Taxation (Business Tax, Exchange of Information, and Remedial Matters) Bill

Bill Number 149-1

Regulatory Impact Statements

Prepared by Policy and Strategy, Inland Revenue

August 2016

Regulatory Impact Statement

Amendments to tax disclosure rules for New Zealand foreign trusts

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It provides an analysis of options to address concerns that New Zealand foreign trusts may be vulnerable to misuse for avoidance or evasion of foreign tax, or for money laundering and other criminal purposes.

The analysis in this RIS was informed by the Government Inquiry into Foreign Trust Disclosure Rules (the Inquiry) which undertook an extensive independent review of the policy and operation of the foreign trust rules.

It should be noted that the Inquiry also recommended changes to the anti-money laundering (AML) requirements. These AML amendments are currently being considered by the Ministry of Justice, alongside work currently underway to bring in Phase II of the AML regime. If these AML proposals are accepted, a RIS for them will be completed as part of the Phase II policy proposals.

To ensure that amendments recommended by the Inquiry and accepted by the Government could be implemented in line with the application time frames recommended by the Inquiry, and to provide for the amendments to be considered by select committee, this RIS was prepared under time constraints.

We have consulted with other relevant government agencies, but not more widely, on the proposals. However, it is noted that as part of its review, the Inquiry invited submissions from the public and received 23 submissions.

The policy option recommended would impose additional costs on New Zealand resident trustees of foreign trusts. However it is considered that as they will reduce the potential for misuse of foreign trusts, these additional costs are justified. None of the policy options would impair private property rights, restrict market competition, reduce the incentives for business to innovate and invest, or override fundamental common law principles.

Carmel Peters
Policy Manager, Policy and Strategy
Inland Revenue

5 July 2016

STATUS QUO AND PROBLEM DEFINITION

Policy and law concerning the taxation of trusts

1. New Zealand tax law distinguishes between different types of trusts. Foreign trusts are trusts with no New Zealand resident settlor (the person who settles assets on the trust)

2. New Zealand's rules for taxing trusts were introduced in 1988, as part of a wider package of international tax reforms. Most countries tax trusts on the basis of the residence of the trustee (which was New Zealand's previous approach). However, from 1988, New Zealand's rules for the taxation of trusts have been based on the residence of the settlor, not the residence of the trustees. That is, New Zealand taxes a trust on its worldwide income if the settlor is a New Zealand resident – regardless of the residence of the trustees.

3. The general idea behind this approach is that even though the trustees have legal ownership of the assets, the settlor is really the economic "power behind the throne" because they set up the trust by transferring the assets to the trust and appointing the trustees. Taxation based on the settlor's residence makes it difficult for New Zealand residents to avoid tax by holding their assets through overseas trustees.

4. From this starting point, it naturally follows that a trust with a foreign settlor is a foreign trust even when the trustees are resident in New Zealand. A foreign trust that derives foreign sourced income will not be taxed in New Zealand on that income (assuming no New Zealand resident beneficiaries).

5. There is now a foreign trust industry in New Zealand as a result of non-resident settlors being able to accumulate assets and income in a foreign trust with no New Zealand tax. New Zealand advisors (and their overseas agents) help foreigners establish and manage foreign trusts for a fee. Foreign trusts with New Zealand trustees are marketed on the basis of New Zealand's settlor-based tax rules, and stable regulatory environment based on common law.

Current tax disclosure and record-keeping requirements

6. Since 2006, foreign trusts which have a New Zealand resident trustee have been required by the Tax Administration Act 1994 (TAA) to disclose certain information to the Commissioner of Inland Revenue upon establishment. There is currently no formal registration process or register for foreign trusts.

7. The information that is required to be disclosed upon establishment is the name or identifying particulars of the foreign trust, the name of a New Zealand trustee, and whether there is an Australian settlor.

8. New Zealand resident trustees of foreign trusts are also required to keep certain records in relation to the foreign trust, including the trust deed, and (if they are known) the names and addresses of settlors who make a settlement on the trust and beneficiaries who receive a distribution.

9. These records must be provided to Inland Revenue on request. If the information provided upon initial disclosure has changed, the New Zealand resident trustee of a foreign trusts must update the information, but annual filing with Inland Revenue is not otherwise required.

Sanctions for non-compliance

10. Under current law, an intentional breach of a requirement to supply information to Inland Revenue can result in a fine of up to $50,000 and imprisonment for up to 5 years.

11. As noted above, foreign trusts are not taxable in New Zealand if they earn no New Zealand sourced income. However, the current rules provide that if a foreign trust does not have a qualifying resident foreign trustee for an income year and information requested by Inland Revenue is not provided, then if a conviction occurs the foreign trust will be subject to New Zealand tax on its worldwide income. A foreign trust will have a qualifying resident foreign trustee if one of its trustees is a member of a specified professional body (such as the New Zealand Law Society or Chartered Accountants Australia and New Zealand).

12. This means that where a trustee of a foreign trust is convicted of intentionally not providing information to Inland Revenue in relation to that foreign trust, the foreign trust will not be subject to New Zealand tax as long as one of its trustees is a New Zealand lawyer or chartered accountant.

Audit activity and information sharing

13. Inland Revenue currently performs some audit activity in relation to foreign trusts. A key reason for these audits is to ensure that the trusts do not in fact have New Zealand settlors (as if they do have a New Zealand settlor the trust is taxable in New Zealand on its worldwide income), and that the record-keeping requirements of the TAA are complied with.

14. Where Inland Revenue finds information that is of interest to other authorities (overseas tax authorities or domestic law enforcement agencies) in the course of these audits, Inland Revenue will pass this information on where authorised.

15. Inland Revenue shares information about foreign trusts with overseas tax authorities with whom New Zealand has a treaty which has tax information exchange provisions. This information is shared upon request from the overseas tax authority or where Inland Revenue considers that the information may be of interest to that tax authority. Where the settlor of a foreign trust is Australian, Inland Revenue provides this information automatically to the Australian Taxation Office.

16. The circumstances in which Inland Revenue shares information about foreign trusts with domestic law enforcement agencies are relatively limited (for example, information can be shared if it concerns individuals or if it is requested by Police and it relates to serious crime).

Problem definition and recent developments

17. Concerns have been raised that the existing disclosure and record-keeping requirements in relation to foreign trusts are insufficient – particularly in light of expanding obligations to exchange information with our treaty partners. These concerns may have the potential to impact on New Zealand's international reputation.

18. In particular, in April 2016, information about the "Panama Papers" was released by the International Consortium of Investigative Journalists. The Panama Papers comprise approximately 11.5 million confidential documents of a Panama based law and trust services firm, Mossack Fonseca. The documents, which are said to date back as far as the 1970s, were

obtained in early 2015. Allegations reported in the media include tax evasion, money laundering, and other illicit activities.

19. References in the Panama Papers to New Zealand foreign trusts and, in particular, allegations that New Zealand foreign trusts may be used in structures which are established to hide assets and evade or avoid foreign tax, added to the above concerns.

Government Inquiry into Foreign Trust Disclosure Rules

20. The Government commissioned an Inquiry (the Government Inquiry into Foreign Trust Disclosure Rules) into whether New Zealand's foreign trust disclosure rules and their enforcement are sufficient to ensure New Zealand's reputation is maintained. The terms of the Inquiry can be found at Appendix 1.

21. The Inquiry conducted an extensive review of the disclosure rules relevant to foreign trusts. The Inquiry reported to the Ministers of Finance and Revenue on 20 June 2016. This report can be found at Appendix 2.

22. The Foreign Trust Inquiry made a number of recommendations. These fell into three broad categories:

- Registration and increased disclosure recommendations that would be administered by Inland Revenue.

- Anti-money laundering (AML) law and implementation recommendations.

- Increased information sharing between New Zealand government agencies about foreign trusts for enforcement purposes.

23. It should be noted that the Inquiry also recommended changes to the AML requirements. These AML amendments are currently being considered by the Ministry of Justice, alongside work currently underway to bring in Phase II of the AML regime. If these AML proposals are accepted, a RIS for them will be completed as part of the Phase II policy proposals. For this reason the options considered in this RIS do not attempt to address the AML concerns raised in the Inquiry.

24. We note that other options were considered by the Inquiry. These options included extending Automatic Exchange of Information (AEOI) obligations to foreign trusts, and having a public register for trusts. All these options were rejected by the Inquiry. We have considered the Inquiry's recommendations on these options and we agree with the conclusions for the reasons given by the Inquiry.

Scale of the problem

25. There are about 12,000 foreign trusts with a New Zealand resident trustee that have been disclosed to Inland Revenue.

26. In 2014, it was estimated that the value of the fees collected in respect of foreign trusts, plus employment income for third party employees and principals for each foreign trust provider entity, amounts to approximately $24 million per annum, on average. This figure

has been calculated from Inland Revenue data. (Other reported estimates of fee income resulting from the industry range from $20 million[1] to $50 million[2] per annum.)

27. The contribution to the New Zealand tax take, in terms of income tax on fee income, goods and services tax, and PAYE paid on behalf of third party employees and principals for each foreign trust provider entity, is around $3 million per annum, on average. This figure has been calculated from Inland Revenue data.

OBJECTIVES

28. The **main objective** is to reduce the potential for misuse of foreign trusts in New Zealand (both actual and perceived)[3] in respect of foreign tax avoidance or evasion.

29. The Inquiry also proposed changes to reduce the potential for foreign trusts to be used for money laundering and other illicit purposes. Reducing the potential for foreign trusts to be used for money laundering and other illicit purposes is not an objective against which the options considered in this RIS are assessed. However, the Inquiry considered that increased disclosure requirements would be likely to partially address this issue. It should be noted that the Inquiry also recommended changes to the AML requirements. These AML amendments are currently being considered by the Ministry of Justice, alongside work currently underway to bring in Phase II of the AML regime. If these AML proposals are accepted, a regulatory impact statement for them will be completed as part of the Phase II policy proposals.

30. All the options are assessed against the status quo in relation to the main objective and the following criteria:

(a) **Maintaining New Zealand's reputation as a leader in best practice of international exchange of information** – Ensuring that New Zealand is able to maintain its reputation as a leader in best practice of international exchange of information, particularly in light of the recent expansion of international obligations (in terms of number of treaty partners, the amount of information, and frequency of exchange).

(b) **Maintaining an open economy** – The options should ensure that New Zealand maintains an open economy which welcomes an active financial services sector.

(c) **Fairness and integrity** (including perceptions of fairness and integrity) – The options should ensure that the law is seen as treating people fairly and consistently and should not allow people to avoid their tax obligations (including any foreign tax obligations).

---

1 IFSDG, "Exporting Financial Services: A Report from the International Funds Services Development Group" (IFSDG, 2011) at 47. Cabinet established the IFSDG in March 2010 to look at financial services opportunities for New Zealand. The estimate is said to be from industry sources in 2009.

2 Refer to www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10844389.

3 The Inquiry noted that while it did not find any direct evidence of misuse, it is reasonable to conclude that there are cases where foreign trusts are being used in this way.

(d) **Coherency of the tax system** – The options should be consistent with other fundamental principles of the tax system.

(e) **Efficiency of compliance and administration –** The options should, to the extent possible, minimise compliance costs for foreign trusts and administrative costs for Inland Revenue.

31. In this context, we consider that more weight should be given to criteria (a), (c) and (d). For example, where there is a conflict between maintaining New Zealand's reputation and minimising compliance and administrative costs, there should be relatively more weight attached to maintaining New Zealand's reputation.

REGULATORY IMPACT ANALYSIS

32. Three options have been considered in this RIS:

Option 1: Retain the status quo
Option 2: Implement the changes recommended by the Inquiry that relate to registration, increased disclosure, and increased information sharing with some refinements *(Inland Revenue's recommended option).*
Option 3: Repeal the tax exemption for foreign trusts.

Option 1

33. Option 1 is to retain the status quo.

Assessment against objective and criteria – option 1

Main objective

34. The status quo does not meet the objective of reducing the potential for perceived misuse of foreign trusts in New Zealand in respect of foreign tax avoidance or evasion.

Maintaining New Zealand's reputation as a leader in best practice of international exchange of information

35. Although New Zealand's current disclosure requirements are sufficient to meet the existing obligations for exchanging tax information under treaties, given the recent international movements towards increased information sharing between tax jurisdictions, in the current environment these rules may not be sufficient to maintain New Zealand's reputation as a leader in best practice of international exchange of information.

Maintaining an open economy

36. The status quo is consistent with maintaining an open economy which welcomes an active financial services sector, where those activities are legitimate.

Fairness and integrity

37. Perceived or actual misuse of foreign trusts in New Zealand in order to avoid tax obligations in other jurisdictions could impact negatively on fairness and integrity.

Coherency of the tax system

38. The impact on coherency of the tax system is mixed. The tax exemption for foreign trusts is consistent with New Zealand's framework for taxing trusts. However, the disclosure requirements for foreign trusts seem insufficient in light of recent international trends.

Efficiency of compliance and administration

39. The compliance costs for foreign trusts under current rules are very low.

40. In terms of administrative costs, there are currently some costs for data entry and the exchange of information. Inland Revenue also runs an audit project on foreign trust providers.

Option 2

41. This option would implement a package of changes relating to registration, increased disclosure, and information sharing. This package essentially follows the Inquiry's recommendations, with some minor modifications as indicated. The Inquiry's recommendations are contained in Appendix 1.

Registration and initial disclosure

42. Under option 2 the current disclosure process would be formalised as a registration process. The resident trustee of the trust would be required to declare that the person establishing the foreign trust, the settlor(s) and the trustees have been advised of, and have agreed to provide the information to comply with, the applicable record-keeping requirements in the TAA, the Anti-Money Laundering and Countering Financing of Terrorism Act and Regulations, and the Automatic Exchange of Information (AEOI) requirements (once enacted).

43. To ensure that sufficient information is provided to Inland Revenue, more information would be required to be disclosed upon establishment of the trust, and in particular, the name, email address, foreign residential address, country of tax residence and Tax Identification Number of:

i. the settlor or settlors
ii. the protector (if there is any)
iii. non-resident trustees
iv. any other natural person who has effective control of the trust (including through a chain of control or ownership)
v. beneficiaries of fixed trusts, including the underlying beneficiary where a named beneficiary is a nominee.

44. In addition to the above disclosure, the trust deed would also be required to be filed with the registration form, and, in the case of discretionary trusts[4], any class of beneficiary not listed in the trust deed should be described on the registration form.

[4] A discretionary trust is a trust where the beneficiaries have no fixed entitlement to distributions from the trust.

On-going disclosure requirements

45. There would also be on-going disclosure requirements under option 2. Foreign trusts would be required to file an annual return with Inland Revenue that includes any changes to the information provided at registration, the trust's annual financial statement, and the amount of any distributions paid or credited and the names, foreign address, Tax Identification Number and country of tax residence of the recipient beneficiaries.

46. Inland Revenue considers that, as part of option 2, the annual return should include the amount of any settlements on the trust in the relevant period and the names, foreign address, Tax Identification Number and country of tax residence of that settlor. This information is currently required to be kept as part of the existing record keeping requirements. It would be more useful if this information was directly provided to Inland Revenue.

When a trust qualifies for the tax exemption

47. The exemption from New Zealand tax on foreign-sourced income should apply only to a foreign trust with a resident trustee that has registered and fulfilled the associated disclosure obligations at that time.

48. The Inquiry also recommended that the qualifying resident trustee safe harbour should be reviewed. Inland Revenue considers that, as part of option 2, the qualifying resident trustee safe harbour should be removed.

49. The qualifying resident trustee safe harbour was introduced in 2006, as part of amendments which introduced the current disclosure requirements for foreign trusts. We understand that, at that time, it was considered that this safe harbour would encourage foreign trusts to use a professional New Zealand accountant or lawyer as a trustee, and that having a trustee who is a professional New Zealand accountant or lawyer would be an appropriate check to prevent non-compliance. However, the current qualifying resident trustee safe harbour does not provide a clear and appropriate signal about the importance of complying with the disclosure rules.

Registration and annual filing fees

50. Fees for registration and annual filing would be charged. This recognises that foreign trusts benefit from New Zealand's regulatory environment and that there are costs involved to the Crown, both in processing registrations and returns and in enforcing the rules relating to foreign trusts. Charging fees would recompense the Crown for those costs. The Inquiry's recommendations note that a fee of $500 for registration and then annually would be reasonable. We note that the registration and filing fees recommended by the Inquiry would be higher than those for companies, limited partnerships, and charities under New Zealand law.[5] Inland Revenue considers that further analysis is required to determine the quantum. Further, we consider that, as part of option 2, it may be appropriate for the level of fees to be modified in future by Order in Council. This would allow those fees to be relatively easily changed if necessary to recognise the costs involved in administering foreign trusts, and is consistent with the approach taken in relation to setting registration and filing fees for companies.

[5] The fee for registering a company is $150, and the fee for registering a limited partnership is $270. The annual filing fee for companies and charities is approximately $50, and the annual levy for limited partnerships is $20.

Information sharing with relevant agencies

51. Under option 2 the Department of Internal Affairs and the New Zealand Police would be able to search the register of foreign trusts. These agencies may need the information contained on the register for law enforcement purposes. The list of agencies with access to the register could be expanded in the future if there is good cause for it.

Assessment against objective and criteria – option 2

Main objective

52. Obtaining more information about the settlor and beneficiaries and providing it to other authorities (overseas tax authorities and domestic enforcement agencies) would help ensure that foreign trusts are not misused. More disclosure in relation to foreign trusts and access to the information by relevant agencies would make it difficult for these vehicles to be used to avoid foreign tax. This option meets the main criteria.

Maintaining New Zealand's reputation as a leader in best practice of international exchange of information

53. By increasing the information available to Inland Revenue that can be shared with New Zealand's treaty partners, option 2 would maintain New Zealand's reputation as a leader in best practice of international exchange of information. This would be an improvement on the status quo.

Maintaining an open economy

54. We consider this option is consistent with maintaining an open economy which welcomes an active financial services sector, where activities are legitimate. While there would be some increase in compliance costs for this industry, as noted below, these are not significant given the current record-keeping requirements and in some cases, the similar requirements for AEOI and AML legislation.

