Tax Working Group Information Release

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This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

Appendix F – Compliance cost reductions

Further information on specific revenue-negative proposals

July 2018

Prepared by the Inland Revenue Department and the New Zealand Treasury

Compliance cost reductions

Proposal

1. This option would incorporate the overhaul of small business taxation proposed by the Chartered Accountants Australia and New Zealand (CAANZ). The detail of the proposal is provided below.

2. In addition, this appendix briefly outlines a number of simplifications to the tax rules and certain thresholds in the tax legislation that could be made to simplify the rules.

CAANZ proposal

3. The CAANZ proposal is to tax small business more on a cashflow basis. This would be more aligned with the calculation of goods and services tax (GST), with additional adjustments for items not subject to GST, such as interest and non-GST employment costs.

4. The proposal has two parts:

- an optional cashflow-based tax for small and medium sized businesses (annual turnover between \$60,000 and \$1.2m); and
- an optional turnover tax for micro businesses (annual turnover less than \$60,000) at a final rate of 15%.

5. The design of the cashflow proposal can be summarised as follows:

Criteria	Features
Turnover of between \$60,000 and \$1.2m (previously \$600,000 in 2011).	Small business that trades through a company or partnership will be taxed analogously to a sole trader by taxing the entity based on the personal marginal rate structure.
Designed for more established businesses but could also be used for start-ups if desired.	Transactions such as dividends and salaries between the business entity and its owners are eliminated, as is the need to maintain an imputation credit account.
Income tax will be calculated on a cash basis on the GST return, as an adjustment to the GST return result.	Income tax and GST will be calculated and paid two monthly on a simplified cash basis.
Like GST, income tax will be paid every two months: there will be no year-end adjustments, no provisional tax and no fringe benefit tax.	No balance date and square up issues.
	Trading stock (except for livestock) purchases are deducted on a cash basis – no need for

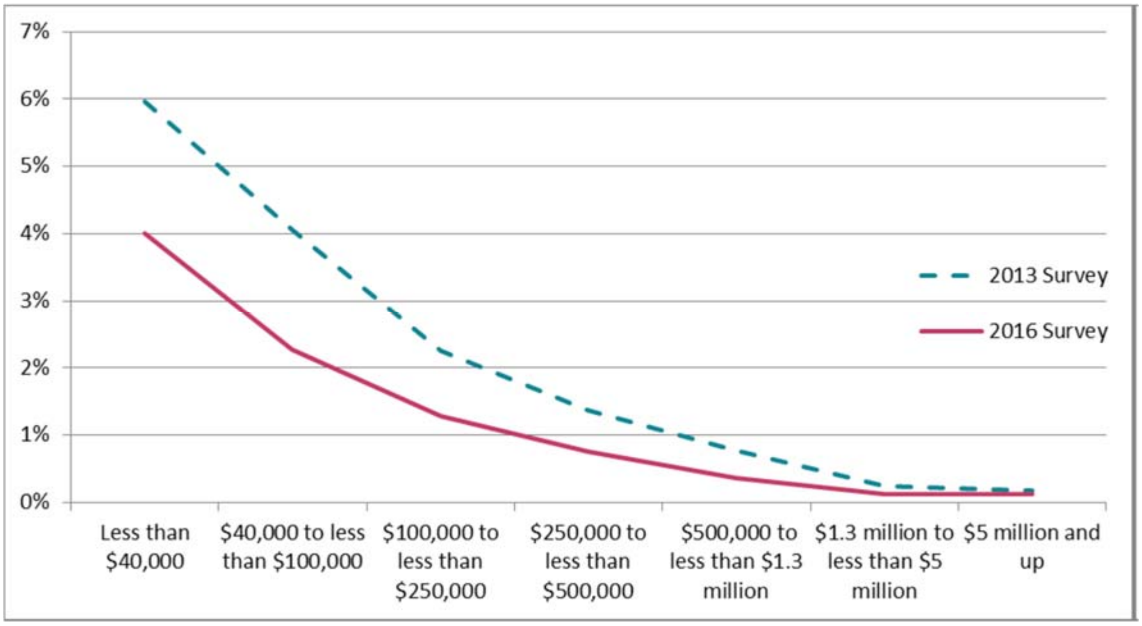
	stocktakes for tax purposes.
	No provisional tax, no fringe benefit tax and no entertainment tax.
	Simplified rules for depreciation.

