to select their own withholding rate, without needing to make an application to Inland Revenue. This will mean an application for a special tax code will no longer be needed to alter the rate applied to a schedular payment.

Example 19: Ben is a building contractor. Ben earns $120,000 each year from his building contracts with several major building companies. The payments to Ben are subject to the current withholding rules and the building companies deduct 20% withholding tax from payments they make to Ben.

Ben predominantly provides labour services and has minimal deductions. At year end he has an additional $6,000 of income tax to pay over and above what has been withheld. This also means Ben will have to pay provisional tax the following year.

Under the new rules Ben can elect a higher withholding rate of 25% (without needing to apply for a special tax code). Ben's withholding now matches his final tax liability, he no longer has to pay provisional tax and his end of year tax bill is minimal.



Prescribed rates of withholding

In some cases a contractor will be unable to select their own rate as they will be subject to withholding at a rate prescribed by the Commissioner. It is intended that, in some circumstances, the Commissioner will be able to give notice to a payer that they are required to withhold at a higher rate than that selected by the contractor. This would occur where the contractor is non-compliant with their tax obligations. Prescribing a higher rate will assist the contractor to become compliant and repay any outstanding debt.

The Commissioner prescribed rate would be similar to the existing power in section 157 of the Tax Administration Act 1994, which enables the Commissioner to require deductions by notice. However, the ability to prescribe rates would be more flexible and practical than the existing provision. Section 157 deductions must be a flat amount and are required to be paid separately to the employer monthly schedule. This process would vary the deduction rate applied to the payment to the contactor, and be reported and paid through the employer monthly schedule and employer deductions processes.

Minimum rates

Allowing contractors to elect their own withholding rate creates a fiscal risk. This risk arises because contractors may use the proposal to attempt to defer or avoid paying their tax through choosing artificially low withholding rates. This also creates additional administration costs for Inland Revenue in collection of unpaid tax debt.

To address this fiscal risk and ensure the integrity of the withholding system, a minimum rate of withholding will be imposed on contractors.

Example 19B (if no minimum rate): After previously electing a 25% rate in 2017, Ben the builder now decides to pick a rate of 0% for the 2018 year. His income and expenses remain the same and therefore his withholding does not match his final income tax liability. Ben now has a terminal tax bill of $30,000 which he will need to pay in 2019.

In 2019 Ben has a terminal tax bill of $30,000 (for income earned in 2018). As a result, he is also now required to pay provisional tax from 2019 onwards (which, if accurate, will mean he has no further terminal tax payments to make).

No further terminal tax payments

If Ben does not pay his terminal and provisional tax, the Commissioner may increase his withholding rate to 50% to ensure his obligations are met.

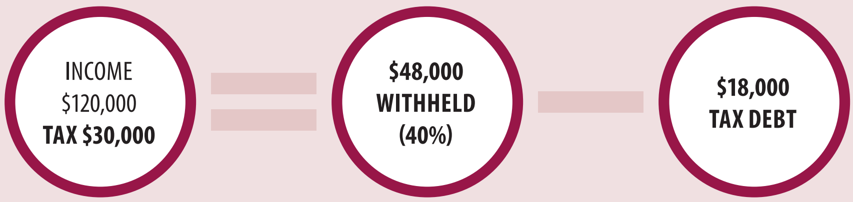
A minimum rate addresses these risks as it decreases the ability for contractors to defer or avoid paying their tax. For example, with a minimum rate of 10%, Ben in the previous example would only be able to defer paying $18,000 of tax rather than $30,000.

Example 19C (if minimum rate of 10%): After previously electing a 25% rate in 2017, Ben the builder now decides to pick a lower rate of 10% for the 2018 year. His income and expenses remain the same and therefore his withholding does not match his final income tax liability. Ben now has a terminal tax bill of $18,000 which he will need to pay in 2019.

In 2019 Ben has a terminal tax bill of $18,000 (for income earned in 2018). As a result, he is also now required to pay provisional tax from 2019 onwards (which, if accurate, will mean he has no further terminal tax payments to make).

No further terminal tax payments

If Ben does not pay his terminal and provisional tax, the Commissioner may increase his withholding rate to 40% to ensure his obligations are met.



However, a minimum rate does have some disadvantages. It is a departure from the self-management framework and may prevent contractors from picking the means of paying tax that works for them. For example, if a contractor would find paying tax easier through provisional tax rather than through withholding, then a minimum rate removes this choice.

In addition, a contractor whose "correct" withholding rate is below the minimum must apply for a special tax code to get the correct rate. This imposes a compliance cost on these contractors.

These costs and benefits are finely balanced. The Government favours a minimum rate of 10% for resident contractors because it is concerned about the fiscal risks, but welcomes submissions on this issue.

Non-resident minimum rate

The Government also favours having a higher minimum rate of 15% for non-resident contractors. This higher minimum rate is favoured because if a non-resident avoids paying their tax it can be difficult for Inland Revenue to collect the unpaid tax if the contractor has returned overseas.

In addition to non-resident contractors, it may be appropriate to have a higher minimum rate for contractors who are on temporary work visas as they are likely to return overseas and pose a fiscal risk.

However, determining whether a higher minimum rate should apply could be difficult for employers. Officials seek submissions as to whether the greater avoidance risk justifies having a different minimum rate for non-resident contractors and contractors with temporary work visas.

Default and non-declaration rates

When a contractor does not specify a rate, a default rate will apply. For contractors working through labour-hire firms (see page 49) the default rate proposed is 20%. This rate would ensure that the majority of labour-hire contractors that do not select a rate have no end of year tax bill and do not have to pay provisional tax.

For contractors not operating through labour-hire firms, the proposed default rate is the same rate that currently applies under Schedule 4 of the Income Tax Act 2007. This helps reduce transitional costs as businesses currently withholding will not need to change the rates for all their contractors.

Under the current schedular payments rules, a contractor subject to withholding is required to provide their name, IRD number and tax code. The IRD number is necessary to ensure that the income information and tax withheld is matched to the contractor, and the contractor is not able to avoid their obligations.

Currently, if a contractor does not provide this information, payments to them must have tax deducted at 15% above the rate that applies under Schedule 4. This non-declaration rate will be replaced with a similar rule to the no notification rule for PAYE whereby there will be a flat rate for non-declaration of 45%.

Non-resident entertainers

Non-resident entertainers currently have a flat withholding rate of 20%. These entertainers can choose to treat this withholding as a final tax and if they do so they are not required to file an end of year income tax return. This treatment helps reduce compliance costs for non-resident entertainers.

Officials propose that non-resident entertainers continue to have a flat rate of withholding of 20% and are not able to elect their own withholding rate. This will mean that these entertainers can continue to have withholding treated as a final tax and will not have to file returns.

Consent of withholder

There may be a concern that the proposal to require the consent of the withholder could increase overall compliance costs. The cost of changing a withholding rate for a withholder could be greater than the benefit to the contractor of having tax correctly withheld.

This problem arises because when a contractor makes a decision to change their withholding rate, there can be a cost to the withholder which the contractor does not personally bear. As a result, a contractor may decide to change their rate in circumstances when it provides them with marginal benefit but imposes relatively larger costs on the withholder.

To resolve this issue, stakeholders proposed that contractors should only be able to change their withholding rate if the withholder consents to the change.