55. In terms of maintaining an open economy, we consider that option 2 is no better or worse than the status quo.

Fairness and integrity

56. The impact on fairness and integrity (including on perceptions of fairness and integrity) is expected to be positive. The requirements are likely to provide increased integrity, and the registration requirements will signal the increased disclosure requirements. This would be an improvement on the status quo.

Coherency of the tax system

57. The impact on coherency of the tax policy framework and disclosure rules would be an improvement on the status quo.

58. This option would retain the tax exemption for foreign trusts, which is consistent with New Zealand's framework for taxing trusts.

59. Increasing the disclosure requirements for foreign trusts would be consistent with recent trends for increased disclosures to tax authorities for the purposes of detecting tax avoidance and evasion.

Efficiency of compliance and administration

60. There may be additional compliance costs for foreign trusts. However we do not consider that these will be significant.

61. Much of the information that would be required to be provided is already required to be collected by the New Zealand-resident trustee in accordance with existing record-keeping requirements.

62. At the moment, identity and address information of settlors and beneficiaries is required to be collected, although only "if known". The new information that foreign trusts will be required to collect mainly relates to identity and address information about the settlor and beneficiary (including the Taxpayer Identification Number for those persons). We note that these information requirements would be broadly in line with the type of information disclosure standards that will be required under the proposed AEOI requirements.

63. The foreign trust would also need to do a new annual return to Inland Revenue rather than simply keeping records.

64. In some (but probably not most) cases, this information may be required to be provided under AEOI or AML legislation. However, we anticipate that entities will be able to use the same information collected for multiple regulatory regimes. Accordingly, while we acknowledge duplication in those cases might potentially increase compliance costs, we consider that compliance costs arising from duplication are relatively minimal.

65. Under option 2, there will be some increased administrative costs for Inland Revenue as a result of redesigning the current disclosure statement, a new annual return, and additional data entry. These costs are likely to be under $1 million. There may also be some additional resources required for increased exchange of information with domestic law enforcement agencies and overseas treaty partners. The costs relating to additional data entry and enforcement could depend on the numbers of foreign trusts.

66. Overall, in terms of efficiency of compliance and administration, option 2 would be slightly worse than the status quo.

Option 3

67. This option would repeal the tax exemption for foreign trusts. This option was suggested by some submitters to the Inquiry. The Inquiry did not recommend this option.

68. We note that it is possible for foreign trusts to be established in New Zealand for legitimate purposes that do not include foreign tax abuse or illicit activity. However, taxing foreign trusts on their worldwide income would deter the use of trusts even if they are used only for legitimate reasons.

__Assessment against objective and criteria – option 3__

Main objective

69. This option would meet the main objective to reduce the potential for misuse of foreign trusts in New Zealand (both actual and perceived) in respect of foreign tax avoidance or evasion.

Maintaining New Zealand's reputation as a leader in best practice of international exchange of information

70. To the extent that this option deters the use of foreign trusts, there would be no relevant activity and therefore no impact on New Zealand's reputation as a leader in best practice of international exchange of information. This is an improvement on the status quo.

Maintaining an open economy

71. This option would not be consistent with maintaining an open economy which welcomes an active financial services sector, as this would deter the use of foreign trusts in New Zealand in situations where they are used for legitimate reasons. This may adversely impact New Zealand's financial services sector. This would be worse than the status quo.

Coherency of the tax system

72. This option is not consistent with other fundamental principles of the tax system, which does not tax foreign-sourced income of non-residents and therefore lacks coherence. Accordingly, this would be worse than the status quo.

Fairness and integrity

73. The impact of this option on New Zealand's on fairness and integrity is likely to be mixed. Overall, to the extent that foreign trusts are (or are perceived to be) misused for foreign tax avoidance or illicit purposes, this would have a positive impact. On the other hand, to the extent that foreign trusts are used for legitimate purposes, this option may have a negative impact as, in the context of New Zealand's other rules, this approach may be perceived as inconsistent. It is not clear that option 3 is better or worse than the status quo.

Efficiency of compliance and administration

74. If this option significantly reduces the likelihood of foreign trusts operating in New Zealand, which we would expect to happen, this would reduce administrative costs to Inland Revenue, and compliance costs for foreign trusts. In this respect it would be an improvement on the status quo.

CONSULTATION

75. Inland Revenue has consulted with The Treasury, the Ministry of Justice, the Department of Internal Affairs, and the New Zealand Police. They have raised no concerns with the proposals in the preferred option (option 2).

76. To ensure that amendments recommended by the Inquiry and accepted by the Government could be implemented in line with the application timeframes recommended by

the Inquiry, while still being subject to select committee scrutiny, the time period for preparing this RIS has been shortened. Accordingly, Inland Revenue has not consulted more widely on the proposals.

77. However, in forming its recommendations, the Inquiry invited public submissions, and received 23 submissions, including from Chartered Accountants Australia New Zealand, the New Zealand Law Society, Transparency International, the New Zealand Council of Trade Unions, accounting firms, trust and company services providers, and individuals. The Inquiry also consulted with the Privacy Commissioner.

78. Part 11 of the Inquiry's report summarised the submissions made to it.

79. Most of the submitters who commented on the taxation of foreign trusts considered that settlor-based approach for taxing trusts (which results in the tax exemption for foreign trusts) should continue, but that there should be some changes to disclosure requirements. Two submitters considered that the trust should be taxed on its worldwide income if there is a resident trustee. One submitter suggested abolishing foreign trusts.

80. Most submitters who commented on the current disclosure rules considered the current disclosure regime to be inadequate. The Inquiry noted that not all submissions were explicit about what disclosure obligations should be changed. One submitter thought that providing the extra information that is obtained for Australian settlors would be sufficient, while others wanted more extensive disclosure, including details of settlors and beneficiaries and annual income statements and distribution information.

81. The Inquiry noted that a number of submissions considered that the upcoming requirements to provide information under AEOI should help address shortfalls in disclosure, and that some thought that AEOI would be a complete solution. However, the Inquiry concluded in Part 6 that, for a significant number of foreign trusts, AEOI will not result in any material increase in the amount of information required to be disclosed to Inland Revenue. Inland Revenue agrees that the AEOI due diligence and reporting requirements seem likely to have only limited application to foreign trusts.

CONCLUSIONS AND RECOMMENDATIONS

82. The following table summarises the consideration of the options from the regulatory analysis section above. Within the overview table the following symbols are used:

✓ Better than the status quo
× No better than the status quo
×× Worse than the status quo
? Unclear

Options	Analysis against the objective and criteria
Option 1 – Status quo	Does not meet the main objective
Option 2 – Increased disclosure, largely following the Inquiry's recommendations *(Inland Revenue's recommended option)*	Meets the main objective New Zealand's reputation ✓ Open economy ✓

	Fairness and integrity ✓ Coherency of tax system ✓ Compliance and administration: ✕✕
Option 3 – Repeal the tax exemption for foreign trusts	Meets the main objective New Zealand's reputation ✓ Open economy ✕✕ Fairness and integrity ? Coherency of tax system ✕✕ Compliance and administration: ✓

83. We do not recommend option 1 (the status quo) as that does not meet the stated objective to reduce the potential for misuse of foreign trusts in New Zealand (both actual and perceived) in respect of foreign tax avoidance or evasion and money laundering and other illicit purposes.

84. We consider that option 2 would address the concerns relating to foreign tax avoidance or evasion. It may partially address the concerns relating to money-laundering and other illicit purposes. Accordingly, the recommended option in this RIS will meet the objective to reduce the potential for misuse of foreign trusts in New Zealand (both actual and perceived) in respect of foreign tax avoidance or evasion.

85. We recommend option 2 (increased disclosure, largely following the Inquiry's recommendations) over option 3 (repeal of the tax exemption for foreign trusts), on the basis that option 2 will address the concerns regarding misuse of trusts without imposing excessive administrative costs. While option 3 would also meet the stated objective, it does not satisfactorily meet the criteria in relation to an open economy and the coherency of the tax system. Option 2 will increase administrative costs for Inland Revenue and compliance costs for trust and company service providers. However, at this stage we consider that the administrative costs are relatively minimal. We do not consider that the increased compliance costs, which relate to additional information and the obligation to file annual returns, are likely to be significant. This increased information is broadly similar to the type of information that trust and company service providers (TCSPs) would be expected to provide where AEOI and AML obligations apply. Accordingly, requiring this information does not seem unreasonable.

IMPLEMENTATION

86. Legislative change would be required to implement option 2. Legislative amendments required to implement option 2 could be included in a bill to be introduced in August 2016. This bill is expected to be enacted by the end of 2016.

87. Transitional provisions for existing foreign trusts are planned to provide them with enough time to comply with the proposed requirements. It is proposed that new foreign trusts would need to comply with the amended rules from the date of enactment, and that existing foreign trusts would have until 30 June 2017 to comply with the registration requirements. This transitional provision would allow existing trusts approximately six months to either collect the information required or to wind-up. New foreign trusts would need to comply with the annual filing obligation from date of enactment. Existing foreign trusts would need to comply with the annual filing obligation in relation to income years beginning on or after 1 April 2017.

88. Inland Revenue would administer the proposed changes. Some systems changes would be required to implement option 2. No changes to FIRST (Inland Revenue's mainframe IT system) would be required. A revised form upon registration and a new annual disclosure form would also be required.

89. In implementing option 2, Inland Revenue would work with TCSPs to ensure that they and their clients understand the changes and their new obligations. As the industry is reasonably small, we consider that this is achievable.

90. Inland Revenue will continue with its current audit and education programme in relation to TCSPs.

91. Implementation of a searchable register of foreign trust registrations would require Inland Revenue to operate a manual spread-sheet database, which will be shared with other government agencies authorised by legislation.

92. Commentary on the proposed legislative changes would be released when the Bill is introduced. In addition, a special report and a *Tax Information Bulletin* containing further explanation of the amendments would be published once the Bill is enacted.

MONITORING, EVALUATION AND REVIEW

93. In general, Inland Revenue's monitoring, evaluation and review of new legislation takes place takes under the generic tax policy process (GTPP). The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as necessary for the new legislation to have its intended effect would be prioritised in the context of the current Tax Policy Work Programme, and any proposals would go through the GTPP.

94. The Inquiry recommended that the registration requirement be the responsibility of Inland Revenue initially, but the Government may want to consider if another department, such as the Companies Office, may be a more appropriate department at a later time.

95. Inland Revenue agrees with the Inquiry's recommendation to review the position in future (after the existing rules have bedded in). It is possible that there may be efficiencies from another department other than Inland Revenue administering the registration of foreign trusts. This review would need to include consideration of:

a. ensuring that information sharing between the other department and Inland Revenue is adequate (given that Inland Revenue may need to share information with its overseas counterparts, and to enforce the sanction of taxing the foreign trust's income); and

b. ensuring that the other department has the appropriate ability to investigate foreign trusts (both under legislation and operationally).

96. As part of this future review, Inland Revenue would report back to Ministers on the operation of the new disclosure rules.

97. The Inquiry also recommended that a review be undertaken of the current legislative arrangements for the sharing of information between three agencies (Inland Revenue, the Financial Intelligence Unit of the New Zealand Police and the Department of Internal Affairs) to determine the financial and efficiency gains and other implications (including secrecy considerations) of sharing strategic intelligence and other information between agencies.

98. Inland Revenue agrees in principle that there should be a review. It may be appropriate to include other regulatory agencies as well. In terms of timing, we consider that this should be considered in light of:

a. current work on reforming the secrecy provisions in the TAA; and
b. the timing of Phase II of AML/CFT and other priorities.

Regulatory Impact Statement

Design of START – legislative issues

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It provides an analysis of options to address three legislative issues that have arisen in relation to transferring tax types from Inland Revenue's current computer system (FIRST) to Inland Revenue's future computer system (START).

The three issues relate to:

- use-of-money interest (UOMI) and transfers of tax;

- Amending the rules for new and increased assessments by the Commissioner of Inland Revenue by removing the new due date concept; and

- the administration of the grace periods concept (which provides for additional time for payment of a debt before late payment penalties are imposed) throughout the transition of tax types from FIRST to START.

The options considered are intended to simplify the transition from FIRST to START while at the same time ensuring that the integrity of the tax system is preserved. The options were developed in the context of the wider tax policy framework of a clear and coherent broad-base, low-rate tax system.

Legislative change is required before February 2017 because this is when GST is planned to be transitioned from FIRST to START. This feature presented a timing constraint on the amount of consultation and the extent of the analysis that could be undertaken.

Inland Revenue has consulted with the Treasury who are supportive of the recommendations set out in this RIS. Wider consultation was not conducted due to timing constraints (legislative change is required before February 2017 as this is when GST would be transitioned from FIRST to START).

A key gap in the analysis is that Inland Revenue does not hold sufficient data to provide an estimate of the fiscal impact of the options relating to transfers of tax and amending the rules for new and increased assessments.

A key risk is if the transition of GST to START is delayed, then FIRST will operate inconsistently with the new legislation. Conversely, if the new legislation is delayed and GST is transitioned to START before the legislation is enacted, START would not be compliant with the existing legislation as it would be programmed in anticipation of the legislative amendments being passed.

None of the policy options would impose additional costs on businesses, impair private property rights, restrict market competition, reduce the incentives for businesses to innovate and invest, or override fundamental common law principles.

Mike Nutsford
Policy Manager, Policy and Strategy
Inland Revenue

27 May 2016

Reader's guide to this RIS

This RIS covers three different proposals. The RIS begins with generic background and objectives sections. These are followed by a regulatory impact analysis section which provides an overview of each of the problems and their associated options for change. Within the overview tables in this section the following symbols are used:

✓✓ - Significant improvement over the status quo
✓✗ - Partial improvement over the status quo
✗✗ - No improvement over the status quo

In order to enhance readability, detailed analysis on each of the proposals has been shifted into a set of three appendices, one for each proposal.

Common consultation, conclusion, implementation and review sections follow the regulatory impact analysis section.

STATUS QUO AND PROBLEM DEFINITION

Inland Revenue's transformation programme

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

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

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

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

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

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

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

8. There is no doubt that Inland Revenue's computer systems (known as FIRST) need replacement to improve resilience and agility. They have reached the end of their life and are not sustainable in the medium to long term. The FIRST systems are aging, extremely complex, very difficult and costly to maintain, and inflexible. Since FIRST was implemented, a number of income-related social policies have been added to the platform. Implementing social policies within a platform designed for tax administration has added layers of complexity and risk to Inland Revenue's business processes and technology infrastructure. This in turn limits the department's ability to respond to government policy priorities.

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

10. As part of BT, FIRST will be replaced with a commercial-off-the-shelf tax and social policy software package from FAST Enterprises, referred to as START.[1] The revenue system will be transitioned to START in the following stages:

- **Stage 1 –** GST (early 2017)
- **Stage 2 –** income and business taxes
- **Stage 3 –** social policy
- **Stage 4 –** any remaining taxes and duties

11. While thinking about how to transition the revenue system to START, three problems have been identified which relate to:

- **Use-of-money interest (UOMI) and transfers of tax.** Put simply, taxpayers are able to receive more UOMI from Inland Revenue on overpayments/refunds of tax than they are entitled to in some circumstances. Underpayment UOMI payable to Inland Revenue on underpayments is also reduced in some circumstances. These outcomes adversely impact the integrity and coherence of the current rules and give rise to both efficiency and fairness concerns

- **Amending the rules for new and increased assessments by the Commissioner after the original due date (removal of the new due date concept)** to remove the requirement for setting a new due date for payment to avoid having to customise the configuration of START to create a new due date in such situations.

- **The administration of the grace periods concept throughout the transition of tax types from FIRST to START.** Different tax types will be transitioned to START in different stages. This means that there will be a period in which tax

[1] START stands for 'Simplified Tax and Revenue Technology' and is the name chosen by Inland Revenue for the GENTAX software provided by FAST Enterprises LLC.

types will be administered from two different systems. This raises an issue with respect to late payment penalty grace periods, as the current rules require the Commissioner to look at the taxpayer's payment history across multiple tax types in determining whether the taxpayer is entitled to a grace period. This would give rise to administrative complexity and cost for Inland Revenue as tax types transition from FIRST to START.

12. Some background and more detail on each of these problems are provided in the appendices at the end of this document.

OBJECTIVE

13. The **main objective** of the options is to simplify the transition from FIRST to START while ensuring the integrity of the tax system is preserved.

14. The transition from FIRST to START is simplified where START is customised as little as possible.

15. The integrity of the tax system is preserved when:

- Taxpayers receive the amount of UOMI they are entitled to, and can continue to legitimately transfer excess tax to mitigate the effects of underpayment UOMI.

- Taxpayers understand how interest and penalties are calculated, their interactions with Inland Revenue are minimised, and revenue collection is improved.

- The Commissioner is able to administer a "grace periods" concept efficiently and accurately in a way that does not present difficulties or complexities for taxpayers.

16. All options are assessed against the following criteria:

(a) **Fairness and equity:** to support fairness in the tax system, options should, to the extent possible, seek to treat similar taxpayers in similar circumstances in a similar way.

(b) **Efficiency of compliance and administration:** the compliance cost impacts on taxpayers and the administrative costs to Inland Revenue should be minimised as far as possible.

(c) **Sustainability of the tax system:** options should collect the revenue required in a transparent and timely manner while not leading to tax driven outcomes.

17. Legislative change is required before February 2017 as this is when GST is planned to be transitioned from FIRST to START. This feature presented a timing constraint on the extent of the analysis and consultation that could be undertaken.

18. It is also noted that we do not have sufficient data to provide an estimate of the fiscal impact of the options relating to transfers of tax and amending the new due date rules for new and increased assessments.

19. There are no social, environmental or cultural impacts associated with the recommended changes.

REGULATORY IMPACT ANALYSIS

20. Officials have developed options to address the above three problems. Each of these problems and the options to resolve them are summarised below. Further detail on these problems and their associated options is contained in the appendices at the end of this document.