6. Both parts of the proposal had various rules relating to ACC levies and the income calculation for social assistance programmes.

Problem

7. Inland Revenue research shows that tax compliance costs are relatively high for small businesses. The research indicates that the main causes of tax compliance costs for small businesses are GST, PAYE, KiwiSaver, and the costs of recording information[1].

Combined compliance costs as a proportion of turnover (2013 and 2016)



(Inland Revenue, 2016)

[1] However, the costs may be overstated in studies such as this, as businesses may attribute core accounting tasks to tax compliance. For example, in this study busineses stated the main cost in complying with GST is recording information which for many businesses may be the same in the absence of a GST due to core accounting needs.

Median annual hours of in-house time SMEs spent by tax type (2004-2016)

Tax type[2]

	2004	2009	2013	2016
GST	33	24	24	14
Income Tax	18	12	12	6
PAYE	15	12	12	12
KiwiSaver	-	9	9	9
FBT	8	3	4	2
All tax types (median annual hours)*	**55**	**48**	**36**	**27**

*Note: As these are medians, the total hours do not equal the sum of the components.

Median annual hours of in-house time SMEs spent on tax activities by tax type (2016)

Apportioned annual hours of in-house time SMEs spent on tax activities (2004 – 2016) Activity	**2004**	**2009**	**2013**	**2016**
Recording information	26.3	23.9	18.9	12.9
Calculating tax, completing and filing returns, paying tax	12.7	10.1	7.2	6.1
Dealing with Inland Revenue	3.1	2.4	2.0	1.3
Tax planning	1.9	1.0	0.9	0.9
Dealing with tax advisors (including providing information)	6.8	5.8	4.4	3.3
Learning about tax laws (new or existing)	4.0	3.8	2.4	2.2
Other	0.2	1.0	0.3	0.3
Total hours (Median)	**55**	**48**	**36**	**27**

*Note: As these are medians, the total hours do not equal the sum of the components.

8. It is important for tax policy officials to consider whether these costs are excessive for small businesses. In particular, it is important to consider whether "close enough is good enough" and if there are ways of reducing compliance costs without providing tax concessions.

9. Measures to simplify tax rules often face a trade-off between the accuracy of the rules in question and reduced compliance costs.

[2] The figures in the two tables look at in-house compliance costs only and do not include external costs of using a tax professional. This is because the research only provides the breakdown of compliance costs for in-house time. In 2016, external costs made up approximately 31% of the total compliance costs for SMEs.

Benefits

10. The CAANZ proposal would likely reduce compliance costs for small businesses. The proposal would likely:
    - reduce the 8 hours spent complying with income tax and FBT for small businesses;
    - reduce the 2.3 hours spent recording information for income tax and FBT (as micro businesses no longer need to record expenses);
    - reduce the 6.1 hours spent calculating tax, completing and filing returns, and paying tax (this is for all tax types and is not able to be apportioned to income tax and FBT).

11. However, the proposal will not necessarily reduce compliance costs associated with entering information for small businesses.

Costs

12. There are four issues with the proposal:

    - turnover is not necessarily a good proxy for net income;
    - the calculation of income for income tax purposes is important for other policy areas;
    - for the regime to be effective, it likely needs to be compulsory; and
    - the regime may have the perverse effect of disincentivising business growth.

The correlation between turnover and net income

13. The micro-business proposal uses turnover as a proxy for net income. However, there is no real evidence that turnover at any given percentage is a satisfactory proxy for tax on net income. Businesses may have high or low costs relative to their turnover. This means that a turnover tax at any rate would over-tax and under-tax some small businesses relative to their net income.

14. Over and under-taxation creates efficiency costs as small businesses have an incentive to avoid incurring expenses (including wage expenses), even if it would increase net profit. It does not align with horizontal equity.