Officials view

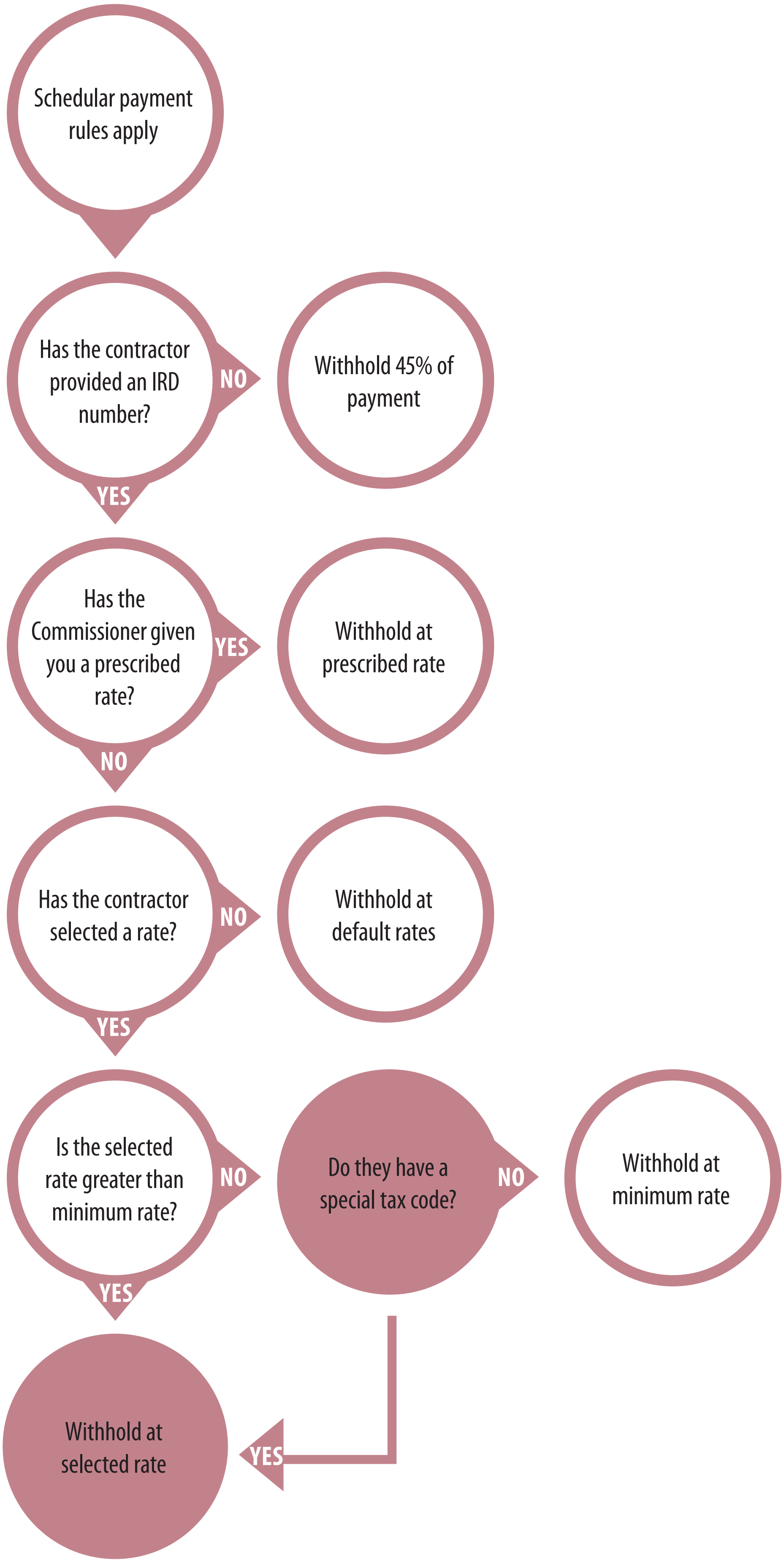
Officials consider that if the proposal to allow contractors to elect their own withholding rate required the consent of the withholder it would create the inverse issue. Withholders would be able to refuse to change contractors rates without bearing the impact that refusing to change rates would have on the contractor. This would mean overall compliance costs would be greater when the benefit to the contractor of changing the rate is greater than the cost to the withholder of changing it.

Officials consider that in the majority of situations the decision to change withholding rates will decrease overall compliance costs. As a result, officials generally prefer allowing contractors to decide their withholding rate without requiring the consent of the withholder.

However, when a contractor repeatedly changes their withholding rates this assumption does not hold. Instead it is likely that repeatedly changing rates will impose excessive compliance costs on withholders for little benefit. As a result, officials propose that the consent of the withholder will be required to change a contractor’s withholding rate if the contractor has previously changed their withholding rate twice in the income year.

THE PROCESS FOR SELECTING A RATE

This diagram sets out how the process of electing a rate would apply.[11]



LABOUR-HIRE FIRMS

As set out earlier, the withholding rules are out-of-date and do not cover changing employment practices and modern industries. Over the last two decades there has been a large growth in the labour-hire firm industry. However, the withholding rules do not adequately address contractors working for this industry.

Labour-hire firms provide workers to perform services to clients. The labour-hire firm engages these workers either as employees or as contractors. While contractors and employees do similar work, the withholding rules that apply to them are quite different.

For employees engaged by labour-hire firms, the current PAYE rules mean that withholding applies to payments made to them so they generally have low compliance costs as a result.

However, current withholding rules do not generally apply to contractors engaged by labour-hire firms. This means these contractors are required to manage their own tax obligations and have to deal with provisional tax.

It also means that these contractors have opportunities for non-compliance (whether deliberate or accidental).

The following examples are based on Inland Revenue audits of labour-hire firm contractors.

IT contractor

Amy is an IT consultant who operates through a company. An audit of her revealed that she had over $100,000 of undeclared income from 2010-2013.

The audit also revealed that Amy was claiming Working for Families over this period and received $16,000 of family assistance payments she wasn't entitled to.

Management accountant

Ben is a management accountant. From 2009-2014 he worked as an independent contractor but did not file tax returns.

After being audited it was discovered he had significant undeclared income, and he did not have money to pay for it.

During 2009-2010 Ben was also receiving the unemployment benefit.

Child support evasion

Carl is an IT contractor. From 2013-2014 he worked as an independent contractor. An audit revealed Carl had undeclared income of over $300,000 over this period.

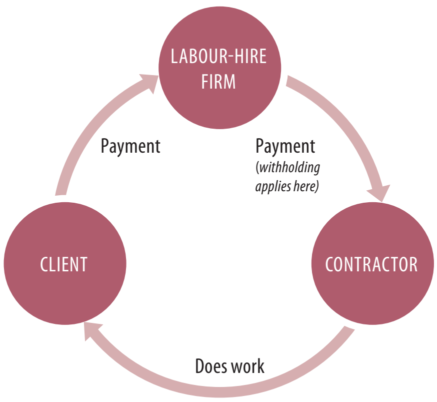
Carl originally had his child support liability assessed at $70 per month. Carl should have been paying in excess of $2,000 per month instead.

To address these issues the Government has announced that the withholding rules will be extended to specifically cover all contractors operating through labour-hire firms. This means that the labour-hire firm will be required to withhold from any payment it makes to its contractors. Extending the withholding rules in this way provides an initial measure to address one set of contractors where there are demonstrated issues.

The proposed approach is consistent with that in Australia, where labour-hire withholding rules have applied since 2000. In Australia, approximately 54,000 labour-hire contractors are subject to withholding and over $400m in tax is withheld annually.[12]

When withholding will apply

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



It is proposed that withholding will apply where:

- There is a labour-hire arrangement (as set out in the diagram above);
- The payer is in the business of providing labour-hire services; and
- The payment is made for that business (that is, the labour-hire arrangement is not incidental to another business).

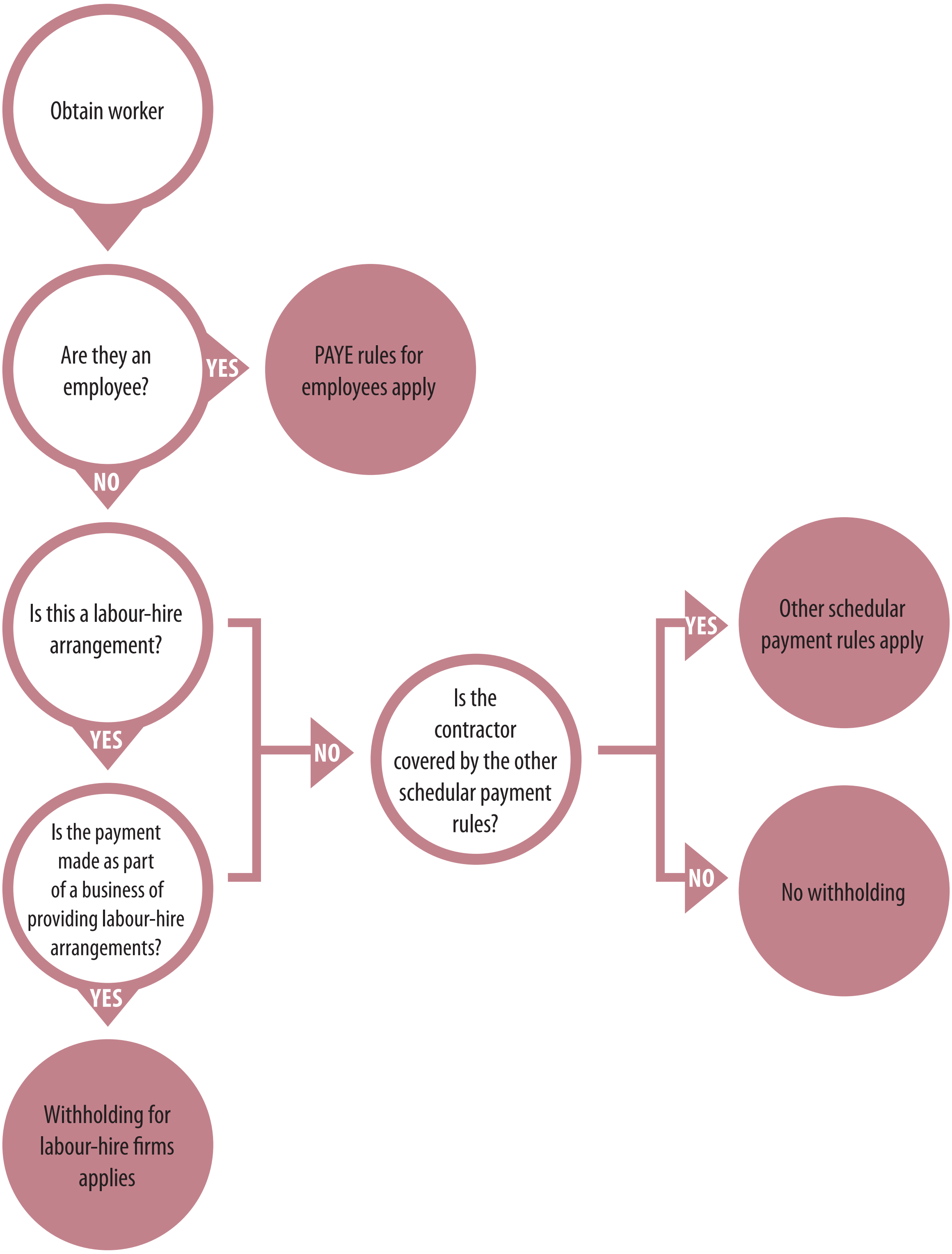
Consistent with the rules set out on pages 42-48, labour-hire contractors will be able to elect their own withholding rates.