UOMI and transfers of tax

21. There are two issues associated with UOMI and transfers of tax:

- *Issue 1*: When an amount transferred to a previous period exceeds the amount owing in that period, UOMI on the excess may start to accrue earlier than if the amount had remained in the original period. This will occur whenever the effective date for the transfer is earlier than the "date interest starts" under the UOMI rules. This is because FIRST incorrectly pays interest from the transfer date, rather than the applicable date under the UOMI rules. Taxpayers aware of this inconsistency are able to make use of it by transferring any overpayment or refund of tax to a prior period before seeking a refund. This is a system and administrative issue as FIRST is incorrectly applying the law. START is able to correctly apply the law with manual administrative processes for staff. Appendix A contains an example that illustrates this issue.

- *Issue 2:* FIRST transfers overpayments of tax at the effective transfer date of a refund, rather than the effective transfer date of an overpayment. Thus where an overpayment has been transferred to satisfy a debt in a previous period, UOMI on that debt will stop accruing earlier than intended because that debt would be treated as having been paid off earlier - that is, at the refund effective transfer date, rather than the overpayment transfer date. Appendix A contains an example that illustrates this issue.

22. These issues arise because FIRST is unable to track the source of a credit (a positive balance for the taxpayer) – for example, what period it arose from and whether it arose from a refund or an overpayment. As a result, FIRST pays UOMI on credits (i.e. refunds or payments) added to a period from the date they are added (rather than the correct date under the UOMI rules), and transfers of overpayments are made at the refund date, rather than the payment date. A further cause of issue 2 is that there is a lack of clarity in the law – basically the law allows a GST overpayment to be transferred at the effective date of a GST refund. The law is clear in relation to transfers of other tax types.

Options and analysis

23. Appendix A contains detailed analysis of the options.

24. The status quo does not meet the objective as START would need to be customised in order to apply the status quo (i.e. START would need to be customised to incorrectly apply the law just as FIRST does) and taxpayers would be able to receive more UOMI than they are entitled to. The status quo has the following implications:

- Fairness and equity: Taxpayers with knowledge of the inconsistencies would gain an unfair advantage.

- Efficiency of compliance and administration: Taxpayers would incur compliance costs, and Inland Revenue would incur administration costs resulting from tax being transferred to prior periods that are not in debt or dispute.

- Sustainability of the tax system: Taxpayers would continue to be able to artificially manipulate UOMI calculations.

Options	**Analysis against the objective and criteria**
Option 1 - Amend the transfer rules to prevent transfers of tax to previous periods that exceed the amount of debt or amount in dispute in that period. Amend the transfer and UOMI rules as they relate to GST to ensure the law achieves the policy intent.	Meets the main objective. Fairness & equity: ✓✓ Compliance and administration: ✓× Sustainability: ✓✓ Overall comment: Significant improvement on status quo.
Option 2 – Configure START to correctly apply the current law. Amend the transfer and UOMI rules as they relate to GST to ensure the law achieves the policy intent.	Partially meets the main objective. Fairness & equity: ✓× Compliance and administration: ✓× Sustainability: ✓× Overall comment: Improvement on status quo.

Recommendation

25. Option 1 was recommended over option 2 as it prohibits excess transfers of tax to prior periods which would prevent taxpayers artificially manipulating UOMI calculations in relation to all tax types. Although taxpayers would be prevented from gaming the system with option 2, this would only be in relation to tax types administered by START. Therefore, if option 2 were chosen, taxpayers would continue be able to game the system in relation to some tax types until 2021 when all tax types have been transitioned to START. Although there would be no harm in allowing excess transfers of tax to prior periods once all tax types were administered by START, such a transfer would serve no purpose. It might also be beneficial to limit these transfers in order to prevent mistakes (i.e. the taxpayer might mistype the period they wished to transfer to).

Amending the rules for new and increased assessments by the Commissioner (removal of the new due date concept)

26. If a taxpayer does not file a tax return, or if a taxpayer files an incorrect tax return, the Commissioner may, subject to limits on her powers, make an assessment for the amount of tax that ought to be imposed. When this occurs, a new (and later) due date that is 30 or more days after the notice of assessment date is generally set for the payment of the resulting tax liability. This allows the taxpayer time to pay the increased tax liability.

27. Interest applies from the day after the original due date for the payment of the tax. However, late payment penalties on the increased assessment are imposed on the day after the new due date for the outstanding tax liability if the taxpayer does not pay the tax outstanding plus interest in full by the new due date. These rules result in different due dates in relation to a single tax period which adds complexity.

28. In addition, any excess tax or amount that becomes refundable (this can be for another tax type or period) between the notice of assessment and the new due date is generally refunded to the taxpayer who is then required to repay the relevant amount to the Commissioner shortly afterwards (by the new due date). This increases compliance costs and effort for taxpayers and increases the risk of incurring additional UOMI and late payment penalties if the taxpayer does not pay the relevant amount in time.

29. There are differences in the way Inland Revenue's current FIRST system and the new START system operate. In FIRST a new due date has to be created for each new or increased assessment in order to allow time for the taxpayer to pay the resulting tax before late payment penalties are imposed. START's core functionality operates on a taxable period basis that allows for a period of time for payment before late payment penalties apply without requiring a new due date to be established each time the Commissioner makes an (re-)assessment for a taxable period. This reduces complexity and reflects the fact that the relevant assessment relates to the original due date of the period and would have been due to be paid on the original due date. However, implementing the current legislative framework for setting new due dates for each new or increased assessment in START requires significant customisation and limits the ability to use some of START's core functionalities.

30. During the course of the BT Programme there would be a period of "co-existence" in which some tax and social policy products would be administered in START and others would be administered in FIRST ("the Coexistence Period"). The amendment outlined in option 2 below would only apply to tax types administered in START. This means that during the Coexistence Period taxpayers would be treated differently depending on the tax type that the Commissioner assessed or re-assessed and whether this tax type was administered in FIRST or in START.

Options and analysis

31. Appendix B contains detailed analysis of the options.

Options	Analysis against the objectives
Option 1 – Maintain the status quo and customise START – a new due date is set for a (re-)assessment 30 days or more after the notice of (re-)assessment and late payment penalties are applied from the day after the new due date.	The status quo does not meet the main objective as it will require significant customisation of START. Fairness & equity: ✓✕ Compliance and administration: ✕✕ Sustainability: ✕✕
Option 2 – Amend the law so that no new due date is set for new or increased assessment; and late payment penalties are applied 31 days or later after the date of the notice of assessment.	Meets the main objective . Fairness & equity: ✓✕ Compliance and administration: ✓✓ Sustainability: ✓✕ Overall comment: Improvement on status quo.

Recommendation

32. Officials recommend option 2 because it would avoid heavy customisation of START, minimise compliance costs for some taxpayers and improve revenue collection.

The administration of the grace periods concept through the transition of tax types from FIRST to START

33. During the course of the BT Programme, there will be a period of “co-existence”, in which some tax and social policy products will be administered in START and others will be administered in FIRST (“the Coexistence Period”).

34. As information relating to the taxpayer’s tax compliance history and payment activity would reside in two systems, it would be difficult for the Commissioner to look across all applicable tax types to determine whether the taxpayer is entitled to a late payment penalty grace period.

Options and analysis

35. Appendix C contains detailed analysis of the options.

Options	Analysis against the objectives
Option 1 – Maintain the status quo by manually managing grace periods across FIRST and START	The status quo only partially meets the main objective because it would require significant manual intervention. Fairness & equity: ✓✓ Compliance and administration: ✕✕ Sustainability: ✓✕

Options	Analysis against the objectives
Option 2 – Integrate FIRST and START to deliver customer level grace periods (integration approach)	Does not meet the main objective As this option does not meet the overarching objective, it does not need to be assessed against the criteria.
Option 3 – Amend the law	Meets the main objective Fairness & equity: ✓× Compliance and administration: ✓✓ Sustainability: ✓✓ This option does not result in an improvement to the status quo with respect to fairness and equity, only partially meeting the criterion, whereas the status quo is fair and equitable. However, this option represents a significant improvement on the status quo with respect to the compliance and administration and sustainability criteria.

Recommendation

36. Officials recommend option 3 on the basis that it would allow accurate and consistent application of the grace periods concept throughout the coexistence period and it would not give rise to any issues with respect to compliance and administration.

CONSULTATION

37. Inland Revenue officials have consulted with the Treasury who are supportive of the options chosen in this RIS.

38. Wider consultation was not conducted owing to time constraints – legislative change is required before February 2017 because this is when GST will be transitioned from FIRST to START. Officials have commenced limited consultation with CAANZ on the proposals to test their reaction. CAANZ has indicated it supports the grace periods proposal. Officials are still to hear back from them in relation to the other two proposals.

CONCLUSIONS AND RECOMMENDATIONS

UOMI and transfers of tax

39. Inland Revenue prefers option 1, which is to amend the transfer rules and UOMI rules to limit transfers of tax to prior periods and to ensure the law achieves the policy intent, for the following reasons:

- It would prevent taxpayers from artificially manipulating UOMI calculations in order to obtain a benefit. This would result in a fiscal gain as Inland Revenue would no longer be paying UOMI to taxpayers who are not entitled to it.

- It would address inconsistencies in the legislation and improve clarity.

- It will prevent taxpayers accidentally transferring excessive amounts to prior periods.

Amending the rules for new and increased assessments by the Commissioner (removal of the new due date concept)

40. Inland Revenue prefers option 2 for the following reasons:

- It would simplify the design of START in relation to new and increased assessments.

- It would avoid customisation of START to minimise long term costs of the system.

- It would reduce compliance costs for taxpayers who wish to have credits applied to a debt and improve revenue collection.

The administration of the grace periods concept throughout the transition of tax types from FIRST to START

41. Inland Revenue prefers option 3 for the following reasons:

- It would allow for an accurate and consistent application of the grace periods concept throughout the Coexistence Period.

- It would not give rise to any system integrity issues.

- It does not require systems to be developed to integrate FIRST and START.

IMPLEMENTATION

42. Amendments to the Tax Administration Act 1994 would be required in order to give effect to these proposals. It is proposed that these amendments be included in the Taxation (Provisional Tax, Exchange of Information, and Remedial Matters) Bill, which is expected to be introduced later this year and receive Royal assent by the end of 2016.

43. When introduced to Parliament, commentary would be released explaining the amendments, and further explanation of their effect would be contained in a *Tax Information Bulletin*, which would be released shortly after the bill receives Royal assent.

44. Inland Revenue would administer the proposed changes. The proposals would have minor systems implications for Inland Revenue but may result in some additional

administrative costs, such as costs associated with publications to communicate the changes. There would also be some staff costs associated with the UOMI and transfers of tax proposals, which is examined in further detail below. These costs are expected to be insignificant and would be met as part of Inland Revenue's Business Transformation Programme.

UOMI and transfers of tax

45. It is important to note that these proposals would only apply to START, not to FIRST. This is because FIRST is unable to apply these amendments because of deficiencies in the FIRST system. It is not feasible to incur costs to amend FIRST when all tax types would be transitioned to START within a few years of the enactment of the legislation. In order to ensure compliance with the legislation, preventing transfers of excess tax to prior periods and ensuring transfers of overpayments to cover a debt in a prior period are made at the correct date would be dealt with administratively by Inland Revenue staff for all other tax types until such time as those tax types are transferred to START.

46. This is not expected to impose a significant administrative burden because:

- Taxpayers are unlikely to attempt to transfer excess tax to prior periods once aware it is no longer legal.

- Transfers of overpayments to cover debts in prior periods is relatively uncommon as taxpayers generally pay off their debts before paying upcoming tax liabilities in order to reduce their exposure to penalties and interest.

Amending the rules for new and increased assessments by the Commissioner (removal of the new due date concept)

47. The proposal for new and increased assessments by the Commissioner would only apply to START and not to FIRST due to system constraints in the way FIRST operates. This means that the proposal would apply to assessments and re-assessments of tax types as and when they transition to START. The existing rules would continue to apply for assessments of tax types that have not yet transitioned to START.

The administration of the grace periods concept throughout the transition of tax types from FIRST to START

48. The proposal for the administration of grace periods would require legislative amendment to ensure that the Commissioner is able to only look at compliance history that exists within the system from which the tax type in question (the tax type in respect of which there has been a payment default) is being administered.

49. As this legislative amendment would allow for each system to administer grace periods independently of the other, this proposal is not expected to impose a significant administrative burden. This is because it would remove the need for grace periods to be managed manually across the two systems.

Implementation risks

50. A key implementation risk would arise if the application dates of the legislation do not align with the transition of GST to START. This would have the following implications:

- If the legislation is in force and GST has not transitioned to START, then FIRST would be operating contrary to the law. This risk could be managed administratively for the transfers of tax and new due date proposals – i.e. Inland Revenue would simply limit transfers of tax to prior periods and not assign a new due date to new/increased assessments. The grace periods proposal would be drafted in such a way that a delay in the transition of GST to START would have no impact.

- If the legislation is not in force but GST has transitioned to START, START would be operating contrary to the law as it would be coded in anticipation of the legislative amendments being passed. This could be managed administratively by backing out what START does, but would involve significant manual work and significant costs.

MONITORING, EVALUATION AND REVIEW

51. Inland Revenue will monitor the effectiveness of the proposed changes in the first 12 months of operation. In general, Inland Revenue monitoring, evaluation and review of tax changes takes place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.

APPENDIX A – UOMI AND TRANSFERS OF TAX

Background – status quo

GST periods, refunds and overpayments

1. GST registered persons[2] must file a GST return and pay any tax owing generally by the 28th of the month following the end of their taxable period. Taxable periods are one month, two months or six months.

2. A GST refund arises where GST inputs/expenses exceed GST outputs/sales. Instead of the taxpayer paying the GST output amount and claiming back the GST input amount, these amounts are netted off and the taxpayer receives a refund without making a payment. This is distinct from a GST overpayment – which occurs when the taxpayer pays more than is necessary to satisfy their tax liability.

Use-of-money interest

3. UOMI is applied to underpayments and overpayments of tax to compensate one party for the use of the other party's money and to encourage taxpayers to pay the correct amount of tax on time. If taxpayers pay too much tax, they receive interest at 1.62% per annum from the Commissioner until the excess is refunded by the Commissioner or applied to another tax liability, whereas if the taxpayer pays too little tax, they must pay the Commissioner interest at 8.27% per annum on the outstanding balance until the balance is paid. Taxpayers do not receive UOMI on prepayments of tax.

4. There are rules in the Tax Administration Act 1994 which determine the date interest starts for the purposes of credit (paid by Inland Revenue to the taxpayer) and debit (paid by the taxpayer to Inland Revenue) UOMI.

5. For underpaid tax, UOMI generally begins on the day after the due date for payment of the tax.

6. For overpaid tax and GST refunds, UOMI generally begins on the latest of:

- The day after the due date for payment;
- The day after the payment is made; or
- The day after the tax return is provided.

7. UOMI stops being charged on underpaid tax on the date that the tax is paid or credited as paid (for example, when the taxpayer transfers tax from a period that is overpaid in order to satisfy the underpayment).

---

[2] Taxpayers with an annual turnover from a taxable activity exceeding $60,000 must register for GST. Taxpayers with a turnover below this threshold or bodies corporate may choose to register.

8. UOMI stops being earned on overpaid tax when it is refunded by the Commissioner or applied to another tax liability.

Transfers of excess tax

9. Taxpayers are able to transfer excess tax to another tax period or to another tax type or even to other taxpayers. This enables taxpayers to transfer overpaid tax to a period/tax type that has been underpaid, in order to reduce UOMI on that underpaid tax. The transfer rules in the Tax Administration Act 1994 restrict what date a taxpayer may choose to transfer excess tax. Tax may be transferred:

- On any date after the end of the GST return period in which the refund arose (for a GST refund).

- On any date that occurs on or after the date the excess tax is paid (for an overpayment of tax).

- A day after the end of the accounting year in which the amount was deducted (for tax deducted on the taxpayer's behalf – i.e. PAYE and RWT).

10. Put simply, a taxpayer is only able to transfer excess tax once they become entitled to it. GST refunds have an earlier effective transfer date than overpayments because the first of the month is in effect when the GST refund arose for the previous month.

11. The transfer effective date is very important as it affects when UOMI on a prior period underpayment stops being charged. For example, if a taxpayer owed $200 for the June GST period, and was entitled to a GST refund of $200 in the July GST period which he wished to transfer to the June period, the effective transfer date for this refund would be 1 August. UOMI on the June underpayment would cease at 1 August, as this is when the July refund is transferred to satisfy the June debt[3].

Problem definition

12. There are two issues with the current tax rules.

Issue 1 – excess UOMI on "overpayments"

13. Taxpayers are able to receive more UOMI from Inland Revenue on "overpayments" than they are entitled to in some circumstances.

Example

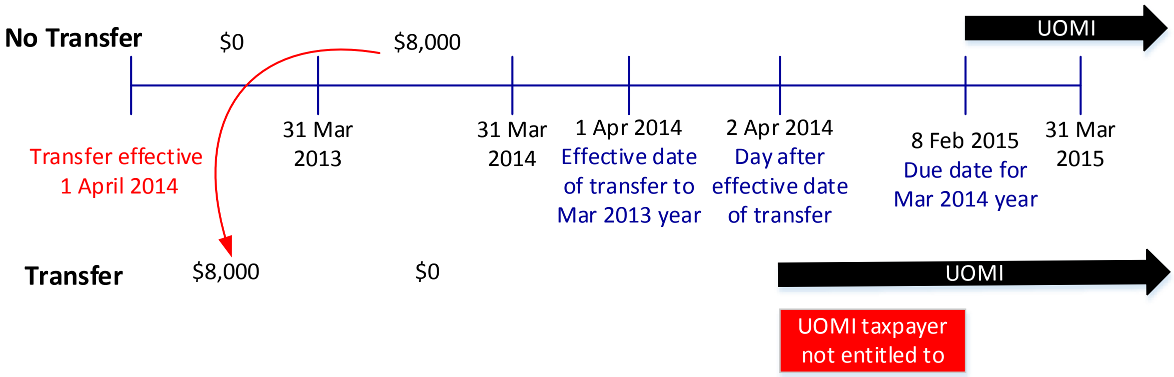
14. Bob files his 2014 income tax return and is due a refund of $8,000 arising from tax being withheld at source at incorrect rates. He requests that this refund is transferred to his 2013 taxable period, which has a nil balance. The $8,000 is transferred as its earliest effective

3 For the purposes of this example assume no penalties or interest accrued on the $200 debt, so that the $200 payment fully satisfied it. Transfers are first applied to any interest or late payment penalties that have accrued on the debt, before being applied to the debt.

date of 1 April 2014 (the day after the end of the accounting year in which the amount was deducted – see paragraph 9).

