



Tax Working Group
Te Awheawhe Tāke

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Coversheet: SME Compliance Cost Savings

*Position Paper for Session 21 of the Tax Working Group
26 October, 2018*

Purpose of discussion

This paper expands on the compliance cost saving initiatives for SMEs that were recommended by the Group in the interim report and discusses some additional items that could be recommended to the Government in the final report.

Key points for discussion

- Does the Group want to add any further compliance cost reduction recommendations to the list it has already included in the interim report ?
- Does the Group want to consider recommending a concession to assist SMEs into using digital technology (such as accounting software) to help them reduce compliance costs ?

Recommended actions

We recommend that you:

- a **agree** to include the three compliance cost reduction suggestions in the interim report in the final report:
 - increase the threshold for paying provisional tax from \$2,500 to \$5-\$10,000;
 - increase the threshold for undertaking a closing stocktake from \$10,000 to \$20-\$30,000; and
 - increase the automatic deduction for legal fees from \$10,000 to a higher value and expand the provision to other forms of professional fees, such as accounting fees.
- b **decide** whether to include the following further compliance cost reduction suggestions to Government in the final report (as the fiscal position permits):
 - review the fringe benefit tax regime (FBT) with a view to simplifying the application to motor vehicles and other benefits;
 - review the entertainment expenditure deduction with a view to either removing or simplifying it;
 - review the thresholds that currently apply to unexpired expenditure with a view to easing compliance costs for small businesses;
 - the removal of resident withholding tax on close company dividends and interest with a view to reducing overall compliance costs of these related party transactions.

- c **decide** whether to also review the FBT and entertainment tax rules in context of micro and small businesses tax obligations more generally (customer focus approach rather than a tax type focus).
- d **decide** whether to recommend to Government that they consider an incentive for taxpayers to adopt digital technology such as cloud based accounting software and assist in the education of small businesses to use that technology.

SME Compliance Cost Savings

*Position Paper for Session 21
of the Tax Working Group*

October 2018

Prepared by the Inland Revenue Department and the Treasury

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Executive Summary

In its interim report, the Group recommended the Government consider measures to reduce business compliance costs, including increasing the thresholds for:

- provisional tax from \$2,500 to \$5-10,000;
- for requiring a year end stocktake from \$10,000 to \$20-30,000;
- the automatic deduction for legal fees from \$10,000 and the expansion of that to other types of professional fees.

The Government has indicated to the Group that it is interested in what proposals the Group would recommend to reduce compliance costs and has asked them to expand on these in the final report.

This paper expands on the proposals in the interim report. It also outlines a number of other items which may reduce compliance costs that the Group may want to include in the final report which have been generated from consultation undertaken by officials. This has included consultation with Chartered Accountants Australia and New Zealand (CAANZ), the Corporate Taxpayer Group, Accountants Tax Agents Institute of New Zealand (ATAINZ), EY, PwC and focus groups of taxpayers arranged through BusinessNZ.

A significant number of changes have recently been made which had the aim of reducing taxpayer compliance costs and, as these have been made in the last two years, they will need time for the benefits to be realised by taxpayers particularly in the area of provisional tax.

The Business Transformation programme is also expected to reduce compliance costs of taxpayers significantly and officials have already seen a greater reduction in costs than was originally estimated.

Compliance cost reduction is also a focus across government in general and there are a number of key initiatives being run by the Ministry of Business Innovation and Employment (MBIE) including e-invoicing and the New Zealand Business Number (NZBN).

The Government has also recently formed a Small Business Council which has been tasked with developing a small business strategy including tax policy which will have a focus on reducing compliance costs overall.

Further items that the Group could consider recommending to Government to reduce compliance costs for business include:

- reviewing the application of Fringe Benefit Tax (FBT) in particular on motor vehicles and other benefits;
- entertainment – consider whether this adjustment is still appropriate or could be modified;
- review the thresholds on unexpired expenditure in line with the other threshold reviews already recommended;

- investigate the removal of resident withholding tax on related party debt by close companies;
- suggest the Government incentivise SMEs to better use technology such as accounting packages and ensure that they are educated to use them.