Withholding will apply to a labour-hire contractor regardless of the form in which the contractor structures their business. This removes the ability for the contractor to avoid withholding by structuring as a company.

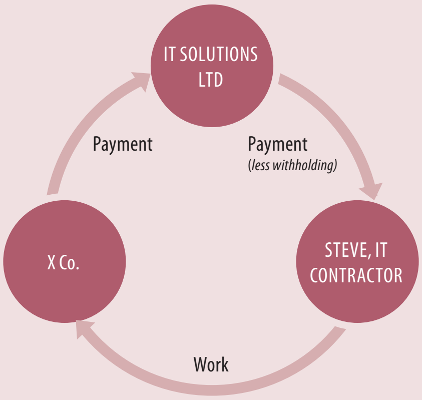
Contractors subject to the labour-hire rules must have their income reported to Inland Revenue via the employer monthly schedule. This means that a labour-hire contractor would not generally be able to get a certificate of exemption to remove themselves from the rules and the requirement to have their income reported to Inland Revenue.[13]

In circumstances where withholding is inappropriate, or where the minimum withholding rate is too high, the contractor will be able to obtain a special tax code to reduce their withholding rate. These contractors would still have their income reported to Inland Revenue via the employer monthly schedule.

APPLICATION OF THE LABOUR-HIRE FIRM RULES

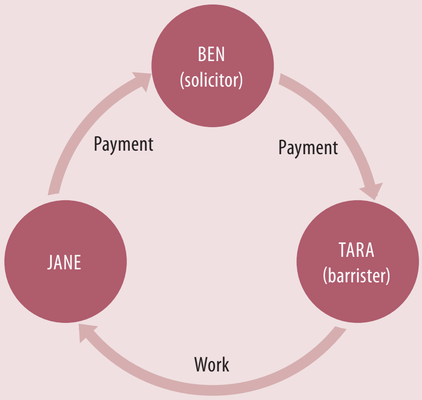


Example 20: IT Solution Ltd provides staff to assist other businesses with their IT projects. X Co. asks IT Solutions Ltd for IT workers to assist with an upgrade of their systems. IT Solutions Ltd provides one of their contractors (Steve, a New Zealand resident) to assist X Co.



IT Solutions Ltd are in a labour-hire arrangement with Steve and X Co. and this arrangement is part of their labour-hire business. As a result, IT Solutions Ltd will be required to withhold tax from any payments to Steve. Steve can specify the rate of withholding, but it must be at least 10%.

Example 21: Ben is Jane's solicitor. Jane is engaged in litigation and requires a barrister to represent her in court. For this purpose, Ben instructs Tara and pays Tara on Jane's behalf.



The payment from Ben to Tara is part of a labour-hire arrangement. However, Ben is not required to withhold from these payments because he is not in the business of providing labour-hire arrangements. The payment is incidental to his business of providing legal services.

VOLUNTARY WITHHOLDING

Contractors not covered by the schedular payment withholding rules are not currently able to have tax withheld on a payday basis. The Government has announced new rules to allow contractors to opt in to voluntary withholding agreements. This will allow those contractors who are not covered by any other withholding provision to opt in and obtain greater flexibility to manage their tax obligations.

A voluntary withholding agreement will require mutual agreement – that is the payer must also agree to withhold. This means that compliance costs will be minimised, as those payers who do not have the systems in place to easily withhold do not have to agree to withhold. However, the requirement for mutual agreement does mean that some contractors who want a voluntary withholding agreement may not be able to obtain one, as the payer does not agree.

[9] Based on customised Statistics New Zealand data from the Household Labour Force Survey 1996-2014.

[10] Companies in the agricultural, horticultural and viticulture industries and non-resident contractor companies are subject to withholding under the schedular payments rules.

[11] This diagram does not apply to non-resident entertainers.

[12] Figures taken from data for the 2012/2013 year. See https://data.gov.au/dataset/taxation-statistics-2012-13/resource/233cbf28-6fda-4e53-bbe9-3a37a65fb742.

[13] Except where there is a specific rule allowing for non-residents to obtain a certificate of exemption due to the effect of a double tax agreement.

CHAPTER 5

MAKING THE SYSTEM FAIRER

As foreshadowed in the discussion document *Making Tax Simpler – Towards a new Tax Administration Act*, a different approach to penalties may be required. This chapter outlines changes the Government has announced to late payment penalties.

LATE PAYMENT PENALTIES

The late payment of tax is currently subject to a series of late payment penalties, which are imposed from the first day the tax is overdue and accrue incrementally and indefinitely thereafter. Overdue tax incurs an initial 1% penalty one day after the due date, another one off 4% penalty seven days after, and an incremental penalty of 1% for each month thereafter. Use of money interest (UOMI) is also imposed to compensate the government for not having the money available to them. It is applied one day after the due date and is calculated on a daily basis and does not compound. The longer the tax is outstanding, the more financial penalties are imposed. After two years, the penalties and use of money interest can accumulate to more than 50% of the original tax owed.

Current penalties compound and are imposed over the outstanding tax, with use of money interest imposed over outstanding tax and penalties. With the current use of money interest underpayment rate of 9.21%, the combined penalty and interest rate aggregates to approximately 27% per annum (in the first year). In some years the use of money interest rate has been higher, resulting in a higher effective rate.

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 penalty. The third is unlikely to be motivated by a financial penalty and so other tools would be more effective.

In recent years, Inland Revenue has conducted research to learn more about the relationship between penalty and interest rates and compliance behaviour. This research has revealed that the existence of financial penalties is important as they encourage most taxpayers to comply, but high penalty rates may not be essential to encourage all taxpayers to comply. Many surveyed taxpayers commented that it was the existence of possible financial penalties that was the reason they would always file and pay on time. However, beyond the existence of penalties many taxpayers surveyed did not have a complete understanding of the financial consequences of getting into tax debt. When the current late payment penalty rules were explained, over 86% of taxpayers surveyed said that they would be sufficiently encouraged to pay their debt, once the debt had incurred a combined penalty and use of money interest rate of 5.2% (this currently occurs with the debt being outstanding for approximately 8 days).[14]

While late payment penalties encourage on time payment, there is a point when the accumulated penalties and interest overwhelm taxpayers. Taxpayers surveyed suggested that this tipping point is approximately $10,000 of tax debt for small and medium sized businesses. At this point, taxpayers may struggle to see a way forward and become less engaged in resolving their debt. Consequently, imposing more penalties will not encourage repayment. In addition, for many small businesses, the total amount outstanding quickly becomes so big it cannot be repaid using expected future cash flows. At this point, any repayments mostly go to reducing the interest and penalties, with little being left over to pay the outstanding tax itself.

Over the years, the current rules have resulted in a significant amount of unpaid tax, penalties and use of money interest being added to the government tax debt book. The debt book for non-social policy tax debt is currently above $5 billion,[15] with Inland Revenue in recent years being required to write off and impair approximately $800 million to $1 billion of uncollectible debt per annum.[16]

The Government has announced that it will introduce legislation to reform the late payment penalty by no longer imposing the 1% monthly incremental late payment penalty from new GST, income tax and Working for Families Tax Credit (WfFTC) overpayment debt.