15. FIRST treats this transfer date of 1 April as a payment date and pays UOMI on the $8,000 balance from 2 April 2014 (the day after the "payment" was made). This is a misapplication of the rules as interest should begin on 8 February 2015 (the day after the due date for payment of tax for the 2014 period).

16. However, as FIRST is unable to track the source of payments, it sees a "payment" being made on 1 April and therefore the only UOMI rule it could apply would be the "day after the payment is made" rule (FIRST couldn't use the "day after tax return is provided" or "day after due date for payment" rules as it is unable to track that the payment actually comes from a refund in the 2014 taxable period). As a result, Bob is paid almost a year's worth of interest to which he is not entitled (interest is paid from 2 April 2014 rather than 8 February 2015).



17. Taxpayers aware of this inconsistency are able to make use of it by transferring any overpayment or refund of tax to a prior period before seeking a refund.

Issue 2 – reduced UOMI on underpayments

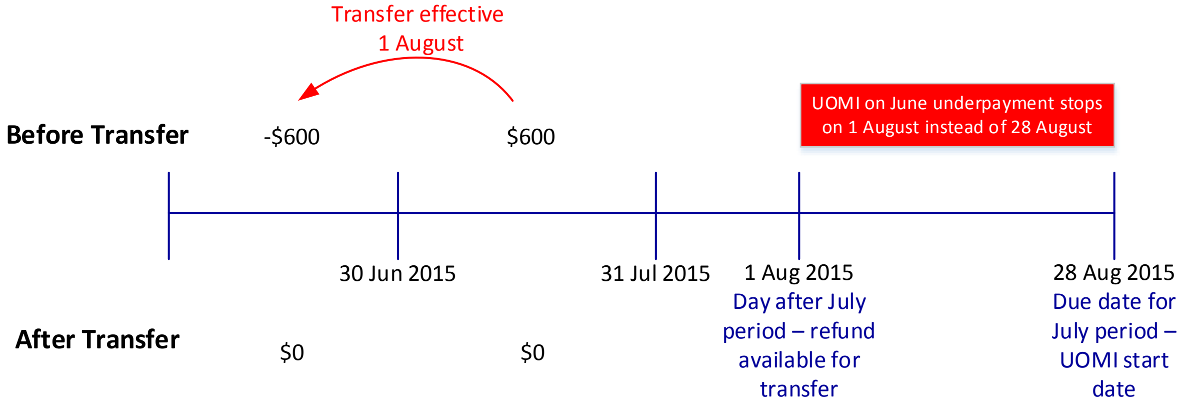
18. Taxpayers are able to reduce the amount of UOMI payable to Inland Revenue on underpayments of GST in some circumstances.

Example

19. Vicki has a debt of $600 for her June GST period. She files her July GST return on 28 August, and mistakenly overpays (also on 28 August) by $600. Vicki requests that this $600 overpayment is transferred to the June period. Based on the intended application of the transfer rules, the effective date for this transfer is any date from 28 August.

20. FIRST treats the transfer as having been made on the 1st of August (which is the refund transfer date). As a result, UOMI that Vicki had to pay the IRD on her $600 June debt ceases on the 1st of August,[4] rather than on the 28th of August (this is the correct date under the UOMI rules).

[4] For the purposes of this example assume no penalties or interest accrued on the $600 debt, so that the $600 payment fully satisfied it.



Scale of the problem

21. A large number of tax agents manufacture UOMI by transferring any overpayment or refund of tax to a prior period before seeking a refund.

22. Without any legislative change, taxpayers could continue to "game the system" by artificially increasing the amount of UOMI paid to them by Inland Revenue. This practice effectively allows taxpayers who have knowledge of this inconsistency to push the tax burden disproportionately onto other taxpayers. This was not intended. The amount of underpayment UOMI taxpayers must pay to Inland Revenue would also be reduced in some circumstances, although taxpayers are unable to manipulate this.

Options and analysis

23. Two options have been considered for addressing the problem and achieving the main objective. The options are:

- Option 1: Amend the transfer and UOMI rules (Officials' preferred option).
- Option 2: Configure START to apply the current law.

Option 1

24. Under this option, the following amendments would be made to the UOMI and transfer rules:

- Taxpayers would be prevented from transferring tax to a prior period that exceeds the amount of debt or amount in dispute in that period. This would prevent taxpayers from obtaining credit UOMI on overpayments transferred to prior periods.
- The difference between a GST refund and GST overpayment would be clarified for the purposes of the transfer rules. This would prevent taxpayers from being able to reduce underpayment UOMI by obtaining the GST refund effective transfer date for an overpayment.

- The difference between a GST refund and GST overpayment would be clarified for the purposes of the UOMI rules. This would enhance clarity in the legislation.

25. It is important to note that, unlike START, FIRST is unable to prevent transfers of excess tax to prior periods. By the application date of the above amendments, only GST would have transitioned to START. For all other tax types, these amendments would be manually administered by Inland Revenue staff (see paragraphs 45 and 46 in the main report for further information).

Assessment against objective and criteria – option 1

- Main objective: This option would meet the main objective for two reasons. First, START would not need to be customised in order to prevent transfers of tax to prior periods that exceed that amount in debt or dispute in that period, as this option is available within START's default settings. Second, taxpayers would only receive the amount of UOMI to which they are entitled and would continue to be able to mitigate the effects of underpayment UOMI by transferring refunds/overpayments to satisfy debts in prior periods.

- Fairness and equity: This option would improve equity as it would prevent taxpayers from obtaining UOMI artificially, therefore preventing taxpayers with knowledge of this from obtaining an unfair advantage over other taxpayers. This option meets this criterion.

- Efficiency of compliance and administration: This option would reduce compliance costs as taxpayers will no longer incur compliance costs associated with moving tax between periods in order to artificially manipulate UOMI. This option would result in a minor and temporary increase in administrative costs arising from Inland Revenue staff having to manually administer these amendments in relation to tax types that have not transitioned to START at the application date of the legislation. This option partially meets this criterion.

- Sustainability of the tax system: This option would improve the sustainability of the tax system as it prevents taxpayers from artificially manipulating UOMI calculations. It also prevents underpayment UOMI from ceasing earlier than it should. This option meets this criterion.

26. Option 1 represents a significant improvement on the status quo.

Option 2

27. Under this option START would be configured to correctly apply the current law (i.e. START would be able to track the source of a credit so will know what period a payment came from, and would therefore be able to pay UOMI from the correct date). The law would only be applied correctly for tax types that are administered in START (tax types will be transitioned to START in stages as outlined in paragraph 10 in the main report), and therefore would not fully prevent the problems outlined until all tax types have transitioned to START.

Amendments would also be made to the transfer and UOMI rules in relation to GST (bullet points 2 and 3 of paragraph 24 of Appendix A).

Assessment against objective and criteria – option 2

- Main objective: This option partially meets the main objective. START would not need to be customised in order to be able to track the source of a credit as this is part of START's inherent functionality. Taxpayers would receive more UOMI than they are entitled to on other tax types until those tax types are transitioned to START. Taxpayers could continue to mitigate the effects of underpayment UOMI by transferring refunds/overpayments to satisfy debts in prior periods.

- Fairness and equity: This option would improve equity as it would prevent taxpayers from obtaining credit UOMI artificially, however it only partially meets this criterion as taxpayers would be able to artificially obtain UOMI on tax types until they are transferred to START.

- Efficiency of compliance and administration: This option would reduce compliance costs (albeit delayed because of the timeline for transitioning other tax types to START) as taxpayers would no longer incur compliance costs associated with moving tax between periods in order to artificially manipulate UOMI. This option would only result in very minor administrative costs, such as costs associated with publications to communicate changes. This option partially meets this criterion.

- Sustainability of the tax system: This option would improve the sustainability of the tax system as it prevents (albeit delayed in relation to tax types other than GST) taxpayers from artificially manipulating credit UOMI calculations. This option partially meets this criterion.

28. Option 2 represents an improvement on the status quo.

Fiscal implications of the options

Options	Fiscal impact
Option 1 – Prevent transfers of excess tax, amend the UOMI and transfer rules.	This option results in an unquantifiable fiscal gain resulting from: - preventing taxpayers obtaining credit UOMI they are not entitled to; and - ensuring underpayment UOMI taxpayers must pay to Inland Revenue on underpayments is not artificially reduced.
Option 2 - Configure START to apply the current law.	This option also results in an unquantifiable fiscal gain resulting from the above; however it would be slightly delayed given that not all tax types will immediately transition to START.

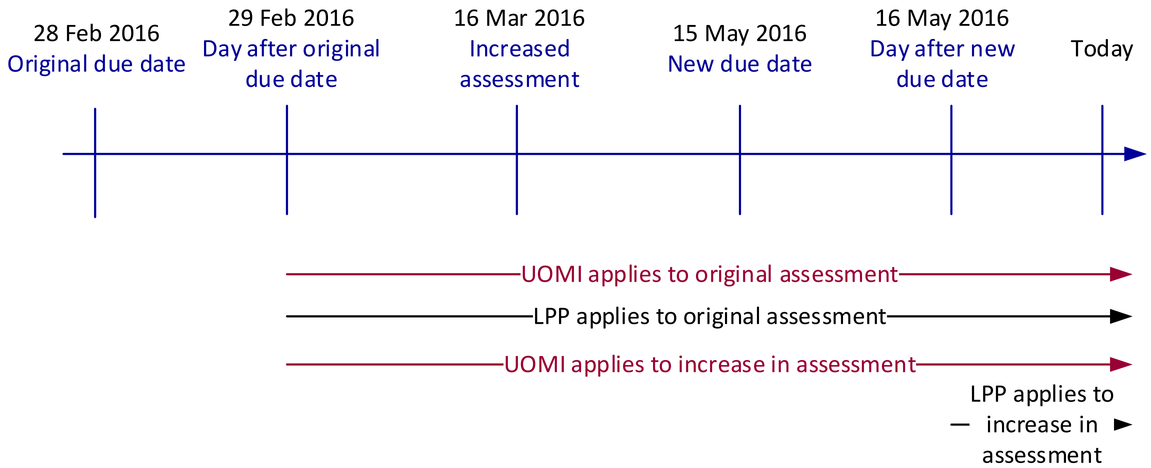
APPENDIX B –DUE DATES FOR NEW AND INCREASED ASSESSMENTS BY THE COMMISSIONER

Background – status quo

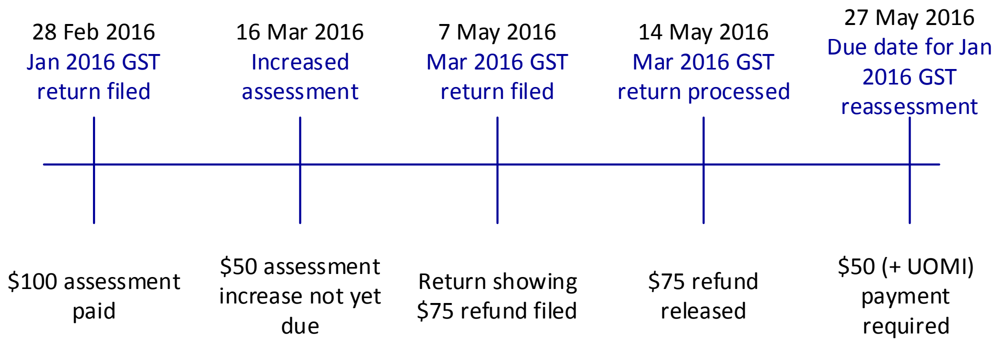
1. The transition from FIRST to START provides opportunities to streamline and improve the way taxpayers and Inland Revenue interact. However, it also presents some challenges due to the different ways FIRST and START operate. One area of opportunity and challenge is the setting of new due dates for new or increased assessments by the Commissioner and the resulting complexities.

2. The new due date is required to be set 30 or more days after the date of the notice of the assessment. Administrative practice is to set the new due date 60 days after the assessment. Interest starts on the day after the original due date for the payment of the tax. Late payment penalties, however, are imposed on the day after the new due date for the outstanding tax liability if the taxpayer does not pay the tax outstanding plus interest in full by the new due date. These new due date rules result in different due dates in relation to a single tax period which adds complexity to the calculation of interest and penalties.

3. The following diagram shows the differing dates for the calculation of UOMI and penalties for a January 2016 GST return that is not paid and is then reassessed on 16 March 2016.



4. The following diagram shows how a refund can be released even when the taxpayer has been assessed for a period that has passed its original due date for payment and will be required to pay the assessed amount shortly, and is already incurring UOMI.



Problem definition

5. Implementing the current legislative framework for setting new due dates in START would require significant customisation and would limit the ability to use some of START's core functionalities. START has the ability to automatically apply any excess tax or credit that becomes refundable to satisfy a debit amount in the system. This limits underpayment UOMI charged to a taxpayer and also reduces the interaction they are required to have with Inland Revenue.

6. START does this by looking at taxable periods that have passed their due date and whether there is any outstanding amount in relation to these previous periods. However, this period based approach means that the system does not distinguish between a debt (an amount that has passed its due date for payment) and a debit (an amount that relates to a taxable period that has passed its original due date, but that itself is not yet due to be paid).

7. Although this system configuration can be supressed, it would mean significant customisation and manual processing. This would also impact other desirable features of START, such as real-time balancing of taxpayer accounts which provides transparency for taxpayers of what they are required to pay at any time.

Options and analysis

8. The status quo and an option for change have been considered for addressing the problem and achieving the main objective. The options are:

- Option 1: Maintain the status quo by customising START to allow the setting of a new due date for new and increased assessments (status quo).

- Option 2: Amend the law so that no new due date is set for a new or increased assessment by the Commissioner for taxable periods that have passed their original due date for payment, but allow time for payment of the assessed amount before late payment penalties are applied (officials' preferred option)

Option 1

9. This option would involve implementing the existing new due date rules for new and amended assessments in START and customising START to the extent needed to allow for

different due dates (original and new due date(s)) to be created and managed within a single tax period.

Assessment against objective and criteria

- Main objective: This option would not meet the main objective as it would require significant customisation of START to an extent that it would limit the use of some of the core functionalities of START. Manually managing transfers and the application of credits against liabilities within START would be required. Owing to the significant complexity involved in manually managing transactions there is potential for error.

- Fairness and equity: Taxpayers have time to pay a tax liability resulting from a new or increased assessment before late payment penalties are applied. Taxpayers who have a refund available in START in the relevant timeframe will have this refunded to them then be required to make a separate payment on the due date. Taxpayers who are aware of this can ask for the refund to be transferred to meet their liability which may result in lower UOMI than if they have the amount refunded then repaid. This only partially meets the criteria.

- Efficiency of compliance and administration: Under this option any excess tax or other credit that becomes refundable to the taxpayer in the period between the notice of assessment and the new due date for payment will continue to be refunded to the taxpayer, despite the fact that the taxpayer will be required to make payment of the tax resulting from the notice of assessment to Inland Revenue shortly after receiving this refund (i.e. by the new due date). Manual managing of some transfers and the application of credits in payment of tax and other liabilities would be required, which gives rise to increased resourcing and administrative costs to Inland Revenue. This does not meet the criteria.

- Sustainability of the tax system: Due dates and the calculation of interest and penalties for new and increased assessments will continue to be complex. Taxpayers are at a higher risk of incurring penalties and increased interest because overpayments of tax are refunded to the taxpayer unless the taxpayer requests otherwise even where a payment is due shortly after the refund. This does not meet the criteria.

Option 2

10. This option would involve a legislative change that the Commissioner would not set a new due date for new or increased assessments. However, the current way interest is calculated would be retained and the date for applying late payment penalties would also be unchanged as they would be imposed 31 or more days after the (re-)assessment.

11. During a Coexistence Period some tax types and social policy products will be administered in START and others in FIRST. In relation to this option this means that during the Coexistence Period taxpayers would be treated differently depending on the tax type that the Commissioner has assessed or re-assessed. For tax types that are administered in START no new due date would be set and refunds or credits becoming available would be applied to the tax liability from the assessment date. Relevant assessments of tax types that are

administered in FIRST would receive a new due date for payment. Credits and refunds that become available between the assessment date and the new due date would not be applied to offset the new or increased tax liability unless the taxpayer requests otherwise but would be refunded to the taxpayer.

Assessment against objective and criteria

- Main objective: This option would meet the objective as it would avoid customisation and minimise complexity of START and allow Inland Revenue to leverage the inherent system functionality.

- Fairness and equity**:** Taxpayers who have no refund available in START in the relevant timeframe will continue to have time to pay tax resulting from a new or increased assessment before late payment penalties are applied. These taxpayers will have the same financial outcome as under the status quo. However, taxpayers who have a refund available in START in the relevant timeframe will have this applied to satisfy their tax liability automatically when it becomes available. This means that these taxpayers would effectively "pay" earlier than is required under status quo; however, this may reduce their UOMI liability. Any further excess credits available would be refunded to the taxpayer. This is an improvement on the status quo.

- Efficiency of compliance and administration: Compliance costs are reduced for taxpayers whose refunds are applied to satisfy the tax liability arising from a new or increased assessment, instead of receiving a refund and having a payment obligation shortly after. This option would enable Inland Revenue to take advantage of START's core functionalities in relation to automatic handling of transfers and application of credits to satisfy liabilities within the system and does not require any additional resources and accordingly does not give rise to the efficiency concerns raised in respect of option one. This is a significant improvement on the status quo.

- Sustainability of the tax system: Due dates, interest and penalty calculations within a tax period that had a new or increased assessment would be simplified and easier to follow for taxpayers. Revenue collection will be improved. This is an improvement on the status quo.