These items will need to be subject to consultation with the private sector and the fiscal costs of these measures determined once the final design of the proposals is completed after consultation. Where possible we have given an indication of the fiscal impact of these below, however, a number of the measures' fiscal impacts will depend on the design or taxpayer behaviour which make it difficult to estimate.

1. Introduction

1.1 Purpose

1. The purpose of this paper is to expand on the SME compliance cost savings proposals recommended by the Group in the interim report. This paper covers those items recommended by the Group and some additional items that could be recommended to the Government in the final report.

1.2 Context

2. The cost of compliance with tax falls disproportionately on smaller taxpayers, who are more likely to lack the systems and knowledge to easily comply with tax obligations.

3. One of the keys to the design of a good tax system is to make it as simple as possible for taxpayers to comply. However, it is inevitable that no matter how easy the system is designed, smaller businesses will always have higher compliance costs compared to those larger businesses where scale makes compliance significantly easier.

4. As part of its recommendations in the interim report, the Group recommended that the Government:

- not reduce the company tax rate;
- not introduce a progressive company tax;
- not introduce an alternative basis of tax for smaller businesses such as a turnover or cashflow tax;
- not change the thresholds around depreciation and write off of fixed assets; and
- consider other measures to reduce compliance costs for small businesses, dependent on the fiscal position of the government, including increasing the threshold for paying provisional tax, increasing the year-end closing stock adjustment and increase the automatic deduction for legal expenses and expand that to other professional fees.

5. The Ministers of Finance and Revenue have commented on the Group's interim report, and stated that they are interested in the Group's finding that reducing compliance costs through the tax system would provide a better approach than a progressive company tax rate. They indicated that they would welcome the Group expanding in the Final Report on what compliance cost reduction options would be beneficial¹.

¹<https://www.beehive.govt.nz/sites/default/files/2018-09/TWG%20letter%20final.pdf>

6. Also, as requested by the advisor to the Group, we have included a discussion of a compliance cost saving measure suggested by Federated Farmers in their submissions to the Group relating to resident withholding tax and associated party debt.

1.3 Work to date

7. Recent legislative changes that have reduced compliance costs for smaller businesses include:

- removal of use of money interest for most provisional taxpayers who use the standard uplift until the final instalment of provisional tax;
- increase of the safe harbour from use of money interest from \$50,000 residual income tax² to \$60,000 and expansion of that safe harbour to companies and trusts;
- introduction of a further method to calculate provisional tax using accounting software to pay tax as you earn income called the accounting income method (AIM);
- allowing small businesses who provide motor vehicles to shareholder employees to make a private use adjustment instead of paying fringe benefit tax;
- increasing the ability of taxpayers to correct errors in their tax returns in the next period;
- simplification of the calculation of deductions for dual use vehicles and premises;
- removing the requirement to annually renew resident withholding tax exemption certificates;
- increasing the threshold for annual FBT returns from \$500,000 to \$1 million of PAYE/ESCT;
- a new short process rulings regime contained in the *Taxation (Annual Rates for 2018-19, Modernising Tax Administration, and Remedial Matters) Bill*; and
- the modification of the 63 day rule for monetary remuneration to reduce compliance costs of calculating that adjustment.

8. However, there are a number of other areas that have been consistently raised as compliance cost intensive by smaller businesses and the Group has addressed some of these in its recommendations.

1.4 Consultation process

9. In developing those recent changes, officials had undertaken an extensive consultation exercise with interested parties and focus groups which included small business owners. Subsequent to the enactment of those changes, officials again went out looking for a second round of potential compliance cost reducing changes.

² Residual income tax is the remaining tax liability after tax credits such as PAYE have been taken into account.