The proposed change will benefit approximately 65,000 taxpayers with income tax debt, 67,000 taxpayers with GST debt and 23,000 taxpayers with WfFTC debt. Other tax types may be considered for similar treatment in the future as they transition to START.[17]

New tax debt incurred on or after the application date will incur the initial late payment penalty and use of money interest. This will reduce the effective rate of penalties and interest imposed in the first year, from 27% per annum, to approximately 15% per annum.[18] This combined penalty and interest rate is more in line with established commercial (unsecured) lenders and will lead to less uncollectible debt, which over time will reduce the write-off of uncollectible late payment penalties.

There is a risk that some taxpayers may view the removal of the incremental late payment penalty as a reduction in the 'cost of borrowing' from Inland Revenue, and decide that it is financially worthwhile to delay their tax payments. While the effective rate has been reduced, given Inland Revenue's other recovery and enforcement tools, it is unlikely a reasonable person would consider it prudent to borrow from Inland Revenue, if they could otherwise borrow at a similar rate from a commercial lender. Also, it is important to note that Inland Revenue has a number of non-financial tools available (including the proposed ability to disclose tax debt to credit reporting agencies, discussed in Chapter 6) to address the issue of some taxpayers deciding not to resolve their tax debt.

WfFTC shares the same late payment penalty rules as income tax. Therefore WfFTC recipients face similar issues regarding the fast accumulation of penalties and interest on outstanding WfFTC debt.

The major cause of WfFTC debt is Inland Revenue's lack of accurate information on families' household income and circumstances during the year. Approximately 200,000 (half of all) WfFTC recipients choose to receive their entitlement during the year in weekly or fortnightly instalments. However, many of these recipients are paid more than they are entitled to receive during the year. This is because the WfFTC instalments are either based on a default, rudimentary estimate of recipients' projected end of year entitlement, or rely on the recipient notifying Inland Revenue of changes and asking for their instalments to be changed accordingly. At the end of the tax year when WfFTC recipients' entitlements are finalised (through square-ups with their income tax returns) these overpayments are treated as a debt. If the debt remains unpaid after the due date, late payment penalties are imposed.

Much of this debt is incurred by low income families, many of whom are the least likely to have the financial ability to repay it. Imposing high late payment penalties is unlikely to further encourage WfFTC recipients to repay their debt. No longer imposing the incremental 1% penalties (leaving just the initial late payment penalties of 1% and 4%) will provide WfFTC recipients a better opportunity to repay any debt that arises.

Inland Revenue intends to address the cause of WfFTC debt as part of the review of social policy in a subsequent discussion document about the administration of social policy. For example, collecting and using better, more real time information about recipients to ensure they receive the correct entitlement should prevent and reduce debt.

The application of this measure will be staggered as tax products begin to be administered by START. This provides the most cost-effective transition option.

However, the staggered approach means that, in the future, some indebted taxpayers will continue to have incremental late payment penalties imposed on them, depending on whether the debt is administered in FIRST or START. This will be the case until all GST, income tax and WfFTC debt is being administered in START.

[14] Material relating to the research undertaken by Inland Revenue will be released two weeks after the release of this issues paper.

[15] Inland Revenue Annual Report, 2015. Total debt book excluding student loan and child support debt.

[16] Inland Revenue Annual Report, 2015.

[17] START – Simplified Tax and Revenue Technology – is Inland Revenue's computer system to replace FIRST. This system is based on the GenTax platform supplied by FAST Enterprises as part of the Business Transformation programme.

[18] Based on initial penalties of 1% and 4% and the current use of money interest rate.

CHAPTER 6

IMPROVING THE OPERATION OF MARKETS THROUGH GREATER TAX TRANSPARENCY

Critical to compliance is taxpayer trust that their information will not be disclosed inappropriately. However, the need to keep tax information secret should be balanced against supporting economic efficiency and growth, and wider government outcomes. Accordingly, there are a number of specific exceptions in the tax secrecy legislation to enable tax information to be disclosed. An example is the provision of tax information to the New Zealand Police relating to serious crime.

The Government has announced two new measures to share information to better protect the New Zealand business community. These measures will disclose information relating to taxpayers with significant tax debts and information relating to taxpayers who may have committed serious offences against the Companies Act 1993. Both measures, while primarily focused on protecting the wider community, also carry tax administration benefits.

CREDIT REPORTING OF TAX DEBT

Information about tax debt, like all tax information, is subject to the tax secrecy rule set out in section 81 of the Tax Administration Act 1994 (the TAA). 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, in essence, little difference between a tax debt and any other debt a taxpayer may have.

The lack of visibility of tax debt can have a significant impact on other businesses, as they may have made different decisions about dealing with someone had they been aware of the debt. In addition, the non-payment of tax debt can allow non-compliant businesses to unfairly compete against those who are compliant.

The Government has announced that it will introduce legislation to permit the disclosure of tax debt information for the most serious cases of non-compliance to credit reporting agencies. This will apply to significant income tax and GST debt, and to employers' unpaid PAYE, child support, student loan and KiwiSaver deductions from employees' salary and wages. Disclosure will enable businesses contemplating providing credit to make more informed commercial decisions, as including tax debt information in a credit check would provide a more comprehensive picture of a business's total position.

In addition to contributing to economic efficiency, this will reduce opportunities for non-compliant taxpayers to continually fail to address growing tax debt.

Criteria for disclosure of tax debt

It is proposed that legislation will set out the criteria to be met before Inland Revenue shares information with credit reporting agencies, including that:

- The debt is significant;
- The debt is not disputed;
- Reasonable efforts have been made to collect the debt;
- The taxpayer does not qualify for serious financial hardship relief; and
- The taxpayer has been personally served notice of the Commissioner's intention to disclose debt information to credit reporting agencies, and given 30 days to repay the debt or arrange for repayment.

"Significant debt" is proposed to be defined in regulation as debt relating to income tax, GST or an employer's PAYE, child support, student loan or KiwiSaver deductions, where the debt is either:

- Overdue by a certain period of months (for example, 18 months) and greater than a set percentage of a taxpayer's:
  - Gross income; or
  - Unencumbered assets; or
  - Non tax third party liabilities;

or

- New debt that is greater than a certain dollar threshold, (for example, $150,000) and there is a high risk the debt will not be repaid.

The criteria outlined above will ensure that only cases of serious non-compliance are disclosed to the credit reporting agencies. The inclusion of percentage measures and a fixed dollar threshold will allow reporting only when it would be a proportionate response, given the particular taxpayer and the risk their tax debt represents to other businesses. Officials welcome submissions on the criteria, including the appropriate setting of the thresholds and percentages. It is proposed that the significant debt criteria be set out in, and able to be varied by, Order-in-Council.

The Commissioner will be responsible for ensuring the criteria are applied consistently. It is proposed that annual summaries will be published including levels of information that have been shared with credit reporting agencies.

Who will tax debt be disclosed to?

New Zealand has a number of experienced credit reporting agencies. These agencies source credit data and package and provide it either directly to requesting businesses, or to other businesses that provide credit reporting services. The agencies obtain data from a range of sources including private businesses such as banks and other lending institutions, utility and telecommunications providers, and some government agencies including the Ministry of Justice (court fines) and the New Zealand Transport Agency (licence status and demerit point history).

As a result of their experience and access to a wide range of other credit information, the credit reporting agencies are best placed to provide the most comprehensive picture of a business's credit history. They are therefore considered the most appropriate channel through which to disclose tax debt information. As part of the implementation of this proposal, Inland Revenue will work with credit reporting agencies interested in receiving significant tax debt information to ensure they have the capability to deal with the information securely and effectively.

What will be disclosed?

Three categories of information are proposed for disclosure:

- Identity information – this is required to ensure the credit reporting agency can accurately identify a particular taxpayer and ensure any accompanying debt information is attached to the correct taxpayer. This might include information such as the taxpayer's name and address, the business's trading name (if applicable), a company's date of incorporation, and New Zealand Business Number.

- Existence of tax debt – this information could be presented as a yes/no indicator and would include the date the information was provided to show how current it is.

- Information about the tax debt – this could include tax types, the age of the debt and the total amount represented as a band, for example "$150,000-$175,000".

The first two categories of information are essential. However, the third category may not be necessary to make other businesses aware of the existence of significant tax debt. Submitters' views are welcomed on whether additional detail on the amount of tax debt would be beneficial.