12. This option represents an improvement on the status quo.

Fiscal implications of the options

Options	**Fiscal impact**
Option 1 – Maintain the status quo	None
Option 2 – Amend the law	A small unquantifiable fiscal loss of UOMI due to automatic application of credit or refund to tax liability is largely offset by an earlier resolution of the tax obligation.

APPENDIX C – ADMINISTRATION OF THE GRACE PERIODS CONCEPT

Background – status quo

Late payment penalty grace periods

1. The current legislative framework for penalties sets out that a late payment penalty will be imposed if a taxpayer does not pay on time.[5] However, where the taxpayer has punctually paid all taxes due in the two years prior to the default in question, the Commissioner must first issue a notice to the taxpayer specifying a further date for the unpaid tax, before a late payment penalty can be imposed. This gives the taxpayer a grace period in which to pay the amount owing before the imposition of late payment penalties.[6]

2. The application of the late payment penalty grace period is determined on the basis of the taxpayer's previous compliance in terms of the payment of tax across all relevant tax types (such as GST, income tax and PAYE deductions).[7]

3. The transition from FIRST to START will be done on a tax-type by tax-type basis, with GST being transferred to START in early 2017 and income tax, FBT and PAYE being transferred in 2018. This raises an issue with respect to the late payment penalty grace period, as the current legislative framework for the application of the penalty requires the Commissioner to consider the taxpayer's compliance history across all applicable tax types.

Problem definition

4. As information relating to the taxpayer's tax compliance history and payment activity will reside in two systems, it will be difficult for the Commissioner to look across all applicable tax types to determine whether the taxpayer is entitled to a grace period. Without significant manual intervention, or an integration of FIRST and START, Inland Revenue will not be able to administer the current grace period rule.

Scale of the problem

5. The manual intervention necessary to look across both systems to see all applicable tax types would require significant resources on the part of Inland Revenue.

6. By way of illustration, the number of customers who could have been eligible for a late payment penalty grace period in respect of the due date of 20 November 2015 was 603,867. If this were to occur during the Coexistence Period (with the status quo retained), this would require 603,867 manual interventions to correctly administer the grace periods rules.

---

[5] A financial penalty for late payment of tax is automatically imposed at 1% on the initial date the tax was due to be paid, at 4% seven days later, and at 1% each month after that.

[6] If the taxpayer does not make payment within that notified further period, the late payment penalty is imposed as usual from the day after the original due date.

[7] The late payment penalty grace period applies to all tax types except the following: child support, student loan scheme, tax credits (formerly known as rebates), certain types of provisional tax, KiwiSaver voluntary employer contributions and complying fund debt referred to Inland Revenue from the Financial Markets Authority.

Options and analysis

7. Two options for change and the status quo have been considered for addressing the problem and achieving the stated objectives. The options are:

- Option 1: Maintain the status quo by manually managing grace periods across FIRST and START (status quo)

- Option 2: Integrate FIRST and START to deliver customer level grace periods (integration approach).

- Option 3: Amend the law (officials' preferred option).

8. Within the third option, there are two "sub-options" with respect to the way in which the selected legislative amendment makes provision for the consideration of payment behaviour history. The two "sub-options" are outlined below, as part of the analysis of the third option.

Option 1

9. This option would involve continuing to apply the existing grace period rules until all tax types have been transitioned and the implementation of START is complete. As the current rules require a taxpayer's compliance history across all tax types to be considered, this option would require Inland Revenue to manually manage customer-level grace periods across FIRST and START.

Assessment against objective and criteria

- Main objective: This option partially meets the objective because, while it does not require any additional configuration to the START system and will not present difficulties or complexities for taxpayers, it would require significant manual intervention.

- Fairness and equity: Retaining the current grace period regime throughout the Coexistence Period maintains equity among taxpayers as, in all cases, the applicability of a grace period will be determined on the basis of the taxpayer's compliance across all tax types, irrespective of whether the tax type in question is being administered through FIRST or START. This option meets this criterion.

- Efficiency of compliance and administration: This option does not meet this objective in that manually managing grace periods across the two systems would give rise to increased resourcing and administrative costs to Inland Revenue. In addition, it is considered that this option poses a risk to the integrity of Inland Revenue's administration of the tax system due to the significant complexity of and difficulties inherent in manually managing grace periods across two systems, and the risks associated with this. Manually managing grace periods across two systems gives rise to significant potential for error, which could also inadvertently result in different treatment among taxpayers.

- Sustainability of the tax system: This option preserves the application of the current grace periods rules and therefore will not give rise to any difficulties for taxpayers or to the potential for tax-driven outcomes. There is, however, the potential for this option to give rise to an integrity risk for Inland Revenue, in that manually managing grace periods across two systems will generate significant potential for error. This option partially meets this criterion.

Option 2

10. The Integration Approach involves continuing to apply the existing grace period rules and integrating FIRST and START to the extent needed to identify all late payments and determine the appropriate application of grace periods.

11. Integrating FIRST and START for the purpose of managing grace periods would require real-time interfaces in FIRST and START to enable the real-time transfer of information, which would require new code to be written. The new code and real-time interfaces developed for this purpose would only be used for the duration of the Coexistence Period. As this option requires START to be reconfigured, this option does not meet this objective.

Assessment against criteria

12. As this option does not meet the overarching objective, it is not a viable option and accordingly does not need to be assessed against the criteria.

13. This option would not lead to any improvement on the status quo.

Option 3

14. This option involves amending the legislation to allow grace periods to be managed independently in each of the two systems.

15. The proposed legislative amendment would mean that when a taxpayer defaults on a payment, the Commissioner would only look at information regarding the taxpayer's previous behaviour that is contained in the system (FIRST or START) from which the tax type in question is being administered when determining whether the taxpayer is entitled to a grace period.

16. The previous behaviour information that is contained in START will be dependent on the form in which compliance history is brought across to START. The two options for the way in which taxpayer compliance history is brought across to START are outlined below.

(a) Customer level indicator

17. The first option with respect to the transfer of compliance history to START is to bring across an indicator that would show when the taxpayer is next entitled to a grace period, based

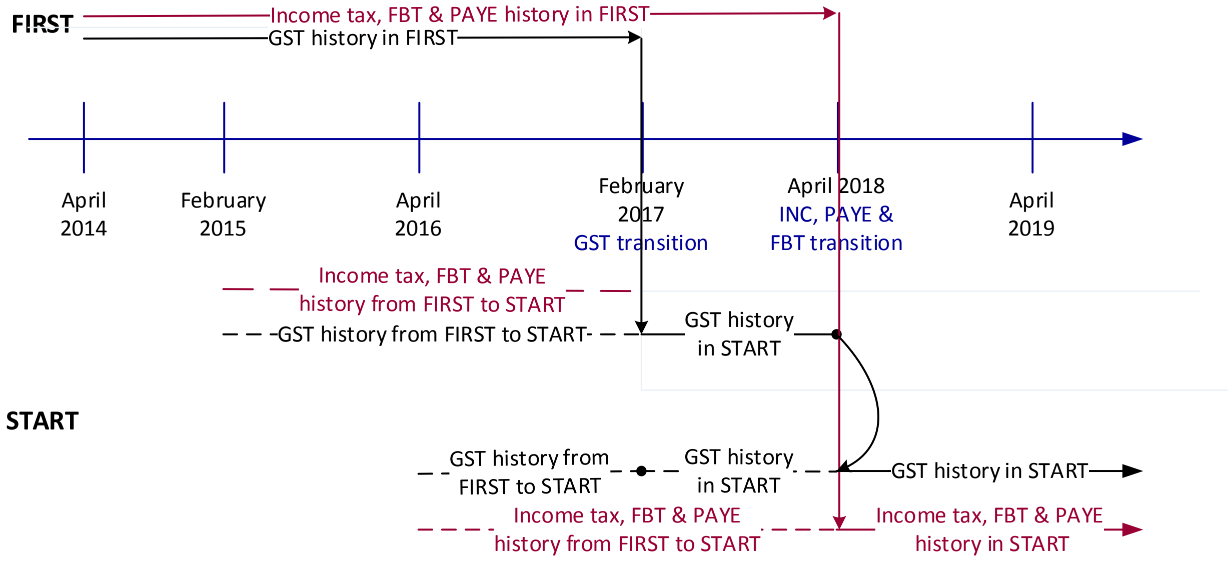
on the date that they last paid late. The indicator would encompass the taxpayer's payment history from February 2015 (two years before GST is brought across to START) to February 2017 in respect of income tax, GST, FBT and PAYE.

18. Although the taxpayer's payment history across all these tax types will inform the indicator date (the date at which the taxpayer will next be entitled to a grace period) it will not be possible to identify the tax type in respect of which the default has occurred.

19. During Stage 1 of START, this indicator would be used to determine whether the taxpayer is entitled to a grace period when they default on a GST payment (where the GST period in issue is a period after the date on which GST was transferred to START). Where the taxpayer defaults on a payment in respect of a tax type that is still being administered through FIRST, the compliance history that exists in FIRST at that time will be used to determine whether the taxpayer is entitled to a grace period.

20. It should be noted that the indicator will be a "snapshot" of the taxpayer's compliance history from February 2015 to February 2017. Information relating to the taxpayer's compliance regarding income tax, PAYE and FBT after February 2017 will not be able to be taken into account in determining whether the taxpayer is entitled to a grace period when they default on a GST payment after this date. As time passes, there will accordingly be a "compliance history relevance tail-off" in terms of the indicator for the purposes of determining whether the taxpayer will be entitled to a grace period for products remaining in FIRST in respect of defaults in payments of GST.

21. The intention is that a new "compliance indicator" will be brought across when income tax is transitioned to START. Assuming that income tax is transitioned to START in April 2018 (noting that this is only a proposed date), this second indicator would encompass the taxpayer's payment history from April 2016 (two years before income tax is brought across to START) to April 2018 in respect of income tax, FBT and PAYE. The second indicator would "top up" the relevant compliance history encompassed by the first indicator from February 2019 (the end date of the indicator brought across with GST) to April 2020 (two years from the date on which the second compliance indicator is brought across). As GST will have been operated from START from February 2017, the information that is brought across by the second indicator will not encompass GST. The information relating to the taxpayer's compliance with respect to GST payments will be required to "supplement" the information on the second indicator. This is illustrated on the diagram below.



22. Compliance information with respect to periods that occur after the tax type in question has transitioned to START will only exist in START and will not be visible in FIRST.

(b) Individual tax type compliance history

23. The second option with respect to the transfer of compliance history to START is to only bring across compliance history that relates to the specific tax type that is being transferred. For stage one, only the customer's compliance history that relates to GST would be transferred across to START. This option would mean that, if a taxpayer misses a payment date, the Commissioner would only look at the taxpayer's previous behaviour regarding payments made in respect of the tax type in question, and any other tax types administered from the same system, when determining whether or not to impose a penalty.

24. During stage 1 of the implementation of START, this would mean that the timeliness of a taxpayer's GST payments would be considered in isolation from all other tax types. As the Business Transformation Programme continues and more tax types are moved from FIRST to START, a more holistic view of the timeliness of a taxpayer's payment history would once again be considered when deciding whether to apply a late payment penalty.

25. Compliance information with respect to periods that occur after the tax type in question has transitioned to START will only exist in START and will not be visible in FIRST.

Required legislative amendments

26. Irrespective of which of the compliance history options is selected, the third option will require legislative amendment to ensure that the Commissioner is able to only look at the compliance history that exists within the system from which the tax type in question (the tax type in respect of which there has been a payment default) is being administered.

Assessment against objective and criteria

- Main objective: This option will not require any additional configuration to START, irrespective of which of the compliance history options is selected. This option therefore meets the objective.

- Fairness and equity: This option raises an issue with respect to horizontal equity in that, during the period in which different tax types are administered out of different systems, some taxpayers will be able to benefit from a grace period to which they would previously not have been entitled. The way in which this could arise is illustrated by the following hypothetical examples:[8]

(i) The date is 31 August 2017. Taxpayer 1 is a small business owner who fails to pay their GST liability by the 28 August 2017 due date. They were two weeks late in paying their PAYE liability by the 20 June 2017 due date. As the PAYE period in which they defaulted occurred after GST and the compliance history indicator was transferred to START, this will not be able to be considered in determining whether Taxpayer 1 will be entitled to a grace period in respect of their late payment of GST for the period ended 28 June 2017. Taxpayer 1 will accordingly be entitled to a grace period to which they would not, under the current system, have been entitled.

(ii) The date is 31 August 2017. Taxpayer 2 is a small business owner who fails to pay their PAYE liability by the 20 August 2017 due date. They were also two weeks late in paying their GST liability by the 28 June 2017 due date. As the GST period in which they defaulted occurred after GST was transferred to START, this will not be able to be considered by FIRST in determining whether Taxpayer 2 should be entitled to a grace period in respect of their late payment of PAYE for the period ended 20 August 2017. Taxpayer 2 will accordingly be entitled to a grace period to which they would not, under the current system, have been entitled.

(iii) The date is 30 June 2017. Taxpayer 3 is a small business owner who fails to pay their PAYE liability (of one period) by the 20 June 2017 due date. They were two weeks late in paying last year’s income tax liability, due 7 April 2016. A late payment penalty will automatically be imposed, as PAYE and income tax will still be being administered within the FIRST system. Taxpayer 3 will not be entitled to a grace period, as they were late in paying the income tax they owed last year. Viewed against the previous two examples, this scenario illustrates how, under option 3, taxpayers’ entitlements to a grace period will to some extent be dependent on the tax type in respect of which they have made a late payment and the system through which this tax type is being administered.

It should be noted that option (b) with respect to the way in which compliance history is brought across to START gives rise to a slightly greater issue with respect to horizontal

8 It is assumed, for the purpose of these scenarios, that the taxpayer has not defaulted on any payments other than those stated in the examples.

equity (in that the number of scenarios in which a taxpayer could be afforded a grace period to which they would, under the current system, have previously not been entitled is greater). This is illustrated by a comparison of the two compliance history options in the following example:

(iv) The date is 28 June 2017. Taxpayer 4 fails to pay their GST payment due on 28 June 2017. They previously defaulted on their income tax payment due on 7 April 2016. If option (a), the compliance history indicator, is selected as the way in which compliance history should be transferred to START, Taxpayer 4 will not be entitled to a grace period, as information relating to their payment history in respect of all tax types (including income tax) from February 2015 to February 2017 will have been transferred to START. If option (b), the individual tax type compliance history, is selected as the way in which compliance history should be transferred to START, Taxpayer 4 will be entitled to a grace period, as only historical information concerning their payment behaviour with respect to GST will be brought across to START.

In light of this, it is considered that the preferred option with respect to the way in which compliance history is transitioned to START is option (a), the customer-level indicator.

It is noted, however, that the legislative amendment option with the customer-level indicator does not result in an improvement to the status quo with respect to the fairness and equity criterion. The fact that some taxpayers will be able to benefit from a grace period to which they would not otherwise have been entitled means that this option only partially meets the fairness and equity criterion. The status quo meets this criterion.

- <u>Efficiency of compliance and administration</u>: As this option will enable grace periods to be managed independently in each system, it will not give rise to any compliance or administration issues. This option represents a significant improvement on the status quo, as it will not require any manual management and will therefore not require any additional resources.

- <u>Sustainability of the tax system</u>: This option will not give rise to any difficulties for taxpayers or to the potential for tax-driven outcomes. This option represents a significant improvement on the status quo as it does not give rise to the potential for error as a result of manual intervention.

27. Overall, this option would represent an improvement on the status quo.

Fiscal implications of the options

Options	**Fiscal impact**
Option 1 – Status quo	This option does not result in any fiscal impact as it maintains the current grace periods legislative provisions.
Option 2 – Integration Approach	This option does not result in any fiscal impact as it maintains the current grace periods legislative provisions.
Option 3 – Officials' preferred option	This option results in a fiscal loss in that it gives rise to instances where a taxpayer could be granted a grace period to which they would not, under the current rules, have been entitled. A fiscal loss will be incurred in each year of the Coexistence Period, as follows: • June 2015 – June 2016: $0.1 million • June 2016 – June 2017: $1.5 million • June 2017 – June 2018: $1.3 million • June 2018 – June 2019: $0.1 million • June 2019 – June 2020: $0.1 million The fiscal loss detailed above has been calculated on the basis of option (a), the customer-level indicator, being selected as the way in which compliance history is brought across to START. Option (b), the individual tax type compliance history option, would result in a slightly higher fiscal cost due to it resulting in a greater number of instances in which a taxpayer could be afforded a grace period to which they would not have been entitled.

Regulatory Impact Statement

Implementing New Zealand's commitment to Automatic Exchange of Information (AEOI)

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It provides an analysis of options to determine how best to give effect to New Zealand's commitments to implement the G20/OECD standard for *Automatic Exchange of Financial Account Information in Tax Matters*. The AEOI standard is a global framework for cooperation between countries in the detection and prevention of tax evasion. Specifically, the AEOI standard responds to international concerns that individuals and entities can relatively easily evade their tax obligations by concealing their wealth in 'off-shore' financial accounts.

New Zealand's international commitments to implement the AEOI standard were made in 2014 and in 2016 Cabinet supplemented those commitments with a decision to commence AEOI obligations from 1 July 2017. For this reason, this RIS is concerned solely with implementing AEOI and detailed design matters.

Three implementation options and the status quo are assessed in this RIS. The exact form that these options will take in practice depends on the specific design features that are ultimately decided upon. Given this and the fact that there is limited data about who may be impacted and how they may be affected by AEOI it is not possible to accurately estimate some of the costs involved (such as compliance costs) and benefits associated with each of the options. Even so, we have undertaken several rounds of consultation with financial institutions and their representative bodies (the most affected by AEOI), government agencies, and the general tax community, and the feedback from consultation has helped to inform our high-level assessment of the nature and extent of the costs and benefits.

It is acknowledged that implementing the AEOI will involve potentially significant compliance costs on financial institutions and administrative costs on Inland Revenue.

Additionally, the AEOI initiative will only be successful if jurisdictions implement AEOI on the same timeline and with consistent rules. If some jurisdictions are allowed to lag behind or implement to a lesser standard, the off-shore tax evasion problem is likely to simply relocate to those jurisdictions.