10. In this second round of consultation officials obtained “wishlists” from a number of interested parties including Chartered Accountants Australia and New Zealand (CAANZ), the Corporate Taxpayer Group, Accountants Tax Agents Institute of New Zealand (ATAINZ), EY and PwC. We also undertook a large number of meetings with small businesses that were facilitated by BusinessNZ with the workshops run in conjunction with Iron Duke and Phil O’Reilly.

11. In our appendix F to the paper *Potential revenue-reducing options: Position paper for session 14 of the Tax Working Group* we summarised the compliance cost reduction possibilities that resulted from those wishlists and workshops.

12. We have also recently held a further workshop with CAANZ to discuss the areas where they see that compliance costs could be reduced for businesses and in particular small businesses. This workshop was held after the due date for this paper and an update on the outcomes from that workshop will be discussed at the next TWG meeting.

1.5 Continuity

13. The changes that have been recently made to provisional tax have been operating for just over a year. This is the first major change to the standard uplift method for a large number of years and officials believe it is important for those changes to bed themselves in as we are aware that taxpayers are still coming to terms with those changes. Those changes to the standard uplift method have been generally welcomed by taxpayers and, although provisional tax is a constant area of criticism by taxpayers those changes should have reduced the pain points associated with provisional tax.

14. It will be interesting to canvass businesses in a year or two to see if provisional tax remains one of the main issues they raise as a compliance issue but it is important to let the changes settle in as taxpayers will, generally, take some time to fully understand them.

1.6 Business Transformation

15. A main goal of Business Transformation is to make it easier for taxpayers to interact with Inland Revenue through more direct communication between taxpayers software and Inland Revenue systems. This has a direct impact on taxpayer compliance costs.

16. Business Transformation is a multiyear programme that is expected to be completed in 2023. Currently GST and FBT are the main tax types which have been transitioned to the new system, and despite some initial transitional issues, taxpayers seem to be interacting with the new technology platform well.

17. Part of the costs incurred by SME taxpayers is having to complete and file forms with Inland Revenue as well as other interactions usually by phone or paper based correspondence.

18. The Business Transformation programme was expected to reduce the time that SME customers³ spent meeting their tax-related obligations from between 18 and 26 hours per annum. The economic value of that saving was estimated to be \$1.3 – \$2.3 billion. This represents an overall reduction of effort of 30-42%.

19. These benefits are expected to be fully realised in 2023 once the Business Transformation programme is completed. To date, SMEs have reported reduced compliance efforts from the implementation of new services delivered as part of the programme. The 2016 SME compliance cost survey⁴ results indicated that, since 2013, customer effort to meet their GST obligations⁵ had reduced by 10 hours which was ahead of the 9 hour estimate for Release One of Business Transformation.

20. It is expected that the entire Business Transformation programme will deliver substantial savings in compliance costs for SMEs by 2023 without creating any distortions or incentives within the tax system, but rather simply making it easier to interact with Inland Revenue.

1.7 All of government response

21. While we continue to look to reduce the impact of tax compliance through simplifying policy settings, Inland Revenue also works closely with other agencies under the “Better for Business” umbrella to improve the overall experience businesses, particularly small businesses, have with government. This includes how we can collectively reduce the effort of meeting regulatory requirements. The Better for Business Customer Experience Index research, shows that the biggest pain points businesses experience when dealing with government are lack of service consistency and co-ordination across agencies. Addressing these is key to freeing up business time and effort, improving the experience and increasing productivity.

22. Key initiatives led by MBIE on behalf of government agencies include:
- Business.govt.nz - provides information spanning multiple government agencies to businesses. This allows businesses to easily get information they need without looking across individual agency websites.
 - New Zealand Business Number (NZBN) - all businesses can register for a unique business identifier, and record key business details against that number. Over time this will mean easier and cheaper transacting with other businesses and with government through easy identification and reuse of information. Examples of how this is

³ For these estimates the SME population is considered to be a business taxpayer with five or fewer employees.