Similar to other Inland Revenue information sharing arrangements, a memorandum of understanding will be entered into with each participating credit reporting agency before any information is shared. This will require the agencies to screen Inland Revenue information before it is incorporated into a credit file, to ensure it is matched to the correct file. The credit reporting agencies keep a record of who requests and receives information, and have established processes for updating information. Credit reporting agencies are already required to provide individuals with copies of their own credit information free of charge, upon request.[19]

Privacy implications

Officials have been working with the Office of the Privacy Commissioner to understand the privacy implications of disclosing individuals' personal information held by Inland Revenue to credit reporting agencies, and by credit reporting agencies to members of the business community.

Credit reporting agencies in New Zealand are subject to a code of practice, the Credit Reporting Privacy Code 2004 (the Code). The Code prescribes privacy standards for the industry to follow when dealing with personal information. Officials continue to consult with the Office of the Privacy Commissioner on the interaction of this measure with the Code.

Example 22: Olds Mobile Limited (Olds Mobile) is a transport company that provides transport for retirement villages to take residents on day trips and excursions.

It runs a fleet of ten vans and has 15 employees. Olds Mobile has faced a downturn in bookings over the last few years. This has resulted in the company getting behind on its taxes. Specifically, the company has around $200,000 of GST arrears that is older than 18 months and exceeds 20% of Olds Mobile's gross income.[20]

Despite repeated requests for payment Mr Stutz, the owner of Olds Mobile has not responded to correspondence from Inland Revenue. On 1 August Olds Mobile is issued a final 30 day demand for payment of the outstanding amount. On 31 August Mr Stutz has still not made contact with Inland Revenue regarding payment. On 1 September Inland Revenue provide information regarding Olds Mobile to the credit reporting agencies.

On 2 September La Salle Finance Limited does a credit check on Olds Mobile Limited for a loan of $300,000. It finds that in addition to a number of other debts Olds Mobile has a tax debt of between $200-225,000 which has not been disclosed on its loan documentation. This extra debt indicates that Olds Mobile is insolvent and could not have repaid any loan from La Salle. Credit reporting has assisted La Salle in not making what would have turned out to be a bad loan to Olds Mobile.

Officials welcome submissions on the measure generally, and in particular are interested in submitters' views on:

- The criteria for credit reporting;
- The definition of significant debt; and
- The level of information to be disclosed.

INFORMATION SHARING WITH THE REGISTRAR OF COMPANIES

The Companies Office administers a number of public business registers. In so doing, it oversees some important regulatory requirements which ensure business accountability and responsibility. The Companies Office aims to:[21]

- Promote confidence in the New Zealand business environment by ensuring integrity of registered information;
- Ensure that those who are responsible for fulfilling the statutory duties of registered bodies or individuals comply with those responsibilities; and
- Hold to account those who abuse the privileges of the corporate structure.

The Registrar of Companies (sometimes under various statutory titles such as the Registrar of Friendly Societies or the Registrar of Incorporated Societies) is the statutory officer responsible for establishing and maintaining the various registers, and for taking compliance and enforcement action against those who fail to comply with or breach their statutory obligations.

The Registrar of Companies has the power to collect information in order to administer the Companies Act 1993 (Companies Act),[22] verify compliance and to detect breaches of that Act.[23] Inland Revenue has, on occasion, information that would assist the Registrar of Companies to detect and enforce serious offences under the Companies Act, and assist with the prosecution of these offences. Currently Inland Revenue is unable to share this information and this can mean that non-compliant companies are able to continue to trade and receive a commercial advantage over other compliant businesses. This may cause harm to members of the public, businesses and the New Zealand economy generally when these breaches continue undiscovered for periods of time.

The Government has announced that Inland Revenue will enter into an agreement to provide information to the Registrar of Companies. Inland Revenue will be permitted to share information with the Registrar of Companies where:

- There is reasonable suspicion that a serious offence has been, is being, or will be committed;
- Inland Revenue considers the information 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 agreement will improve the Registrar of Companies' ability to enforce serious offences under the Companies Act and hold non-compliant businesses and directors accountable for breaching their corporate responsibilities. This, in turn, will prevent harm to other businesses and individuals, and promote public confidence in the integrity of New Zealand's business environment.

Improved enforcement of serious Companies Act offences is expected to also provide tax administration benefits. Research undertaken by Inland Revenue into habitual non-compliance has found non-compliance with other government obligations to be a strong predictor of non-compliance with tax obligations.[24] Directors who are seriously non-compliant with their obligations under the Companies Act may also be non-compliant with tax obligations for which they also have responsibility, including the obligations of their company and its employees.

This measure has similar objectives to Inland Revenue's current information sharing agreement with the New Zealand Police, which enables the sharing of information relating to serious criminal offences. It is intended that the principles reflected in that agreement are incorporated as much as possible into the new agreement with the Registrar of Companies.[25]

Offences regarding which information will be shared

Information sharing arrangements between Inland Revenue and enforcement agencies should balance public interest with tax secrecy and, in the case of information about individuals, privacy interests. It is proposed that, as is the case for Inland Revenue's information sharing with the New Zealand Police, information sharing with the Registrar of Companies is limited to "serious offences" with a potential maximum penalty of at least 4 years imprisonment.

Inland Revenue has consulted with the Companies Office regarding the serious offences it would most benefit from receiving information about. As a result of these discussions it is proposed that Inland Revenue shares information about the following:

- *Serious breach of director's duty to act in good faith and in best interests of company.*[26] This offence is intended to prevent directors acting in bad faith and in a way that harms the interests of a company. A director commits this offence by exercising powers or performing duties as director in bad faith toward the company, believing that the conduct is not in the best interests of the company, and knowing that the conduct will cause serious loss to the company;

- *A person authorising or making false statements.*[27] This is intended to prevent directors and other persons from knowingly making statements that are materially false or misleading, or from knowingly omitting material information, with regard to required documents and statements and reports relating to company affairs;

- *Breach of statutory prohibition from managing company.*[28] Prohibition is automatic for a person convicted of an offence in connection with promoting, forming or managing a company or of being convicted of several specified offences.[29] It is a serious offence to breach a statutory prohibition. This offence is intended to prevent prohibited persons from causing further harm to others;

- *Breach of a court order disqualifying a person from managing a company.*[30] Court orders are intended to prevent directors who have failed to comply with relevant legislation, who have committed fraud, or who have previously behaved recklessly or incompetently as a director from promoting or managing a company for the specified period (these can be permanent or for a period up to 10 years);

- *Breach of prohibition by Registrar or Financial Markets Authority (FMA)*[31] *from managing a company.*[32] The Registrar or FMA may prohibit a person from managing a company for up to 10 years. This power may be exercised in respect of directors or persons who took part in management of a failed company, where the Registrar is satisfied that the way in which the company was managed was wholly or partly responsible for its failure;

- *Breach of prohibition by Registrar or FMA from managing a company (additional power).*[33] Such prohibitions are intended to prevent directors of companies that have been removed from the register for failing to confirm or correct information, providing inaccurate information or persistently and seriously failing to comply with the requirements of the Companies Act or Financial Reporting Act 2011 from being a director or promoter of a company for up to 10 years; and

- *Director of failed company being a director of or managing a phoenix company*. This prevents directors of failed companies from going on (without the permission of the court) to participate in the management of a phoenix company, or a company with the same or similar name as the failed company.[34]

The penalty for the above offences is a sentence of up to 5 years' imprisonment or a fine of up to $200,000.[35]

What information will be shared?

Examples of information that Inland Revenue could share include:

- ***Information Inland Revenue holds on a specified person:*** This may include their IRD number, entity information, the taxes for which they are registered, income history, tax payment history (including any compliance issues), types of income, expenses, asset and liability information, and actions taken or planned to be taken in relation to the specified person.

- ***Information Inland Revenue holds on other persons or entities that are associated with, or related to, the specified person:*** This may include information necessary to understand beneficial ownerships or the nature of the structures the specified person is involved with.

- ***Information Inland Revenue holds that is aggregated, derived or inferred that is relevant to the specified person (or associated or related persons):*** This may include judgements about compliance behaviour, and judgements on possible approaches by the specified person to compliance with tax and other legal obligations. Information shared would include documents Inland Revenue may have that would support another agency's enforcement action.

How will information be shared?

Inland Revenue will share information in response to a request from the Registrar of Companies relating to the enforcement of the offences described above. In the case of offences involving breach of a prohibition or disqualification order, Inland Revenue will also be able to share information proactively that it discovers in the course of its day-to-day operations, which would be of interest to the Registrar of Companies in relation to those offences.

In either case, the party initiating the sharing must have reasonable grounds to suspect that one of the specified serious offences has been, is being, or will be committed. The agency sharing or requesting information must also have reasonable grounds to suspect that the information shared or requested is relevant to the prevention, detection or investigation, or is evidence of, the serious offence or non-compliance. Inland Revenue will also need to ensure any information shared is readily available, and that is practicable and in the public interest that the information is provided to the Registrar of Companies.