There are no other significant constraints, caveats or uncertainties concerning the analysis undertaken.

The preferred option is to adopt a balanced approach to implementation that seeks to minimise compliance costs and administrative where possible, provided those choices do not result in New Zealand failing to meet international expectations.

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

Emma Grigg
Policy Director, Policy and Strategy
Inland Revenue

13 May 2016

STATUS QUO AND PROBLEM DEFINITION

1. This Regulatory Impact Statement (RIS) deals with the question of how best to give effect to New Zealand's commitments to implement the G20/OECD standard for *Automatic Exchange of Financial Account Information in Tax Matters* (in short, Automatic Exchange of Information, or AEOI).

2. New Zealand's international commitments to implement the AEOI standard were made on:

   - 7 May 2014, by joining in a general declaration of support for the AEOI initiative issued at the OECD Ministerial Council Meeting;

   - 3 June 2014, by signing an administrative instrument[1] that sets out the terms for AEOI exchanges (the jurisdictions we will exchange with are still to be specified[2]); and

   - 16 November 2014, by reiterating our commitment at the November 2014 G20 Leaders Summit in Brisbane.

3. These commitments were general in nature. In February 2016, Cabinet supplemented the commitments with a decision that the start date from which AEOI obligations will apply in New Zealand will be 1 July 2017. From this date, financial institutions must start collecting the information needed for subsequent exchange. Although 1 July 2017 is later than the start date adopted by most other jurisdictions, it aligns with Australia's start date.

International considerations

4. AEOI is a global framework for cooperation between jurisdictions in the detection and prevention of tax evasion.[3] Specifically, AEOI responds to international concerns that individuals and entities can, with relative ease, evade their tax obligations by concealing their wealth in 'off-shore' financial accounts.

5. Jurisdictions implementing AEOI must:

   - enact legislation that will impose obligations on financial institutions to collect and report information to their local tax authority on accounts held or (in certain circumstances) controlled by non-residents; and

   - establish the legal mechanisms (primarily tax treaties) necessary for exchanging that information with other jurisdictions.

6. The exchanged information will be used by the receiving jurisdiction to ensure that their tax residents have correctly reported off-shore income for tax purposes.

---

[1] The OECD *Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information* (MCAA)

[2] Determining these jurisdictions will be subject to a separate process, as explained at paragraphs 120 and 121 below.

[3] AEOI forms part of the wider picture of a focus on cross-border tax compliance, both internationally (for example, the G20/OECD Base Erosion and Profit Shifting (BEPS) initiative which primarily relates to multinational enterprises) and domestically (for example, GST and online shopping).

7. This RIS pertains solely to the above requirement to enact legislation. It contains only passing references to certain necessary associated processes (for example, the publishing of New Zealand-specific lists of exchange partners and excluded entities/accounts) and legal mechanisms for exchange.

8. The AEOI initiative will only be successful if jurisdictions implement AEOI on the same timeline and with consistent rules. If some jurisdictions lag behind or implement to a lesser standard, the off-shore tax evasion problem is likely to simply relocate to those jurisdictions.

9. Accordingly, the G20 has taken a strong stance on ensuring that jurisdictions implement AEOI on a consistent and timely basis. Similar to the global standard for Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT), the AEOI standard constitutes 'soft law' (that is, international recommendations that are effectively mandatory, rather than just 'best practice').

10. As regards consistency, the *Global Forum on Transparency and Exchange of Information for Tax Purposes* (the Global Forum) has been tasked by the G20 with conducting peer reviews and on-going monitoring to ensure that jurisdictions implement the standard as it is set out in the OECD documentation.

11. As regards timing, the G20 and OECD have identified a target group of 101 countries that must implement AEOI on a timeline that will enable first exchanges to be completed by 30 September 2018. The target group includes all G20 and OECD member countries, and any other jurisdictions that have been identified as having or operating as an international finance centre are expected to implement AEOI on a similar timeline. As an OECD member country, New Zealand is included in the target group.

12. To clarify, 1 July 2017 will be the start date from which New Zealand financial institutions are to begin collecting information for subsequent reporting to Inland Revenue. Inland Revenue must then exchange that information with tax treaty partners by 30 September 2018.

13. All 101 jurisdictions in the above target group have committed to implement AEOI according to the G20 requirements. A small number of these, referred to as 'early adopters', have committed to complete their first exchanges a year earlier than the September 2018 deadline.

14. Jurisdictions outside of the target group do not face implementation deadlines as they are not considered to pose a significant risk in the context of off-shore tax evasion.[4]

Domestic considerations

15. The principal benefit for New Zealand in implementing AEOI lies in the information we will receive reciprocally from our treaty partners. This information will be available to

---

[4] Many of these jurisdictions may nevertheless implement AEOI. In the main, they are smaller developing countries. International organisations concerned with implementing the global *Post-2015 Development* and *Financing for Development* agendas are factoring AEOI implementation into their work programmes, as a key aspect of the 'domestic resource mobilisation' element of that agenda.

Inland Revenue to verify that its tax residents are correctly reporting off-shore financial assets and/or income.

16. To the extent that this facilitates a reduction in tax evasion (either through evasion actually detected, or more generally by deterring such activity), New Zealand will derive fiscal benefits. AEOI can generally also be expected to enhance voluntary tax compliance, through improved taxpayer perceptions that everyone is paying their fair share of tax.

17. New Zealand has been a strong supporter of all international initiatives to improve transparency and international cooperation in tax matters. There will be reputational benefits for New Zealand from being seen to be compliant with international standards.

18. It is acknowledged that AEOI implementation will impose potentially significant compliance costs on financial institutions and administrative costs for Inland Revenue. However, failure to implement AEOI, or to implement AEOI to a lesser standard so as to reduce compliance costs and administrative costs would damage New Zealand's international reputation.

The Common Reporting Standard (CRS)

19. New Zealand's enabling legislation will largely involve imposing obligations on financial institutions. These obligations are set out in a key element of the AEOI standard referred to as the *Common Reporting Standard* (CRS).

20. The rules set out in the CRS (as clarified and supplemented in the accompanying OECD commentary) are complex. In broad terms, incorporating the CRS into New Zealand domestic law will involve imposing *due diligence* and *reporting* obligations on New Zealand financial institutions in respect of their financial accounts.

21. Due diligence will be undertaken to identify the *tax residence* of:

- the account holders; and
- the controlling persons of accounts held by certain passive entities.

22. The due diligence procedures are highly prescriptive. In very generalised terms:

- in respect of *pre-existing accounts* (accounts already open as at 1 July 2017), financial institutions will generally be allowed to rely on documentation already held for other purposes (particularly that collected for AML/CFT or other 'know-your-customer' purposes) to determine the tax residence of each account holder and (where relevant) controlling person;
- in respect of *new accounts* (accounts opened on or after 1 July 2017), financial institutions will generally determine tax residence by obtaining a *self-certification* from each account holder and (where relevant) controlling person; and
- the *passive entity* account holders to be 'looked through' to determine their controlling persons are those that (i) are not themselves financial institutions, and (ii) have assets that primarily produce or are held for the production of *passive*

income (such as interest or dividends) – entities that meet these criteria are referred to as passive non-financial entities (*passive NFEs*).

23. Financial institutions will be required to report (on an annual basis) the following information to Inland Revenue:

- In respect of account holders or controlling persons that have been identified as tax residents of jurisdictions that have implemented AEOI,[5] they must generally report:
  - *identity information* such as name, address, and (in defined circumstances) date of birth and tax identification number; and
  - *financial account information* such as account balances and interest, dividends and other income earned.
- If they have been unable to determine the status of an account, they are required to report the account as an '*undocumented account*' in defined circumstances.

24. The CRS also requires implementing jurisdictions to have rules and procedures in place to ensure compliance and address non-compliance. This includes appropriate anti-avoidance rules, document retention requirements, auditing programmes, and sanctions to deal with identified non-compliance. Jurisdictions are specifically required to follow up on any undocumented accounts that are reported.

25. The CRS contains exclusions for certain categories of financial institution and financial account that are considered to pose a low risk of facilitating or being used for tax evasion. However, in some cases the criteria for exclusion are not automatic, and require submissions to be made by the financial institutions concerned. These criteria are very stringent. The application of the criteria in such cases will be dealt with as a stage two implementation matter. The process will involve Inland Revenue calling for submissions, and if possible making the necessary determinations before the end of 2016.

New Zealand's precedents and existing mechanisms

26. New Zealand has had an active exchange of information programme for many years. This primarily operates on the basis of responding to specific requests for information, but certain categories of information are subject to automatic exchange. As yet, we only automatically exchange *financial account* information with one country – the United States (US), pursuant to their 2010 *Foreign Account Tax Compliance Act* (FATCA) initiative.

27. FATCA operates on a similar basis to AEOI, in that New Zealand financial institutions are required to identify accounts held or controlled by US tax residents or citizens[6]

---

[5] Note that the option of a 'wider approach', which would capture non-residents from all jurisdictions, not just those in jurisdictions we will exchange information with is elaborated on below in this report.

[6] The reference here to 'citizens' is a key point of difference from AEOI. AEOI only applies to tax residents, reflecting the fact that most countries only tax the worldwide income of persons who are tax resident. The US, however, also applies this approach to citizens, regardless of whether they are also tax residents of the US.

Financial account information on those accounts is then reported to Inland Revenue, which automatically exchanges the information with the US.

28. The framework legislation for FATCA in New Zealand is contained in Part 11B of the Tax Administration Act 1994. The detailed rules are set out in an Intergovernmental Agreement (IGA) with the US that has been given legislative effect in New Zealand by Order in Council.

29. Part 11B of the Act contemplates entering into similar arrangements with other countries. Strictly, therefore, New Zealand legislation already provides for automatic exchange of financial account information with countries other than the US. However, the legislation as currently framed requires entering into further arrangements through treaties similar to the US IGA. This does not match the approach taken by the G20 and OECD for AEOI.

30. FATCA and AEOI rely in part on information already required to be collected by financial institutions from account holders, particularly under AML/CFT 'know-your-customer' requirements. However, the overlap between the AML/CFT requirements is not an exact match for those applying under the CRS. For example, under New Zealand's AML/CFT laws a financial institution may not collect all of the information required by the CRS in respect of discretionary trusts. Accordingly, in some areas, the AEOI due diligence obligations will require information to be obtained that is not required under AML/CFT laws.

31. Although AEOI exchanges can be made under other tax treaties, international expectations are that most, if not all, AEOI exchanges will take place under the OECD/Council of Europe *Multilateral Convention on Mutual Administrative Assistance in Tax Matters* (the Multilateral Convention). New Zealand signed the Multilateral Convention in 2012.

OBJECTIVES

32. The policy options considered in this RIS will be assessed against the following objectives:

    (a) To implement AEOI in a way that ensures **consistency with the requirements of the CRS** and its accompanying commentary so as to enable New Zealand to:

        (i) meet international expectations;

        (ii) comply with the international deadline of 30 September 2018 for completing first exchanges; and

        (iii) successfully undergo Global Forum peer review.

    (This objective reflects the aim of achieving sustainability and fairness in an international environment that is focused on establishing a global level playing field through implementation consistency.)

(b) To implement AEOI in a manner that **maximises the opportunity for New Zealand to derive domestic and international benefits**. (This objective is primarily concerned with efficiency and sustainability.)

(c) To implement AEOI in a manner that **minimises the compliance costs** that will be imposed on financial institutions. (This objective is primarily concerned with fairness and efficiency.)

(d) To implement AEOI in a manner that **minimises the administrative costs** that will be imposed on New Zealand regulatory agencies. (This objective is primarily concerned with efficiency.)

33. These objectives are listed in descending order of importance.

34. Objective (a) is the overarching consideration, given that New Zealand's implementation of the AEOI standard will be subject to peer review and other international scrutiny. The identification of deficiencies would damage New Zealand's international reputation and result in international and domestic pressure to take immediate remedial action. More generally failure to implement AEOI correctly could result in suspicion of New Zealand's motives, potentially leading to greater scrutiny of the off-shore activities of New Zealand tax residents and adding to the cost for New Zealanders of doing business internationally.

35. Objective (b) reflects the objective of the AEOI standard, which is to facilitate the detection and prevention of off-shore tax evasion. Implementation is not just about compliance with an international imperative. The ultimate purpose of AEOI is to improve tax compliance and provide fiscal benefits to jurisdictions. It is important that this objective be viewed as a key focus.

36. Objectives (c) and (d) reflect acknowledgement that implementing AEOI will impose potentially significant compliance costs on financial institutions and administrative costs on New Zealand regulatory agencies. However, implementation decisions to reduce compliance and/or administrative costs should only be made if that is achievable without lowering the overall effectiveness of the standard in New Zealand or being seen as undermining the multilateral initiative.

REGULATORY IMPACT ANALYSIS

37. Four policy options have been considered for implementing the AEOI standard described above:

- Option 1: Maintain the **status quo** – that is, do not implement AEOI.

- Option 2: A **low cost approach** – that is, to implement AEOI on the basis of design decisions that favour minimising compliance costs for financial institutions and administrative costs for Inland Revenue over meeting international expectations.

- Option 3: A **balanced approach** – that is, to implement AEOI on the basis of implementation decisions that strike a balance between minimising compliance costs for financial institutions and minimising administrative costs for New Zealand regulatory agencies and meeting international expectations.

- Option 4: A **high cost approach** – that is, to implement AEOI on the basis of implementation decisions that favour meeting international expectations over minimising compliance costs for financial institutions and administrative costs for Inland Revenue.

38. The 'Implementation' section of this RIS discusses key design features of AEOI. Some of these features are specifically referred to in the analysis of the options below in order to highlight key differences between the options.

Option 1: Maintain the status quo

39. Option 1 would not meet any of the objectives and is not considered to be tenable. A decision not to implement AEOI would mean New Zealand defaulting on commitments and result in international (and domestic) criticism and reputational damage.

Option 2: Low cost approach

40. This option would involve making design decisions that would favour minimising compliance costs for financial institutions and administrative costs for Inland Revenue over meeting international expectations.

41. Examples would involve lenient phase-in options (as discussed in paragraphs 120 to 121) not contemplated by the CRS and limiting due diligence for CRS purposes to existing due diligence requirements under AML/CFT laws (as discussed in paragraphs 115 to 117).[7]

42. Option 2 has been measured against the objectives listed in paragraph 32 above.

Objective (a) – Consistency with the requirements of the CRS and its accompanying documentation

43. Design decisions that favour minimising compliance costs as described above would in most cases fall short of the CRS requirements, and would result in failed peer review.

44. The consequences of failing peer review have not been articulated by the G20 or OECD. At a minimum New Zealand would face reputational damage. At the extreme, it is possible that we could face international sanctions. In any case, New Zealand would come under intense pressure to rectify any deficiencies, effectively meaning that any damage incurred will have been for little gain.

45. Therefore, option 2 does not meet this objective.

Objective (b) – Maximise the opportunity for New Zealand to derive domestic and international benefits

---

[7] As noted, AEOI due diligence depends to a significant degree on information obtained for AML/CFT purposes. However, there are gaps where AEOI due diligence obligations go beyond AML/CFT requirements.

46. The benefits to New Zealand from implementing AEOI primarily lie in the reciprocal information other jurisdictions will provide to Inland Revenue about New Zealand tax residents. Lowering the standard and quality of the information New Zealand provides to other jurisdictions will not directly affect this benefit.

47. However, it is possible that some jurisdictions might respond by refusing to provide information to New Zealand.

48. Aside from the benefit of reciprocal information, AEOI implementation will provide other benefits such as reputational benefits and enhancing voluntary compliance in tax matters. These benefits would be adversely compromised.

49. Therefore, this option partially meets the objective.

Objective (c) – Minimise the compliance costs to be imposed on financial institutions

50. As noted above, this option would be aimed at minimising compliance costs for financial institutions so meets the objective.

Objective (d) – Minimise the administrative costs to be imposed on Inland Revenue

51. This option would be aimed at minimising administrative costs for Inland Revenue so meets the objective.

Option 3: A balanced approach

52. Option 3 recognises that it is possible to implement AEOI in a way that enables New Zealand to meet international expectations while making choices that seek to minimise compliance costs and administrative costs.

53. The CRS is set by the OECD, and implementation will largely involve incorporating its rules (as clarified and supplemented by the OECD commentary) directly into domestic law. However, the CRS itself provides implementing jurisdictions with a number of options that can be taken. Adopting these options may assist in reducing compliance costs and administrative costs.

54. Outside of the options specifically contemplated by the CRS, other decisions could be taken under option 3 which would bear a low risk of exposure to international criticism. Key examples include:

- the timing for phasing in certain due diligence obligations (such as allowing 24-months to complete due diligence of pre-existing entity accounts, rather than the 12-months provided by Australia – see paragraphs 106 to 109), and

- allowing a transitional period in respect of enforcement – during which financial institutions identified as not complying with their obligations could mount a 'reasonable endeavours' defence and be allowed a reasonable period of time to rectify any errors (see paragraph 121).

55. Option 3 has been measured against the objectives listed in paragraph 32 above.

Option (a) – Consistency with the requirements of the CRS and its accompanying documentation

56. Design decisions under this option would be made on the basis of mitigating compliance costs and administrative costs wherever possible. In some cases, this may involve a judgement call whether CRS requirements would or would not be met.

57. The transitional approach to enforcement demonstrates this point. Although the CRS generally leaves the design of an effective enforcement regime up to jurisdictions, the terms of reference and methodology for peer reviews have not yet been set by the Global Forum.

58. Decisions made on the basis of option 3 would therefore involve some potential risk that peer review will determine that CRS requirements have not been met. However, the risk of reputational damage arising from the identification of deficiencies in peer review would be low, given that the decision was made on the basis of a judgement call that CRS requirements were met.

59. Therefore, this objective is met.

Option (b) – Maximise the opportunity for New Zealand to derive domestic and international benefits

60. The balanced approach to implementation should have no adverse implications in terms of the benefits likely to accrue to New Zealand from AEOI implementation so meets the objective.