Example scenario
Consider two small businesses both with net income of $30,000. One is a contractor earning $30,000 in revenue with no expenses and the other runs a small store with revenues of $60,000 and expenses of $30,000. With a turnover tax of 15%, the contractor has an effective tax rate of 15% and the store owner has an effective tax rate of 30%.

The impact on other policies that also use income tax measures

15. A number of other Government policies are dependent on the current tax definitions of income. These include KiwiSaver, child support, ACC, student loans and social welfare entitlements.

16. Adopting a turnover basis for micro businesses would require either using a turnover basis for these entitlements or retaining an income tax treatment for other social policy purposes. The first option could undermine the goals of other Government policies and introduce inconsistency between taxpayers with different expense levels. The second option would lead to an overall increase in business compliance costs, as they would have to calculate their income under two different methods.

Need to be compulsory

17. The CAANZ submission suggested the turnover and cashflow proposal be optional for businesses. However, it is likely that a taxpayer would only enter the regime if it resulted in them paying less tax. This would suggest both a reduction in tax revenue and an increase in compliance costs, as taxpayers calculate their liabilities twice to determine the best option.

Transitional issues

18. A specific regime for small businesses could incentivise them to stay small, due to the potential difficulties with transitioning to a large business regime. A threshold test based on turnover can also create uncertainty for taxpayers, particularly if they are close to the threshold.

Fiscal impact

19. This option could be approximately fiscally neutral if it was compulsory and an appropriate rate was set. If optional, it would likely have a fiscal cost as taxpayers choose the low-tax option.

Distributional impact

20. This proposal would predominantly benefit small businesses. However, it is impossible to determine whether the result would be progressive or not because that is dependent on the level of expenditure against the income and the income or wealth of the owner of the business, particularly in respect of the micro business proposal.

Conclusion

21. The Secretariat would not recommend this proposal. Although the proposal could have compliance cost benefits for income tax and FBT, it would not target the key areas of recording transactions, GST, PAYE and KiwiSaver compliance costs,

which create the greatest costs for small businesses. As a result, the efficiency and fairness costs created by the proposal are likely to outweigh the compliance cost benefits.

22. In addition, compliance costs appear to be reducing significantly for small businesses. Reforms in 2017 have made a number of simplifications to address concerns for small businesses particularly in the area of provisional tax. The impact of these are likely to have reduced compliance costs further since the last research.

23. Inland Revenue research indicates that a significant part of the reducing compliance costs is due to the growing use of accounting software. Inland Revenue is currently working to leverage this to reduce compliance costs further. We consider that this provides a more promising avenue for reducing compliance costs without the fairness and efficiency issues that this proposal would create.

24. Therefore, the Secretariat does not see a strong case for the radical overhaul of small business taxation this proposal would involve. Instead, if the Group wishes to recommend measures to reduce compliance costs for small businesses, options to simplify the current system are preferred. A number of potential options are outlined in the following section.

The Accounting Income Method (AIM)

From 1 April 2018, a new method of provisional tax was introduced. It includes a number of features that are in the CAANZ proposal, and has the potential to include others as the method develops over time.

The CAANZ submission to the Group suggested AIM was “over-engineered” and that it should have been a simple system based on “real cash flow” utilising accounting software to calculate provisional tax. For most taxpayers who use AIM that is exactly what it will do, albeit on an interim rather than final payment basis. The complexity that CAANZ suggest arises as businesses become more complex and the true cashflow measurement then becomes significantly less accurate.

For most small businesses that have little trading stock, fixed assets and don’t make accounting adjustments, AIM is a very simple product that will approximate a cashflow basis of taxation. Evidence from current users to date indicates there are very few tax adjustments being made to the calculation of provisional tax payable. The main risk around AIM is the way that taxpayers code transactions within their accounting software. This was accountants’ main reservation with using accounting software to base provisional tax calculations. AIM allows for the correction of errors in subsequent periods on a “close enough is good enough” basis, which seeks to address this concern.