Information will be transferred on a case-by-case basis (bulk information transfer is not proposed). The provision of information will use existing administrative mechanisms that provide information regarding serious crime to the New Zealand Police and tax information to other jurisdictions under Double Tax Agreements. A central point in each agency will be responsible for dealing with all requests for information.

A memorandum of understanding between the agencies will be required before any information sharing commences. This will outline the process for requesting and providing information, the protections available and requirements regarding security and use of information.

If the information provided by Inland Revenue is subsequently used in a prosecution, at the time criminal disclosure obligations are triggered, the alleged offender must be informed that information was provided by Inland Revenue. This would enable the affected taxpayer (the alleged offender) to challenge the decision to release the information if they wish. At this point the Court may consider the evidence is inadmissible, either due to a problem with the release of the information or on other Evidence Act 2006 grounds (as is standard in the existing criminal disclosure and evidence admissibility processes).

This approach would have three benefits:

- Preserving the affected person's privacy interests and rights under section 21 of the New Zealand Bill of Rights Act 1990;
- Ensuring there is judicial scrutiny when the information provided is used, but not burdening the judiciary with every information request or provision; and
- Providing a mechanism to ensure that decisions to release information are robust and appropriate by allowing for decisions to be reviewed.

In addition, should an individual have concerns about how their information has been treated they will be able to either use the internal complaint procedures of Inland Revenue and/ or the Companies Office or seek assistance from the Office of the Privacy Commissioner.

[19] Rule 6, Credit Reporting Privacy Code 2004.

[20] The 18 months and 20% of gross income are used for illustrative purposes only and do not form part of the proposals. These are still to be determined.

[21] Companies Office enforcement policy guidelines, 1 July 2013 - https://www.business.govt.nz/companies/about-us/enforcement/policy-guidelines.

[22] The sections referred to in the remainder of this chapter relate to the Companies Act unless otherwise stated.

[23] Section 365.

[24] Habitual Non Complier Tier 1 Analysis, Inland Revenue 2012.

[25] While the current agreement with Police is an Approved Information Sharing Agreement (AISA) under part 9A of the Privacy Act, it is not intended that this will be the case for the agreement with the Registrar of Companies. Tax secret information about a company cannot currently be shared under an AISA.

[26] Section 138A.

[27] Section 377.

[28] Section 382.

[29] Sections 377-380 and dishonesty offences contained in the Crimes Act 1961.

[30] Section 383.

[31] Information sharing with the Financial Markets Authority is not currently proposed; however further extensions of serious offence information sharing with other enforcement agencies will likely be considered following the introduction of this measure.

[32] Section 385.

[33] Section 385A.

[34] Section 386A.

[35] See section 373(4) and the sections referred to therein.

CHAPTER 7

MAKING THE SYSTEM SIMPLER

The Government has announced a number of proposals to simplify the tax rules for businesses to allow them to spend less time on tax compliance and more time on running their business.

The measures outlined in this chapter comprise:

- Fringe benefit tax (FBT) simplification for close companies;
- Increasing the threshold for self-correction of minor errors;
- Simplified calculation of deductions for dual use vehicles and premises;
- Removing the requirement to renew resident withholding tax exemption certificates annually;
- Increasing the threshold for annual FBT returns from $500,000 to $1 million of PAYE/ESCT; and
- Modifying the 63 day rule on employee remuneration.

FRINGE BENEFIT TAX CALCULATION FOR CLOSE COMPANIES

Close companies that provide their shareholder-employees with a motor vehicle for private use are required to register and pay FBT on that benefit, with some exemptions. On the other hand, sole-traders and partners of a partnership who use a motor vehicle as part of their business are not required to register and pay FBT on that motor vehicle. Rather, they apportion expenditure incurred in relation to that vehicle between business and private use.[36] The amounts relating to private use are not deductible for tax purposes.

This differing treatment for similar businesses arises purely because of the type of entity the business has chosen to trade through.

Close companies are required to calculate the availability of a vehicle for private use to work out the amount of FBT to pay. Often this is calculated on an annual basis as these taxpayers pay FBT annually. This creates an additional compliance burden when they are providing a single fringe benefit, when compared to similar businesses being run as a partnership or a sole trader.

The Government has announced that it will align the treatment of motor vehicles for these particular types of entities. This will remove the compliance costs incurred by a close company having to register for and pay FBT for no other reason than the provision of a motor vehicle to one or two shareholder-employees.

The rules for motor vehicle expenditure contained in subpart DE for sole traders and partnerships will be extended to apply to close companies. This will be optional as there may be some close companies that are comfortable with the current treatment.

There are three methods for apportioning business and private use:[37]

- Actual records - showing the reason and distance travelled for all business purposes;
- Logbook records – maintained for a test period of at least 90 days to establish the extent of business use. This can then provide the basis for determining the business use of the motor vehicle for a three year period; or
- Mileage rates – this method can only be used for less than 5,000 km of business travel - the actual business mileage is used multiplied by Inland Revenue mileage rates.[38]

Taxpayers who use this option will no longer have to file and pay FBT on the single benefit they provide to their shareholder-employees. Instead they can use one of these methods to claim motor vehicle expenditure.

For the avoidance of doubt, the private non-deductible portion of the expenditure will not be treated as a deemed dividend to the shareholder-employee.

It is proposed that the option would be available to close companies who qualify for the close company option in the FBT rules[39] on the basis that the only fringe benefit they provide is the availability of 1 or 2 motor vehicles for the private use of their shareholder-employees. These taxpayers will have a choice on how to account for the private use of a motor vehicle provided to a shareholder-employee.

One consideration for taxpayers is that in some circumstances there could be some GST adjustments required to reflect the change in how private use of the motor vehicle is calculated. These GST adjustments don't currently arise for close companies under the FBT regime as GST is accounted for on the value of the benefit for FBT purposes.

In addition, further calculations will be required when the vehicle is disposed of to reflect the private element of any gain or loss made.

Example 23: Mary is the controlling shareholder of Percyville Books Ltd which has a 31 March balance date. She is the only employee of her company. The company provides Mary with a vehicle for both business and unlimited private use. During the 2017 income year Mary's business use of the vehicle was 40% of the running. The total costs relating to the vehicle for the year were $3,250. The cost price of the vehicle was $20,000.

The company will have the choice of paying FBT on the availability for private use of the vehicle using the cost price of the vehicle as a basis and multiplying by 20% to get the value of the fringe benefit ($4,000) and pay FBT of $1,970.

Alternatively, Mary could use the actual business use of the vehicle to apportion the costs related to the vehicle using the actual use records from a logbook she maintains fastidiously. This would result in the business not claiming 60% of the total running costs of $3,250 (i.e. $1,950).

In addition, there will be differing adjustments required for GST purposes under each method.

Whilst in this example the option of measuring actual business use results in a deduction amount slightly less than the FBT amount to be paid, it does provide a more accurate measure of the business and private cost of the vehicle. It also aligns the treatment with other similar taxpayers who are not structured as a company.

There is a question as to whether making this proposal optional provides an opportunity for taxpayers to cherry pick methods to pay the least amount year-by-year. Officials propose restricting the ability for taxpayers to do this if the proposal remains optional. Officials are interested in submissions on how changing methods could be restricted and also whether this proposal should be compulsory for close companies that meet the criteria.

In addition, given the requirement to make adjustments for GST based on changes in actual use and when the motor vehicle is disposed of, officials consider the compliance cost savings of this proposal may be marginal. Officials would be interested in submitters' views on this.

INCREASING THE THRESHOLD FOR SELF-CORRECTION OF MINOR ERRORS

Section 113A of the Tax Administration Act 1994 permits a person to correct an error in a return in the subsequent return where:

- The return contains one or more errors for income tax, FBT or GST; and
- The error was caused by a clear mistake, simple oversight or mistaken understanding by the person; and
- The total discrepancy is $500 or less.

If the error results in more than a $500 tax difference, then the taxpayer must ask the Commissioner to correct the error either through a voluntary disclosure or an application to amend the assessment under section 113 of the Tax Administration Act 1994. Interest and penalties may be payable on a shortfall corrected by the Commissioner.

The Government has announced that the self-correction threshold will increase from $500 to $1,000 of tax. This will allow taxpayers to correct simple errors of up to $1,000 (tax effect) in their next return.

The proposal will remove the compliance costs of having to apply to the Commissioner for relatively small amounts, and help ensure that interest and penalties do not discourage voluntary disclosure.

The $1,000 limit represents a maximum adjustment of income or deductions of $3,571 for a company, $3,030 for an individual and $7,667 for GST. These are relatively low values, particularly for larger businesses. Consequently, while the higher threshold will apply to all taxpayers, it will likely be of greatest benefit to small and medium businesses.