Option (c) – Minimise the compliance costs to be imposed on financial institutions

61. The balanced approach to implementation would represent an attempt to minimise compliance costs to the extent possible so this objective is met.

Option (d) – Minimise the administrative costs to be imposed on Inland Revenue

62. The balanced approach to implementation would represent an attempt to minimise administrative costs to the extent possible, so meets this objective.

Option 4: High cost approach

63. Option 4 would carry the least risk of international criticism. In contrast to option 3, which involves making some judgment calls as to whether CRS requirements have been met, option 4 would involve a greater focus on meeting those requirements. However, this approach would result in the imposition of some compliance costs on financial institutions that could otherwise have been mitigated.

64. For example, under this approach, the transitional approach to enforcement would not be contemplated.

65. Option 4 has been measured against the objectives listed in paragraph 32 above.

Option (a) – Consistency with the requirements of the CRS and its accompanying documentation

66. Under this option, all design decisions would be made on the basis of meeting CRS requirements, so this objective would clearly be met.

Option (b) – Maximise the opportunity for New Zealand to derive domestic and international benefits

67. The high cost approach to implementation will have no adverse implications in terms of the benefits likely to accrue to New Zealand from AEOI implementation. Therefore, this objective is met.

Option (c) – Minimise the compliance costs to be imposed on financial institutions

68. The high cost approach to implementation would not attempt to minimise the compliance costs to be imposed on financial institutions so this objective is not met.

Option (d) – Minimise the administrative costs to be imposed on Inland Revenue

69. The high cost approach to implementation would not attempt to minimise the administrative costs to be imposed on financial institutions so this objective is not met.

Administrative impacts

70. In order to implement AEOI, a secure technology platform capable of receiving, storing and aggregating information from financial institutions in accordance with the CRS and exchanging it with other tax authorities is needed. Additionally, guidance and support must be provided to financial institutions to enable them to meet their obligations in full. Inland Revenue will also be responsible for the effective enforcement of AEOI.

Social, environment or cultural impacts

71. There will be no negative social, environmental or cultural impacts associated with any of the options identified above.

CONSULTATION

72. Several rounds of consultation were undertaken with affected parties including financial institutions and their representative bodies, the umbrella groups such as the New Zealand Law Society and Chartered Accountants of Australia and New Zealand and a number of Government agencies, including those concerned with New Zealand's privacy laws and anti-money laundering/countering the financing of terrorism (AML/CFT) laws.

73. In February 2016, an Officials' issues paper entitled *Implementing the global standard on automatic exchange of information* was released for public consultation. 21 submissions were received on the paper.

74. None of the submissions received on the issues paper proposed that New Zealand not proceed with implementation. This suggests that there is widespread acceptance of the need to implement AEOI to meet international expectations and to carry through with the commitment New Zealand has already made to implement AEOI.

75. The submissions often expressed a wide divergence of views as to how AEOI should be implemented. However, some common themes emerged, including:

- A strong preference for New Zealand to align its implementation decisions, where possible, with those taken internationally – and in particular with Australia.
    - Alignment with Australia seems particularly relevant in the context of New Zealand banks that are owned by Australian parents. But it is also relevant for financial institutions that have trans-Tasman financial products or an Australian client base.
- A strong preference that, where the CRS permits implementing jurisdictions to provide financial institutions with a choice of due diligence and reporting procedures, that choice should be available to institutions.
- A strong preference that financial institutions should not be required to obtain or report information about accounts unless the information is specifically required under the CRS or because of a choice that they have made.
    - This point essentially responds to an OECD suggestion that implementing jurisdictions could consider going further than the CRS requirements in certain areas – for example by making it mandatory to collect tax identification numbers or date of birth information in all cases (whereas the base expectation under the CRS is that for pre-existing accounts financial institutions do not need to go beyond reasonable endeavours to obtain this information). A further example is whether to require reporting of controlling persons of passive NFEs that are New Zealand residents.
    - The one exception to this point is the proposed application of the 'wider' approach to CRS due diligence (and reporting), outlined below. As will be noted, there was strong support for adopting the wider approach, to due diligence in particular.
- A strong preference that New Zealand should, where possible look to align the entities and accounts that will be excluded from CRS obligations with the entities and accounts that are excluded for FATCA. Some submitters noted that this alignment should also apply to entities and accounts that are excluded under New Zealand's AML/CFT regime.
- A strong preference that New Zealand should, where possible, look to align CRS due diligence procedures with those carried out under FATCA and New Zealand's AML/CFT regime, so that any additional AEOI due diligence is minimised. (There was widespread acceptance that the information that needs to be reported under AEOI will be different from that reported under these other regimes.)

- A strong preference that New Zealand should adopt a ‘soft landing’ approach to addressing any non-compliance with CRS. (Essentially, that is, to take a light or transitional approach to penalising non-compliance.)

76. All of the points raised in submissions and in consultation discussions have been considered.

77. Those that would lead to a high risk of international criticism and failing peer review have generally been ruled out. In this regard, it is worth reiterating that the AEOI standard is a global standard and its success depends on consistent application across jurisdictions.

78. However, some submissions have helped to shape key design decisions. A notable example is the proposed transitional approach to enforcement. Other examples include decisions to allow optionality, to align with the FATCA reporting period, and to align with the Australian wider approach for due diligence and reporting[8].

79. A number of public sector agencies were consulted including the Treasury. Given the strong links with New Zealand’s AML/CFT laws, additional consultation was held with AML Regulators (the Department of Internal Affairs, the Financial Markets Authority, and the Reserve Bank of New Zealand). The Ministry of Justice and the Office of the Privacy Commissioner were specifically consulted in respect of privacy concerns.

CONCLUSIONS AND RECOMMENDATIONS

80. Inland Revenue supports the adoption of option 3 (the balanced approach) on the basis that it meets all of the objectives.

	Consistency with the CRS	Maximise the benefits for NZ	Minimise compliance costs	Minimise administrative costs
Low cost approach	✗	✓✗	✓	✓
Balanced approach	✓	✓	✓	✓
High cost approach	✓	✓	✗	✓✗

Key: ✓ = meets, ✓✗ = partially meets, ✗ = does not meet

81. Option 1 (the status quo) is not supported because it is not tenable. Options 2 and 4 are not supported because they do not meet all of the objectives. In particular, option 2 would result in New Zealand failing to meet international expectations, whereas option 4 would meet international expectations but impose compliance costs and administrative costs that could otherwise be mitigated.

[8] We note, however, that although Australia has opted to make the wider approach mandatory in all cases, New Zealand will allow the wider approach to be optional in the case of reporting.

IMPLEMENTATION

82. Option 3 would involve implementing AEOI on the basis of balanced implementation decisions that reduce compliance costs for financial institutions and administrative costs for Inland Revenue where possible, but only to the extent that those decisions would not jeopardise New Zealand's ability to meet international expectations.

Key design features

83. The key design features of the preferred option are outlined below.

Optionality

84. As noted above, the CRS is set by the OECD, and implementation will largely involve incorporating its rules directly into domestic law. However, the CRS itself provides implementing countries with a number of options that can be taken.

85. For the most part it is proposed to leave these options open to the financial institution, so that they can choose the option that best suits their particular circumstances.

86. For example, for consistency the CRS sets certain default due diligence thresholds in US currency, such as a threshold of US$1,000,000 for distinguishing between high value and lower value individual accounts[9]. However, the CRS allows jurisdictions to substitute their local currency. Many financial institutions might find compliance cost savings in not having to convert NZ$ balances to US$ equivalents to determine if the threshold has been exceeded (and simply treating the high value threshold as being NZ$ 1,000,000). Other financial institutions, particularly those that operate in several jurisdictions, might prefer the consistency of applying the same threshold amount in the same currency in all the jurisdictions in which they operate. The proposed approach, in such cases, is to allow each financial institution to choose their threshold. Submissions strongly endorsed this approach.

87. In certain other cases, where consistency is important or is required by the CRS, the taking of an option will need to be mandated in legislation (that is, not left to financial institutions to decide). Two key examples of this are the *reporting period* and *wider approach to due diligence*, discussed below.

88. In deciding on what option to take in this regard (which all financial institutions would be required to apply) it is proposed that the decision is taken that results in the least compliance costs for financial institutions as a whole and that is consistent with CRS obligations (and in accordance with New Zealand's international obligations).

89. Public submissions generally endorsed this approach to optionality.

90. There are also a number of parts of the CRS where implementing jurisdictions have the option of requiring financial institutions to obtain and report certain information beyond the CRS base due diligence and reporting expectations. It is proposed for the most part (with the exception of the *wider approach to due diligence*) that financial institutions should not be required to obtain information about accounts unless the information is

[9] In broad terms, financial institutions need to carry out more extensive due diligence procedures for high value accounts.

specifically required under the CRS or because of a choice that they have made. Submissions strongly supported this approach to optionality

Reporting period

91. The CRS due diligence and reporting obligations operate on the basis of annual ‘reporting periods’. Jurisdictions may choose whether to adopt a calendar year or other appropriate period for this purpose.

92. Australia and most other countries have adopted the calendar year (for both CRS and FATCA). The reporting period New Zealand adopted for FATCA purposes was the tax year (that is, the year ending 31 March).

93. The majority of submitters considered that New Zealand should adopt the tax year for CRS due diligence and reporting, to align with both the New Zealand tax year and the period used for other reporting and regulatory purposes, especially FATCA.

94. Some submitters proposed that this period be ‘optional’. However, it is implicit in the CRS that each jurisdiction will have one period governing due diligence, reporting and exchanging.

95. On balance, the tax year (that is, the period ended 31 March), would provide better domestic alignment, including with FATCA. This will allow financial institutions to better integrate their CRS systems with other existing reporting systems, so overall should assist in minimising compliance costs.

96. Moreover, when combined with the New Zealand start date of 1 July 2017, a 31 December reporting period end date would result in a first reporting period of only six months. A 31 March reporting period end date would result in a first reporting period of nine months, giving financial institutions more time to complete the due diligence reviews required by the CRS in that first period. (See below under ‘initial reporting period’.)

97. For reasons of certainty, consistency and simplicity, it is proposed to mandate the tax year as the reporting period, rather than allowing financial institutions the choice.

98. It is also proposed that financial institutions be required to report CRS information to Inland Revenue by 30 June in line with the FATCA reporting deadline. This will help ensure that Inland Revenue has sufficient time to then process the information for exchange by the 30 September deadline.

99. In this regard note that Australia allows until 31 July rather than 30 June. Aligning with Australia’s 31 July date would allow New Zealand financial institutions more time to report. However, it would shorten the time available for Inland Revenue to prepare the information for exchange from three months to two months. Given the possible need for Inland Revenue to identify and clarify irregularities or deficiencies with financial institution reports (particularly in the initial years of implementation), two months would pose material risks.

Initial reporting period

100. The CRS contemplates due diligence reviews of pre-existing high value individual accounts being undertaken within the first reporting period.

101. Most jurisdictions implementing AEOI will have a start date of 1 January and will operate on the basis of a calendar year reporting period, allowing a full 12 months to conduct these reviews. In contrast, the proposed New Zealand start date of 1 July 2017 and reporting period end date of 31 March will prima facie only allow New Zealand financial institutions nine months (that is 1 July 2017 to 31 March 2018) to complete these initial reviews. This potentially disadvantages New Zealand financial institutions as compared with financial institutions of other countries.

102. Australia has the same 1 July start date as New Zealand, but has a reporting period end date of 31 December. Therefore Australia's first reporting period will only be six months. As this would prima facie only allow six months for completing due diligence of pre-existing high value individual accounts, Australia has adopted a compromise approach that involves allowing additional time to complete the reviews of pre-existing high value individual accounts, albeit still reporting the required information (such as account balances) in the first report.

103. The mechanism is complex, but in essence Australia will allow financial institutions to carry out due diligence on pre-existing high value individual accounts until 31 July 2018 (essentially allowing 13 months for due diligence on such accounts) provided that such accounts are reported in the first report.

104. It is proposed to adopt a similar approach for New Zealand. The 30 June deadline will apply for the purposes of completing due diligence reviews of pre-existing high value individual accounts and reporting the information to Inland Revenue. Under this approach, financial institutions can continue conducting due diligence on high value accounts past the 31 March reporting period end date, provided they report the information about any reportable high value accounts identified in this review to Inland Revenue by 30 June.

105. The same approach will apply for the following year, for the due diligence reviews of pre-existing low value individual accounts and pre-existing entity accounts (that is, allowing review and reporting by 30 June 2019).

Time for completing due diligence reviews of pre-existing entity accounts

106. The OECD documentation is (slightly) ambiguous on the expected time-frame for completing due diligence for pre-existing entity accounts. Most countries appear to be reading the documentation as generally allowing 24 months for these reviews. Australia initially proposed 24 months, but in their implementation legislation enacted in March 2016, ultimately only allowed 12 months.

107. The due diligence for pre-existing entity accounts is expected to be more challenging for financial institutions than due diligence for accounts held by individuals, particularly given that look-through rules apply to accounts held by passive NFEs. In this context, allowing 24 months rather than 12 months to complete these reviews would seem appropriate and broadly aligns with FATCA due diligence time-frames for reviewing such accounts.

108. Although submissions generally call for alignment with Australia where possible, alignment with the Australian 12 month period for entity accounts may be a step too far, particularly given the tight time-frames for New Zealand's implementation.

109. It is proposed to retain the 24 month due diligence period for completing due diligence reviews of pre-existing entity accounts, and not to follow the Australian approach to this issue.

Wider approach

110. During the development of the CRS, private sector interests raised concerns with the OECD that the number of jurisdictions participating in the AEOI initiative can be expected to increase over time. Each new country joining the initiative would trigger a requirement for financial institutions to conduct a new round of due diligence reviews of accounts. This could be prevented by treating all jurisdictions as reportable jurisdictions for due diligence purposes. This approach would have a significant compliance cost saving, and we are not aware of any jurisdiction not adopting the *wider approach to due diligence*. Submissions strongly endorsed this approach.

111. For consistency, to prevent confusion for customers, and to avoid putting financial institutions that adopt the wider approach at a competitive disadvantage, it is proposed to make the wider approach for due diligence mandatory rather for all financial institutions. Submissions generally endorsed this approach.

112. The wider approach to due diligence raises the question of what then happens to the additional information collected that does not need to be exchanged ('the residual information').

113. The residual information could be held by the financial institutions. However, the greatest compliance cost saving would arise from financial institutions simply being allowed to report all of the information they collect (including the residual information) to the local tax administration, even though it will not be exchanged. Under this approach, financial institutions would not be constantly required to keep track of the jurisdictions New Zealand has entered into AEOI relationships with. Instead, financial institutions would merely report all of the information about non-residents to Inland Revenue. This is referred to as the *wider approach to reporting*. Some countries, including Australia, have adopted this option. Others, such as the United Kingdom, require the residual information to be retained by financial institutions.

114. The general preference in submissions is to align with Australia, and adopting the wider approach to reporting would also be consistent with the approach of minimising compliance costs wherever possible. Moreover, the pool of residual information could be used by Inland Revenue to assist in, for example, confirming that the non-residents have the correct non-resident withholding rate (similar to the way that the information to be exchanged can be used) to the extent that such use is consistent with legal obligations and responsibilities. This is a delicate matter that involves balancing benefits against privacy concerns. For consistency with New Zealand's privacy laws, it is proposed that the potential use of the residual information by Inland Revenue be subject to full transparency.

Alignment with existing regimes

115. The CRS due diligence and reporting procedures leverage off FATCA and AML/CFT procedures in a number of ways. For example, CRS uses a number of FATCA terms and concepts (such as what constitutes a financial institution and the types of accounts that are subject to due diligence and reporting). Financial institutions are also sometimes able to use AML/CFT information to assist with CRS due diligence. However, the CRS and supporting OECD documentation are clear that there are a number of areas where CRS due diligence and reporting procedures diverge from FATCA and AML/CFT procedures.

116. One consistent theme of the submissions is that New Zealand should look to align CRS due diligence with FATCA and AML/CFT procedures where possible with a view to minimising compliance costs for financial institutions.

117. Although this approach has been adopted where possible (for example in aligning the AEOI and FATCA reporting periods) it is not possible in all situations. To the extent that there are any differences between regimes, the CRS must drive CRS due diligence and reporting obligations. This is because CRS is a global standard that needs to be implemented consistently worldwide. New Zealand's compliance with this global standard will be internationally reviewed.

Enforcement

118. The CRS requires effective anti-avoidance and enforcement rules to ensure compliance. This includes a specific expectation that implementing jurisdictions will have robust rules in place that will ensure self-certifications are always obtained for new accounts. However, it leaves the design of those rules up to each country.

119. In terms of an anti-avoidance rule, we propose a similar rule to that introduced for FATCA. This would be modified (as required by the CRS) to ensure that in addition to financial institutions it applies to account holders, intermediaries, and certain other persons (in recognition of the fact that such persons often control the information that institutions are required to obtain and report, so could take steps to circumvent CRS due diligence and reporting). The rule could apply, for example, in the case of a financial institution that advises a customer to maintain an account with a related entity in a non-participating jurisdiction (where there is no scope to link the accounts for due diligence purposes), so as to avoid reporting obligations while still offering services to the customer as if the account was maintained by the financial institution itself. It is proposed that this modification will also apply for FATCA purposes.

120. In terms of enforcement rules, we propose a regime broadly based on civil penalties (rather than criminal penalties, as is the case for FATCA). We are not aware of any other implementing country imposing specific criminal penalties for AEOI.

121. Penalties (for example, for failure to conduct due diligence or reporting) would primarily apply at the financial institution level (including a specific penalty for failure

to obtain a self-certification when opening a new account)[10]. However, as a transitional measure, we propose allowing a grace period through to 31 March 2019 during which time a 'reasonable endeavours' defence could be mounted and a reasonable period of time allowed to rectify identified errors. After the transitional period, the penalties would be applied on a more rigorous basis. It is also proposed that undocumented new accounts are reported to be used as a tool to review and monitor compliance by financial institutions with their CRS due diligence obligations.