Specifically, AIM provides:

- The ability for a taxpayer to calculate and pay provisional tax based on the shareholders marginal tax rates;

- Provisional tax and GST is calculated at the same time from, in the majority, the same information;
- It deals with start-up businesses who will only pay tax when they make money;
- Provisional tax and GST is paid on the same payment dates reducing the large provisional tax payments that small businesses found difficult;
- Can remove both the entity and the individual shareholders from provisional tax by effectively using the shareholders marginal tax rates to calculate the tax liability; and
- For businesses that have low levels of trading stock purchases are deducted on a cash basis (with the exception of livestock).

Once AIM has been operating for a reasonable period and the level of year-end tax adjustments for these businesses can be accurately assessed (i.e., the amount payable as terminal tax is low), it may also be possible to remove the requirements to file annual tax returns at some point in the future and have a rolling “final tax” amount payable in real time.

Other compliance cost reduction measures

The measures below have been consistently suggested to officials over the last 3-4 years by external groups as items that could reduce compliance costs. In the majority, these suggestions have not been progressed due to fiscal constraints. Where those constraints can be relaxed some of these could be considered further.

Entertainment

Item	**GST Entertainment Adjustment**
Possible Solution	Remove the GST adjustment for entertainment expenditure from the GST return and change the level of income tax adjustment to reflect the lost adjustment.
Problem	Many businesses fail to make the GST adjustment for entertainment expenditure because the period in which to do this can be some months after a business files its income tax return. It is often one of the most identified audit adjustments for taxpayers.
Pros	Simplifies the adjustment which will improve compliance.
Cons	Can result in a timing disadvantage to taxpayers over the current treatment.
Fiscal Impact	Neutral, although there may be an immaterial timing advantage to the government depending on the timing of the filing of tax returns.

Item	**Entertainment Regime**
Possible Solution	Simplify or eliminate the entertainment regime and return to relying on the nexus test for deductibility of entertainment items.
Problem	Many taxpayers raise the entertainment regime as a compliance cost heavy regime for little overall tax revenue. The entertainment regime, like FBT, does provide a buttress to the taxation of employment but it can be compliance cost intensive (although some of these costs are incurred in reducing the tax impact of the adjustment).
Pros	A reduction in compliance costs for businesses (particularly large businesses).
Cons	May reduce the buttress to employment taxes and allow benefits to be provided with no tax impost.
Fiscal Impact	The current amount that is generated by the entertainment adjustment is \$100-\$110m per year.

Provisional tax changes

Item	**Bringing forward provisional tax dates**
Possible Solution	Bringing forward provisional tax date from the 15th of January to prior to the holiday break.
Problem	Many businesses struggle to account for the provisional tax payment due on 15th January because of the holiday break.
Pros	Removes the issue of the holiday break from paying provisional

	tax on that date.
Cons	A timing disadvantage to taxpayers.
Fiscal Impact	Neutral apart from the immaterial timing advantage in receipt of that payment earlier.

Depreciation changes

Item	**Depreciation Pooling**
Possible Solution	Allow or require small businesses to pool most of their depreciable assets and depreciate them at a flat rate.
Problem	Small businesses generally have to account for each item of depreciable property they own and depreciate them individually according to the relevant rate. (There are currently over 700 depreciation rates). The complexity of depreciation rules is an area creating compliance costs for small businesses.
Pros	Compulsory pooling would reduce the compliance costs for small businesses without lowering the average tax paid by small businesses. As a result, it would be consistent with New Zealand's broad-base, low-rate framework.
Cons	Pooling decreases the accuracy of depreciation deductions. This could result in faster or slower depreciation than appropriate which could result in a reduction in economic efficiency through distorting investment decisions. For this measure to have compliance cost savings it would need to be compulsory. This is because if voluntary, businesses would likely calculate their depreciation deductions using both available methods and then choose the method that leads to a lower tax bill
Fiscal Impact	A compulsory system is expected to have a broadly neutral fiscal impact. However, if the system was voluntary then there is likely to be a negative fiscal impact.