Example 24: Starliner Limited (Starliner) produces drawer liners with celebrity pictures. Ms Studebaker owns Starliner and does all the tax filing for the company. In March she realises that she omitted to include taxable supplies of $5,000 (incl. GST) on her February GST return, because she miscoded it to a liability account in her accounting system.

This resulted in shortfall of GST of $652.17. Previously Ms Studebaker would have had to file a voluntary disclosure or section 113 application to amend Starliner's February GST return. Now she is able to self-correct this error in Starliner's March GST return without the worry of interest or penalties, and it saves her time by not having to contact Inland Revenue.

It is possible that taxpayers are already self-correcting these errors without making an application to the Commissioner. While changing the threshold may not have much immediate impact, it will provide more certainty to taxpayers.

Consideration has been given to whether the self-correction threshold should be a percentage of the taxpayer's tax or turnover rather than a flat amount. A percentage would result in a proportionate scale of self-correction (that is, the larger the business the larger the self-correction could be). However, this could allow large taxpayers to make significant corrections by dollar value, without review by Inland Revenue. For example, a taxpayer with a $50 million tax liability could make a $1 million adjustment if the threshold for self-correction was set at 2%. This represents $3.57 million of income or $7.67 million for GST. These are significant amounts, and for this reason a percentage threshold was not considered to be appropriate.

SIMPLIFIED CALCULATION OF DEDUCTIONS FOR DUAL USE VEHICLES AND PREMISES

Small business owners often use their personal vehicles and homes for both business and private purposes. Because there are numerous expenses for these items, allocating them between business and personal use can create a large compliance obligation compared to the amount of tax at stake.

In an effort to simplify the calculation of deductions and reduce compliance costs of calculating deductions for dual use home premises and vehicles, the Government has announced that taxpayers can use standard values rather than calculating actual costs. This proposal will generally only apply to small enterprises, as there is typically no private use of a larger enterprise's assets.

Vehicles

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

Under this proposal, 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;
- 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;
- Be divided into two 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 (as the fixed costs of vehicle ownership would be over-deducted as usage increased if a single fixed rate was used); and
- Be published by Inland Revenue and updated each year to ensure they are accurate.

Taxpayers would keep a logbook for a three month representative test period to determine the vehicle's proportion of business use for the next three years. Alternatively the taxpayer could elect to maintain a logbook for the entire year and record the actual distance travelled for business purposes.

The method would be optional to provide compliance cost savings for those who wish to use it. This is because there is a wide variance in the actual costs of car ownership, so a single rate would not be acceptably accurate for many taxpayers.

A more accurate compulsory method could be considered, but this would potentially erode the compliance cost savings.

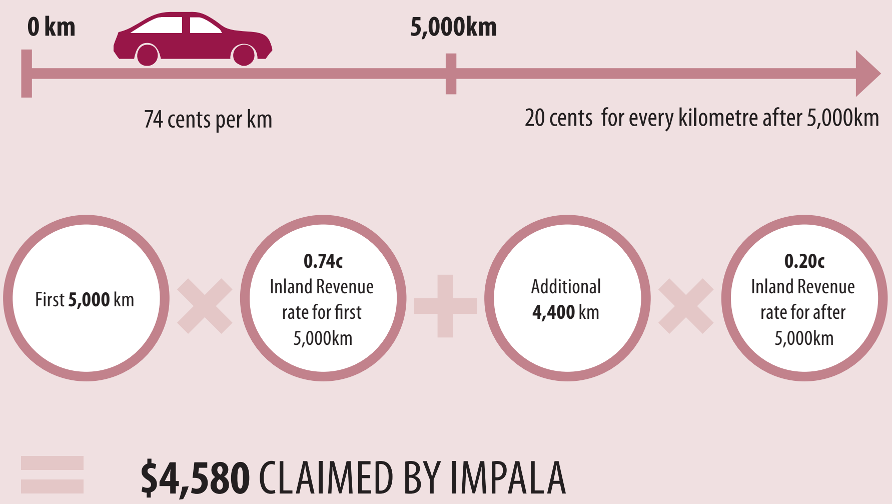
A disadvantage of making the method optional is that some taxpayers will calculate their deductions under both options and claim whichever results in the greater amount. However, an optional method will still provide compliance cost savings for those who wish to use it. A taxpayer would, however, be prevented from changing methods for a particular vehicle to reduce their ability to game the methods on the same vehicle.

Example 25: Impala Limited (Impala) sells highly detailed model cars to collectors. As part of its business the owner of Impala, Chev Rolet, uses his personal car to deliver the models to various model shops around the city and also to the post office to send the models both within New Zealand and to international markets.

At the end of each year Chev has traditionally tried to work out the total running costs of the vehicle, which means he has had to keep private receipts, for petrol, insurance, maintenance etc. In addition, he has had to keep a logbook to determine his business versus private running of the vehicle.

Chev is keen to reduce the time it takes him to calculate the deduction for his vehicle and so begins using the new reimbursement rates set by Inland Revenue. The rates that Inland Revenue has calculated[40] *are 74 cents per km for the first 5,000km and 20 cents for every km thereafter. Chev has kept a logbook for the first three months of the year which results in a ratio of business to total kilometres of 47%. Over the entire year Chev has driven 20,000km of which 9,400km (20,000 x 47%) have therefore been business related.*

Impala therefore claims $4,580 (5,000 x 74 cents + 4,400 x 20 cents) in its tax return for motor vehicle expenses which it, in turn, reimburses to Chev.



Home premises

It is proposed that the deduction for business use of home premises be calculated by multiplying the number of square metres used primarily for business purposes by a single rate. The rate would be:

- Set by an Inland Revenue determination, based on the average cost of items such as utilities per square metre, but excluding rental or rates and mortgage interest costs;
- Updated each year to ensure it is not eroded by inflation;
- Different depending on whether the taxpayer owned or rented their premises; and
- Reasonably accurate for most taxpayers, as there is less variance in the cost of utilities etc. per square metre than there is for vehicle costs.

Taxpayers would also be able to claim a deduction for their actual mortgage interest, rates or rental costs, based on the percentage of the premises used primarily for business purposes. Officials consider there is too much variability in these costs for them to be included in a single representative rate.

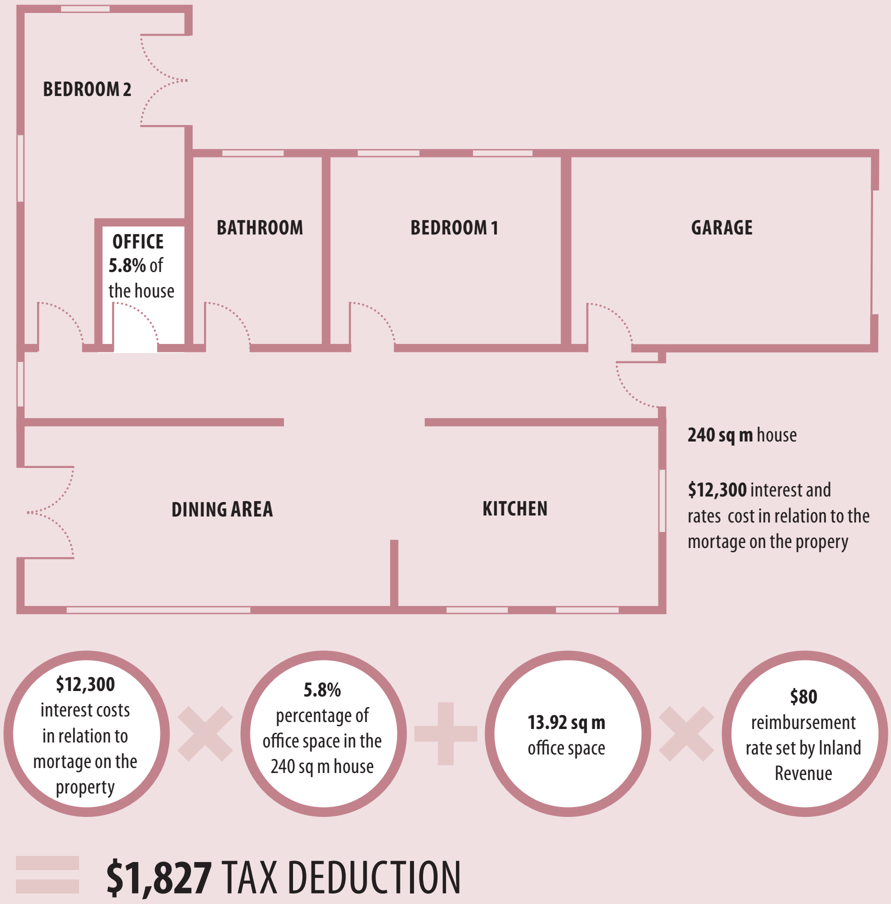
The method will be optional. While the method should produce a fairly accurate measure for most taxpayers, some taxpayers will be entitled to smaller deductions under the method than their actual costs. Such taxpayers may consequently regard a compulsory measure as a cap on their deductions rather than 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 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.