122. In some cases, financial institutions may experience difficulty in obtaining responses from account holders, intermediaries and other persons to requests for documentation (particularly self-certification of tax residence). It is therefore proposed to supplement the penalties imposed on financial institutions with penalties on account holders, intermediaries, or other persons for either providing a false self-certification or (where the person fails to provide a self-certification (or material information about a change of circumstances relating to a self-certification) with the intention of circumventing CRS reporting. There would also be a requirement of persons that hold accounts or funds on behalf of another person to take reasonable steps to provide (on request) CRS information to that financial institution, with a penalty for non-compliance.

123. It is proposed that these penalties on account holders, intermediaries, and other persons, will be extended to apply to FATCA, as there is currently a gap in these areas.

Stage two implementation issues

124. The AEOI standard requires implementing jurisdictions to publish a number of lists. These are:

- *Reportable jurisdictions*. An implementing jurisdiction must list the countries that it intends providing AEOI information to.
- *Participating jurisdictions*. An implementing jurisdiction must also list the countries that it has an arrangement to receive AEOI information from.[11]
- *Excluded Entities and Accounts*. An implementing jurisdiction must list the specific financial institutions and accounts that it has excluded from AEOI obligations on the basis that they pose a low risk in the context of tax evasion.

125. These lists do not need to be finalised in parallel with the implementation legislation, but will need to be in place prior to the 1 July 2017 start date, with sufficient lead time for financial institutions to develop their systems and processes.

126. The issue of reportable jurisdictions raises potential privacy issues, given that the information to be disclosed to jurisdictions is of a highly sensitive personal and financial nature. Frameworks for confidentiality and data safeguards are a key element of AOEI implementation for all jurisdictions, and are the subject of separate Global Forum reviews. However, submissions proposed that a degree of caution should be

---

[10] The CRS commentary is clear that there is an expectation that implementing jurisdictions will have robust provisions in place to ensure that self-certifications are always obtained for new accounts.

[11] Note that, during the global implementation phase, a transitional period will apply during which jurisdictions that have committed to implementing AEOI will be treated as participating jurisdictions.

exercised in the case of jurisdictions such as those that have no previous experience in exchange of information. Submissions strongly proposed that selection of New Zealand's reportable jurisdictions be subject to a robust and transparent process, and Government oversight.

127. In acknowledgement of the concerns raised in these submissions, it is proposed that the list of reportable jurisdictions be selected by a process that will involve Inland Revenue disseminating the outcome of Global Forum reviews and calling for submissions on genuine reasons why a jurisdiction should not be included on the list. Inland Revenue's decisions will be subject to Government oversight through an Order in Council process for announcing and maintaining the list.

128. The issue of determining excluded entities and accounts will also necessarily involve Inland Revenue receiving and considering submissions. However, it is proposed that the Commissioner of Inland Revenue be authorised to announce, and maintain, the lists of excluded entities and accounts, by Commissioner's determination.

129. Similarly, it is proposed that the Commissioner of Inland Revenue be authorised to announce, and maintain, the lists of participating jurisdictions, by Commissioner's determination.

MONITORING, EVALUATION AND REVIEW

130. New Zealand's implementation will be subject to international peer review and on-going monitoring by the Global Forum. The peer review schedule has not yet been determined.

131. As the AEOI standard is determined internationally, future changes at the international level are likely – particularly as countries identify issues and concerns, and make consequential adjustments to the rules to address these issues. New Zealand will need to monitor and respond to these changes.

132. Domestically, an internal review of the AEOI legislation is also proposed 18 to 24 months after enactment. This will primarily be to evaluate if the rules are working as intended or if adjustments are needed. In particular, New Zealand's CRS anti-avoidance and enforcement provisions will be evaluated to determine if they are effective. In addition, it may be possible to use this opportunity to further align FATCA legislation with the AEOI legislation, as we obtain information about how the regimes (particularly the penalties provisions) are working in practice.

133. It is not appropriate to make changes to the FATCA rules as part of the initial AEOI implementation, as AEOI consultation did not specifically seek information on this point.

REGULATORY IMPACT STATEMENT

Proposed changes to business tax

Agency disclosure statement

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

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

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

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

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

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

Keith M Taylor

Keith Taylor
Policy Manager, Policy and Strategy
Inland Revenue

25 February 2016

Contents

Reader's guide to this RIS

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

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

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

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

STATUS QUO AND PROBLEM DEFINITION

Inland Revenue's transformation programme

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

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

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

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

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

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

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

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

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

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

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

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

- **Provisional tax is hard to get right and expensive to get wrong.** This affects businesses' ability to comply, results in compliance or administration costs, and adversely impacts perceptions of fairness.

- **The withholding tax regime for contractors is inflexible, out of date and open to abuse.** This affects the accuracy and timing of tax payments, results in compliance or administrative costs, and adversely impacts perceptions of fairness of the tax system.

- **Penalties are punitive and can reduce taxpayer compliance.** The current penalty rules do not take account of businesses' circumstances or the interaction of the use of money interest (UOMI) and penalty rules and the affect these have in conjunction with the provisional tax rules. Also an automatic penalty is frequently levied against those who did not pay due to an administrative error (as they have underdeveloped business processes), cannot pay (as they do not have the resources) or will not pay (as they have the resources, but choose not to pay). This adversely impacts fairness by imposing excessive costs on businesses who are trying to comply, and reduces compliance.

- **Tax information is not used to protect businesses**. Compliant businesses would be better protected if data held by Inland Revenue indicating serious debt or malpractice was shared appropriately. However, legislation currently restricts this.

- **Rules require accuracy regardless of costs**. Tax rules that try to get to a "perfect" answer can impose undue costs when, in some instances, close enough should be good enough.

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

Problems and their magnitude

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

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

OBJECTIVES

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

- *Fairness and equity:* to support fairness in the tax system, options should, to the extent possible, seek to treat similar taxpayers in similar circumstances in a similar way.

- *Efficiency of compliance and administration*: the compliance impacts on taxpayers and the administrative costs to Inland Revenue should be minimised as far as possible.

- *Sustainability of tax system:* options should collect the revenue required in a transparent and timely manner while not leading to tax driven outcomes.

16. These objectives are weighted equally.

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

REGULATORY ANALYSIS

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

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

B. Self-management and integrity.

C. Making the system fairer.

D. Making markets work better through tax transparency.

E. Supplementary simplification measures.

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

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

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

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

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

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

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

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

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

Options and analysis

26. The proposals to address the issues identified are:

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

Extend the safe harbour from UOMI

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

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

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

Recommendation

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

Remove the application of UOMI

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

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

Options	**Analysis against the objectives**

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

Recommendation

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

Introduce a new method of calculating provisional tax

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

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

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

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

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

Recommendation

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

Paying tax as agent for shareholder-employees

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

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

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

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

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

Recommendation

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

B. Self-management and integrity

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

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

Options and analysis

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

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

Option	Analysis against the objectives
1. Retain the status quo	*Fairness and equity:* ✕✕ *Compliance and administration:* ✕✕ *Sustainability:* ✕✕ *Revenue:* no impact

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

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

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

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

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

Recommendation

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

C. Making the system fairer

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

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

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

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

Options and analysis

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

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

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

Recommendation

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

D. Making markets work better through tax transparency

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

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

Options and analysis

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

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

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

Recommendation

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

E. Supplementary simplification measures

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

Simplified calculation of deductions for dual use vehicles and premises

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

Simplified calculation of deductions for dual use vehicles

Options and analysis

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

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

Recommendation

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

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

Simplified calculation of deductions for dual use premises

Options and analysis

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

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

Recommendation

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

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

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

[2] Section 113A of the Tax Administration Act 1994

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

Options and analysis

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

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

Recommendation

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

Remove requirement to renew a resident withholding tax exemption certificate annually

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

Options and analysis

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

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

Recommendation

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

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

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

Options and analysis

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

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

Recommendations

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

Modify the 63 day rule on employee remuneration

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

Options and analysis

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

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

Recommendations

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

Simplification of fringe benefit calculation for close companies

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

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

Options and analysis

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

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

Recommendations

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

CONCLUSION

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

CONSULTATION

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

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

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

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

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

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

IMPLEMENTATION

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

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

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

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

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

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

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

MONITORING, EVALUATION AND REVIEW

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

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

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

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

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

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

Status Quo and problem definition

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

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

Currently taxpayers have three options for calculating provisional tax:

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

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

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

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

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

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

Constraints

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

Options

The proposals to address the issue are:

1. Extend the safe harbour from UOMI;

2. Remove the application of UOMI;

3. Introduce a new method of calculating provisional tax; and

4. Enable tax to be paid by close companies and partnerships as agent for shareholders and partners.

1 – Extend the current safe harbour from UOMI

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Recommendations

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

2 – Application of UOMI

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

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

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

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

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

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

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

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

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

31

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

Recommendations

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

3 – Calculation method for provisional tax

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

35

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

Recommendations

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

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

4 – Paying tax as agent for shareholder-employees

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

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

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

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

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

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

Four options to address the issue were looked at.

The first option is to retain the status quo and accept that tax operates on the basis of legal form. If individuals want to put their business activities in a separate company, they inevitably create a requirement for transactions – with tax consequences – between that company and themselves.

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

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

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

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

Consultation

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

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

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

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

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

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

Recommendations

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

APPENDIX B – SELF-MANAGEMENT AND INTEGRITY

Status quo and problem definition

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

Withholding at source systems:

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

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

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

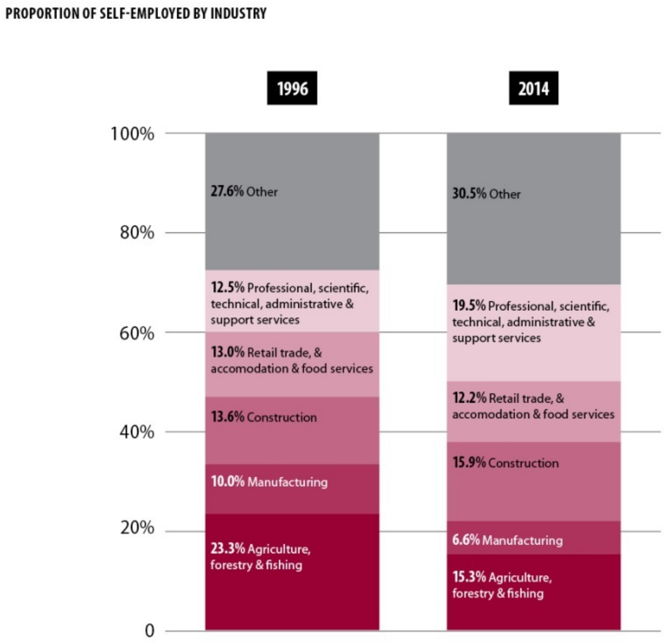
The rules require withholding at flat rates. These rates have not been reviewed since 1979 and for the majority of taxpayers, the amounts withheld do not match their final tax liability (the current rates generally over-withhold on contractors).

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

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

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

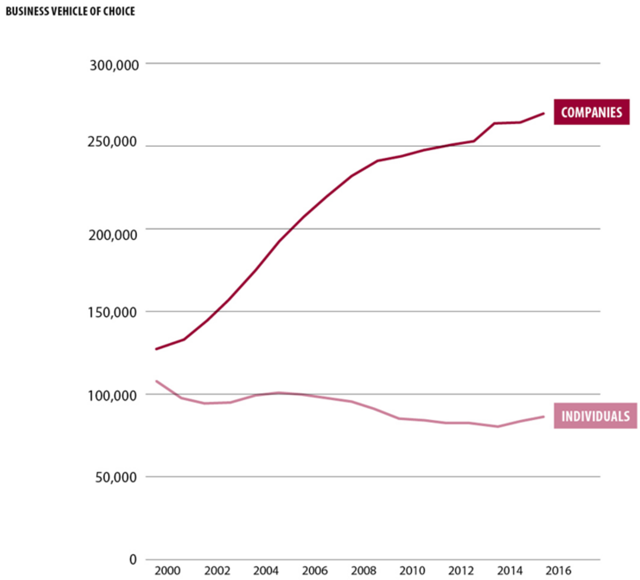
The current withholding tax rules generally do not apply to these modern, professional industries. This means more self-employed people are working in industries not covered by the withholding tax rules.



[3]

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

[3] 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.
[4] Companies in the agricultural, horticultural, and viticulture industries and non-resident contractor companies are subject to withholding under the schedular payment rules.



[5]

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

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

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

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

Options and analysis

The options to address the issue are:

1. Retain the status quo.

2. Allow contractors subject to the schedular payment rules to elect their own withholding rate.

---

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

3. Allow contractors not subject to the schedular payment rules to voluntarily elect into the withholding rules.

4. Extend withholding to labour-hire firms.

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

Measures not considered

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

- Extending withholding to other directly engaged contractors (for example, IT contractors).

- Removing or amending the company exception to the schedular payment rules.

- Using banks as an intermediary for withholding rather than the payer of the contractor.

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

Option 2 - Electing own withholding rate

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

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

Option 3- Voluntary withholding agreements

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

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

Option 4 - Extending withholding to labour-hire firms

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

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

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

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

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

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

47

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

Minimum rates of withholding

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

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

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

Consultation

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

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

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

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

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

Recommendations

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

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

APPENDIX C – MAKING THE SYSTEM FAIRER

Status quo and problem definition

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

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

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

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

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

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

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

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

[6] Inland Revenue Annual Report, 2015.

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

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

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

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

Constraints

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

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

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

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

Options and analysis

Options to address the issue are:

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

Option 1 – Retain the status quo

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

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

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

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

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

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

Option 3 – Remove the 1% incremental late payment penalty

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

57

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

Consultation

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

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

Recommendations

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

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

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

APPENDIX D – MAKING MARKETS WORK BETTER THROUGH TAX TRANSPARENCY

Status quo and problem definition

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

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

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

Significant tax debt

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

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

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

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

---

[7] Section 81, Tax Administration Act 1994

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

Enforcement of wider business obligations

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

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

- some cases of illegal conduct are being committed and discovered (or partially discovered) by Inland Revenue, but are never brought to the attention of the relevant enforcement agency; and

- some cases of illegal conduct that are being investigated or prosecuted by another agency are not being handled as efficiently as they would be if that agency was able to request information already held by Inland Revenue.

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

Constraints

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

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

---

[8] Habitual Non Complier Tier 2 Analysis, Inland Revenue.

- Taxpayers in significant tax debt are likely to have a number of credit arrangements with a number of businesses; and some of these businesses will be unsecured creditors who are vulnerable in the event of the taxpayer's business collapsing.

- Businesses (and their directors and management) behaving illegally are likely to pose a risk to a large number of other parties including their shareholders, creditors, and employees.

Options

Officials have identified the following options:

1. Retain the status quo.

2. Share significant tax debt information with credit reporting agencies.

3. Share significant tax debt information with the general public.

4. Share information on serious offences with the Registrar of Companies.

5. Share information for enforcement of wider business obligations.

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

Option 1 – Status quo

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

This option would involve a new exception to tax secrecy rules to allow Inland Revenue to share information with the Registrar of Companies in relation to certain serious offences (meaning offences with a maximum sentence of imprisonment of 5 years or more) under the Companies Act 1993. These offences relate to serious harmful conduct by company directors and management.

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

- there is reasonable suspicion (on the part of the initiating agency) that a serious offence has been, is being, or will be committed;

- Inland Revenue considers the information being shared will prevent, detect, or provide evidence of, a serious offence that has been, is being, or will be committed; and

- Inland Revenue is satisfied that the information is readily available, it is reasonable and practicable to communicate it, and communication is in the public interest.

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

Option 5 - Share information for enforcement of wider business obligations

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

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

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

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

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

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

Options not considered

Share serious offences information with a range of agencies

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

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

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

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

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

Consultation

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

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

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

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

Recommendations

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

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

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

APPENDIX E – SUPPLEMENTARY SIMPLIFICATION MEASURES

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

Constraints

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

1 – Simplified calculation of deductions for dual use vehicles

Status quo and problem definition

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

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

Simplified calculation of deductions for dual use vehicles

Options and analysis

The options to address this issue are:

Option 1 – retain the status quo

Option 2 – optional single rate method

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

Under this option:

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

- The rates would be set by reference to industry figures, and based on the average per kilometre cost for the average vehicle. The rates would also assume a fixed amount of private use in respect of the fixed cost element, so no apportionment between actual business and private use would be required

- The rate would be divided into 2 tiers. The first tier would provide for the recovery of both the vehicle's fixed costs and per kilometre costs. The second tier would provide for the recovery of the per kilometre costs only.

- Taxpayers would keep a logbook for a 3 month representative test period to determine the vehicle's business kilometres as a proportion of the total distance travelled. Taxpayers could then multiply that fraction by the total distance travelled each year to give the business kilometres. Taxpayers would also be able to choose the current method of recording and using their actual business kilometres for an income year.

Option 3 – Compulsory single rate method

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

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

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

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

Recommendations

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

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

Options and analysis

Options to address this issue are:

Option 1 – Retain the status quo

Option 2 – Optional single rate method

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

Option 3 Compulsory single rate method

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

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

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

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

75

Recommendations

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

Consultation

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

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

Status quo and problem definition

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

Options and analysis

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

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

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

[10] Section 113A of the Tax Administration Act 1994

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

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

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

Consultation

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

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

Recommendations

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

4 – Remove the requirement to renew RWT exemption certificates annually

Status quo and problem definition

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

Options and analysis

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

The first option is to retain the status quo.

Option 2 – Issue certificate for an unlimited period

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

---

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

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

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

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

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

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

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

Consultation

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

Recommendations

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

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

Status quo and problem definition

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

Options and analysis

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

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

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

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

Consultation

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

Recommendations

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

6 – Modify the 63 day rule on employee remuneration

Status quo and problem definition

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

Options and analysis

The following options have been considered for addressing this issue.

The first option is to retain the status quo.

Option 2 – Make the 63 day deferred payment rule optional

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

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

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

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

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

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

Consultation

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

Recommendations

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

7 – Simplification of fringe benefit calculation for close companies

Status quo and problem definition

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

Options and analysis

The following options have been considered for addressing this issue.

The first option is to maintain the status quo.

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

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

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

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

Consultation

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

Recommendations

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