Item	**Low Value Asset Write-off (increasing immediate write-off threshold)**
Possible Solution	Increase the threshold for write-off on purchase from $500 to $1,000 and/or remove the multiple purchase restriction. In order for this to not be a straight concession to smaller businesses it is envisaged that this would apply to all businesses acquiring these assets as is the current practice.
Problem	Currently, businesses may write-off assets that cost $500 or less in the year of purchase unless multiple items less than $500 are purchased together. For assets with value greater than $500 the business is required to depreciate them. This imposes compliance costs.
Pros	This would marginally decrease compliance costs for smaller

	businesses but have limited impact to larger businesses.
Cons	This measure could decrease economic efficiency as it distorts investment decisions towards less costly assets. It would also favour industries that tend to employ lower cost capital goods. If limited to small businesses it may result in more complex depreciation rules and create a disincentive for growth.
Fiscal Impact	This would be fiscally expensive (estimated cost in 2015 was $450 million over four years).

Item	**Low Value Asset Write-off (write-off adjusted tax value below a threshold)**
Possible Solution	Allow assets that have depreciated below a certain point to be written off.
Problem	Assets that are originally purchased for greater than $500 must be depreciated until their adjusted tax value is nil. For assets of a low value, this can mean there is a high compliance cost of keeping them "on the books" for relatively low value.
Pros	This would decrease compliance costs for small businesses.
Cons	This measure could decrease economic efficiency as it distorts investment decisions towards less costly assets. It would also favour industries that tend to employ lower cost capital goods. Unlikely to materially impact on costs for larger businesses and could actually increase compliance costs.
Fiscal Impact	The fiscal cost of a threshold of $500 would be approximately $1b over the first 4 years, with most of this cost in the first year because about 3% of already held assets would be expensed in that year. If the threshold for write off was $1,000 the fiscal cost over the first four years would be approximately $1.9b.

FBT changes

Item	**FBT Simplification**
Possible Solution	Simplify FBT by removing exemptions and standardising adjustments for the most common benefit provided - motor vehicles.
Problem	Some changes were made last year to simplify the application of FBT to small businesses. FBT is an important part of our tax base, more so as a protection for the labour tax base rather than in isolation. Many businesses comment on the cost of compliance of FBT although to a large extent the compliance costs associated with FBT are in reducing the amount of FBT payable. A simplified FBT system would have relatively low compliance costs but a larger FBT cost.
Pros	Substantial reduction in compliance costs of FBT.
Cons	Increased FBT cost.

Fiscal Impact	Likely to be positive depending on the simplification measures.

Threshold adjustments

Item	**Increase threshold – automatic deduction for legal fees**
Possible Solution	Increase the current threshold for the automatic deduction from a total of $10,000 of legal fees to a higher amount and/or automatically adjust for inflation.
Problem	The current threshold for the automatic deduction of legal fees is set at a total of $10,000. This was set in 2010 and could be increased to reduce compliance costs of smaller businesses. It could also be set to adjust for inflation.
Pros	Reduces compliance costs of smaller businesses and, potentially, allows the threshold to move with inflation.
Cons	The frequency of inflation changes could increase compliance costs.
Fiscal Impact	The fiscal impact of this is difficult to estimate as we don't have sufficient information to estimate this and it is dependent on a number of variables.

Item	**Extend threshold – automatic deduction for legal fees to more types of expenditure**
Possible Solution	Extend the threshold for the automatic deduction for legal fees to more types of expenditure (e.g. professional fees in general).
Problem	When filing its tax return a business must classify its expenditure into deductible, non-deductible and depreciable amounts a rule similar to the automatic deduction for legal fees could be extended to other types of expenditure (such as professional fees).
Pros	Should reduce compliance costs for small businesses.
Cons	Depending on the definition of those included expenses could have a compliance cost in determining what is included and what is not.
Fiscal Impact	The fiscal cost of this is difficult to estimate as it will depend on what is included. It could be timing in nature recharacterising depreciable to deductible expenditure.