Officials recommend only allowing a deduction for rent, rates and mortgage interest under this method where there is a separately identifiable part of the house which is primarily used for business purposes. This is because a house is used primarily for domestic purposes, so some threshold of business use should be required before the house can be regarded as used for dual purposes. It is also more difficult to apportion expenses where no identifiable part of the house is used for business purposes. Currently this is not a strict requirement, although apportionment is usually made on this basis. Submitters' views on this point are welcomed.

Example 26: Adventurer Limited (Adventurer) arranges adventure tourism activities in New Zealand for foreign tourists. George De Soto owns the company with his wife Flo and because of the timing of phone and video conference calls with foreign tour operators they have set up an office at home that is totally dedicated to the business.

Flo does all the tax compliance for Adventurer and finds it takes a significant amount of time to calculate the deduction that relates to the home office. She has to work out the costs of electricity and other utilities to get to a final figure to claim in Adventurer's tax return. Flo is keen to use the Inland Revenue rates instead to save her the hassle of doing this each year.

She has worked out that the office space is 5.8% of the total floor area of 240 square metres of the house. She also knows that her interest and rates costs in relation to the mortgage on the property are $12,300. Inland Revenue has published the rate[41] that can be reimbursed in relation to a home office being $80 per square metre. Flo has calculated that the office takes up 13.92 square metres so takes a deduction in the tax return of Adventurer for $1,827 ($12,300 x 5.8% + 13.92 x $80). This calculation takes Flo a fraction of the time it used to take and works out to approximately the same amount.



REMOVING THE REQUIREMENT TO RENEW RESIDENT WITHHOLDING TAX EXEMPTION CERTIFICATES ANNUALLY

Some taxpayers who hold a certificate of exemption from resident withholding tax (RWT) must renew their certificate annually. This is an Inland Revenue, rather than, a legislative requirement. Annual renewal is currently required 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 actual annual gross income over $2 million in the prior year) do not require annual renewal.

Taxpayers have indicated that this is creating compliance costs for relatively little value to the overall system. The Government wishes to reduce these compliance and administrative costs by legislatively requiring RWT exemption certificates to be issued for an unlimited period. This 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.

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

There is a concern that as renewal is not required, Inland Revenue may be unaware that a taxpayer might no longer be eligible for a RWT certificate. Officials 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.

Example 27: Rambler Limited (Rambler) is owned by Bob Nash and arranges self-guided hiking trips. Rambler has not been doing well in the last few years due to people using phone apps to find their way on hikes rather than using the services of Rambler. Bob has created his own app that he hopes will turn the business around in the next five years. Until then Bob is keen for Rambler to obtain a certificate of exemption from RWT to get the funds back into Rambler. He applies for a certificate of exemption from RWT on the basis of the company being in tax losses. The Commissioner issues the exemption certificate to Rambler.

At the end of the year when filing its tax return Bob ticks the box which states that Rambler still meets the criteria to hold the certificate of exemption as it continues to be in a loss position.

Five years later, however, Rambler's business has turned around and it is no longer in a tax loss position. At that point Bob returns the certificate of exemption to Inland Revenue as Rambler no longer meets the requirements to hold the certificate.

INCREASING 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 with 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.[42]

Where a smaller business becomes larger and employs more staff, it may exceed the $500,000 threshold and 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 and can act as a disincentive to employing extra staff.

The Government has announced an increase to this threshold which will allow a business with combined PAYE and ESCT of between $500,000 and $1m to continue accounting for FBT annually rather than changing to quarterly filing. This is intended to simplify compliance obligations for these businesses and lower their compliance costs.

It is estimated this change will benefit approximately 1,500 taxpayers who currently fall between the current and proposed thresholds and who file FBT returns.

Example 28: Eldorado Limited (Eldorado) is owned by Mr and Mrs Brougham and is a manufacturer of tacos. Because of the high quality of their tacos they are in demand and Eldorado needs more staff. They currently have 20 staff and have combined PAYE and ESCT obligations of $450,000 but need to double their employee count to 40. This will result in PAYE and ESCT obligations of $900,000.

Eldorado provides fringe benefits to staff including medical and life insurance and unlimited supplies of taco seconds. The Broughams undertake the tax compliance work for the business with the assistance of a local accounting firm Cady Limited. They are not looking forward to having to prepare FBT returns quarterly and the costs of having Cady Limited review and file the returns for them. They also do not want to stop providing fringe benefits to staff as they are well received.

Under the proposed change in the threshold for annual filing, Eldorado would not have to increase the frequency of filing until they tipped over the $1m threshold of combined PAYE and ESCT saving them both time and money they can instead devote to making tacos.

MODIFYING THE 63 DAY RULE ON EMPLOYEE REMUNERATION

Section EA 4 of the Income Tax Act 2007 contains rules regarding the deferral of deductions for employee remuneration. This rule is commonly referred to as the "63 day adjustment" or "63 day rule". The 63 day adjustment overrides the ordinary "incurred" test for deductibility. The rule provides that a deduction for accrued employee remuneration can be claimed in the year it is incurred only if the remuneration is paid by the end of the 63rd day[43] after the end of that income year. Employee remuneration covers all types of payments of employment income including salaries and wages, retirement leave, holiday pay and bonuses.

The 63 day adjustment is intended to prevent taxpayers from claiming deductions for amounts of employee remuneration that have been accrued but not paid. It was introduced to specifically target deferred payment bonus schemes where employers were claiming large deductions for deferred bonus payments to staff and yet never paying those bonuses. This change is not intended to alter this fundamental principle.

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 items accrued at the end of the previous income year. This can create 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.

The current wording of the provision essentially imposes this compliance obligation on the taxpayer as they do not have a choice as to whether to take a deduction or defer this to the following income year.

The Government has announced it intends altering this rule to make the deduction for payments made within 63 days of the income year optional for taxpayers. For those taxpayers that do not wish to undertake the exercise, it would not be required and the deduction for those payments can be claimed in the following year.

Example 29: Skylark Limited (Skylark) is an airline that provides international passenger and freight services. It has a large workforce that comprises approximately 7,000 employees. At 30 June 2017, the end of Skylark's income year, it has accrued employee remuneration of $58m, including accrued holiday pay of $12,000 for Bob Buick, representing 15 days annual leave.

At the end of the 63 day period (2 Sept 2017) the tax manager at Skylark asks the payroll team to calculate the 63 day rule adjustment for the company. The payroll clerks have to determine the amount of employee remuneration that was accrued at year end but paid out within the 63 days. Bob was lucky enough to be able to have a holiday to the United States to visit the extended Buick family.

He made the 13 hour flight worth it by taking 18 days annual leave from 5-31 August.

The payroll clerk has to match Bob's 18 days of leave taken against his accrual at year end of 15 days and determine that for Bob, Skylark can only deduct $12,000 as the remaining 3 days leave was accrued after year end. The payroll clerk has to also do this for the 6,999 other employees.

At the end of the exercise, because the month of August is not a popular time for people to take leave from Skylark, Skylark claims $250,000 as a deduction for employee remuneration accrued at year end and paid within 63 days. This results in a reduction in Skylark's residual income tax of $70,000, however it cost Skylark $30,000 to calculate.

Skylark decides that it will no longer undertake the 63 day rule calculation and instead will align the deductions with the payments made during the year to save the compliance costs of calculating the deduction.

For some taxpayers this will result in a simpler rule than the current 63 day rule deducting payments of employee remuneration incurred and paid up to the end of the income year. The proposed change will not affect those who wish to continue to undertake the work to determine the deduction based on the existing rule as the existing rule will be optional.

The current provision in section EA 4 will be modified to allow taxpayers to choose whether to apply the 63 day rule or not. Officials are interested in submitters' views on the legislative aspects of this proposal.

[36] In accordance with the rules in subpart DE of the Income Tax Act 2007.

[37] See subpart DE 3 of the Income Tax Act 2007.

[38] See page 72 for proposed changes to this method.

[39] See subpart RD 60 of the Income Tax 2007.

[40] These rates are used for illustrative purposes only and do not represent actual or proposed rates.

[41] Again this rate is for illustrative purposes only. It does not represent proposed or recommended rates.

[42] Sections RD 60 and RD 61 of the Income Tax Act 2007.

[43] This period is extended for shareholder-employee situations with extensions to file their tax returns.