Item	**Increase threshold – Closing Stock valuation**
Possible Solution	Increase the threshold to ignore stock on hand movements from $10k to a larger amount such as $20k and/or adjust for inflation.
Problem	There is a current concession for low-turnover traders that allows them to value their closing stock at the opening stock value essentially taking a tax deduction for purchases during the year. This applies when the turnover of the trader is less than $1.3m and it is reasonably estimated that the balance of closing stock is less than $10,000. This threshold was last increased in 2009 and may no longer be

	appropriate.
Pros	Reduces compliance costs for those taxpayers where the sale of trading stock is a small part of their business.
Cons	May advantage those who have small value stock over those with larger values but lower volumes.
Fiscal Impact	Any adjustment will ultimately be timing in nature but there may be a one off fiscal impact in the first year. It is difficult to quantify this amount as it depends on particular circumstances which cannot be predicted with certainty.

Item	**Shorten the time bar**
Possible Solution	Reduce the time bar to a shorter period than the current four years.
Problem	Currently the Commissioner is able to reassess a taxpayer for a shortfall for up to four years (in non-evasion cases). Some argue that creates compliance costs for taxpayers who are concerned about the certainty of their tax position.
Pros	Provides certainty to taxpayers that the Commissioner will not reopen their tax position earlier.
Cons	Practically has more benefit to larger organisations than smaller ones where there is greater concern that the Commissioner could revisit previous years.
Fiscal Impact	We are unable to quantify the potential fiscal cost of this measure as it depends on many variables.

Item	**Increase thresholds for unexpired expenditure (Determination E12)**
Possible Solution	Increase the thresholds or unexpired time period in determination E12 to reduce the number of adjustments required for unexpired expenditure.
Problem	Prepayments of expenditure are not deductible immediately unless the threshold for level of expenditure or time period in determination E12 are met.
Pros	Reduces compliance costs for business in accounting for unexpired expenditure.
Cons	Reduces the matching of expenditure with the income that the expenditure relates to that could, in extreme cases, give a tax deferral. It may also favour larger over smaller businesses.
Fiscal Impact	Again this adjustment would be timing in nature but may have a one off fiscal cost in the first year.

Item	**Increase thresholds for apportioned supplies for GST**
Possible Solution	Increase the threshold for apportioning supplies when there is a change in use.
Problem	GST registered persons are required to make adjustments for supplies that change from being used for taxable to non-taxable purposes. Currently the threshold to do that is $5,000 (excl GST)

	or less of taxable supplies.
Pros	Could reduce compliance costs mainly for smaller businesses.
Cons	Could result in a fiscal risk depending on the new threshold set.
Fiscal Impact	We do not have sufficient information to enable a fiscal costing to be determined as the cost will depend on a number of variables.

<table>
<tr><td>Item</td><td>Increase threshold for those paying provisional tax</td></tr>
<tr><td>Possible Solution</td><td>The current threshold for paying provisional tax is $2,500. This could be increased to remove people from the liability to provisional tax.</td></tr>
<tr><td>Problem</td><td>Provisional tax is consistently listed as a compliance issue for taxpayers. The changes made to the rules in 2017/18 have made the regime less complex and punitive by removing a large number of smaller taxpayers from exposure to use of money interest but taxpayers continue have issues with paying provisional tax.</td></tr>
<tr><td>Pros</td><td>Reduces compliance costs of taxpayers earning relatively small amounts of untaxed income.</td></tr>
<tr><td>Cons</td><td>Reduces equity with those who earn source deducted income who pay tax throughout the year.</td></tr>
<tr><td>Fiscal Impact</td><td>Will have a cost of approximately (standard balance dates are assumed):
<table>
<tr><th>Threshold</th><th colspan="2">Cash Cost</th><th colspan="2">Revenue Cost</th></tr>
<tr><td></td><td>First Year</td><td>Subsequent years</td><td>First Year</td><td>Subsequent years</td></tr>
<tr><td>5,000</td><td>$350m</td><td>$3m</td><td>$3m</td><td>$3m</td></tr>
<tr><td>10,000</td><td>$1,010m</td><td>$10m</td><td>$10m</td><td>$10m</td></tr>
<tr><td>15,000</td><td>$1,800m</td><td>$15m</td><td>$15m</td><td>$15m</td></tr>
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