⁴ The full report Better for customers: SMEs' compliance costs in 2016 is published on IR's website www.ird.govt.nz/aboutir/reports/research/#07

⁵ No surveys have been completed since the roll out of Release Two of Business Transformation so these results only reflect the savings from Release One which transitioned GST to the new system.

occurring can be found at <https://www.nzbn.govt.nz/about-nzbn/success-stories>.

- E-Invoicing – using the NZBN, this facilitates easy, accurate and standardised electronic invoicing between software systems. This is likely to lead to significant productivity gains, and reduction in fraud, across the NZ digital transaction space.
- Business Connect – addresses the lack of service consistency and co-ordination across government service providers through use of low risk pathways to designing customer-centred digital services, particularly in the repetitive compliance space (e.g., the need for a business to obtain licences, permits, registrations etc.). It provides a consistent user experience spanning local and other government services. Business Connect enables the customer to use and re-use data government holds (e.g., NZBN, LINZ⁶), previous data they have submitted, and simplifies the process through use of business rules. Prototyping has shown efficiency benefits to the customer ranging from 30 - 90%.
- Better Rules / Legislation as code – this recognises the opportunity to develop policy and rules digitally and differently. It explores developing ‘rules as code’ - the rules (legislation, regulations, operational policies) can be understood by computer programs, which improves policy and legislative/regulatory development processes, and therefore service delivery, government transparency and public participation. Examples include use of Tai, an AI digital assistant that supports exporters to navigate across multiple regulative domains (Ministry of Primary Industries and New Zealand Customs), and a review of the Holidays Act using structured business rules.

1.8 Small Business Council

23. Since our previous paper on reducing compliance costs to the Group the Government has also assembled a Small Business Council (SBC) which has been tasked with, among other things, developing a small business strategy which includes tax policy. That process will look to more of a customer-centric viewpoint rather than a tax type focus and so rather than looking at FBT across all businesses look at how compliance costs affects, say, a micro business across all taxes. The SBC’s view is that approach is a preferable way of identifying the cost of compliance.

24. Inland Revenue’s Policy and Strategy has a representative as an advisor to that Council.

⁶ Land Information New Zealand

2. Increasing the threshold for provisional tax

2.1 Context

25. The provisional tax regime is designed around the premise that people should pay tax as they earn their income along with our PAYE⁷ and RWT⁸ regimes. Provisional tax is the option for those people who earn income where tax is not deducted at source, such as business income.

26. In general, provisional tax is payable in three equal instalments based on 105% of the prior year's tax liability (or 110% of the year previous to the prior year where the taxpayer has not filed their tax return for the prior year). The vast majority of provisional taxpayers who are subject to provisional tax use this standard method of calculation.

27. There are a couple of features of the provisional tax system that, in some cases, are perceived to be unfair. The first is that provisional tax assumes that taxpayers earn their income evenly over the year. This is often not the case and many taxpayers have seasonal or volatile income. Secondly, historically the system has applied use of money interest (UOMI) when the instalments paid by taxpayers differed from what they should have paid given their actual liability for the year.

28. Over the past two years a number of adjustments have been made to address these concerns. Firstly, the accounting income method (AIM) was introduced for, generally, businesses that have a turnover of less than \$5 million. To a large extent this addresses the seasonality and volatility issues that arise with the current provisional tax methods.

29. Secondly, for most taxpayers who use the standard uplift method, UOMI has been removed from the first two instalments. With a taxpayer's final instalment of provisional tax being some five weeks after their balance date, at that point, they should have a good understanding of their tax liability for the year and can make a top-up payment, if necessary, which will mean that they are not charged UOMI.

30. In addition, for those earning lower amounts of income, the safe harbour from UOMI was increased from \$50,000 of residual income tax to \$60,000, and extended to non-individuals, taking some 19,000 taxpayers out of the UOMI rules until their terminal tax date although still requiring them to pay provisional tax during the year.

31. Provisional tax has, historically, constantly ranked as a pain point for smaller businesses. In large part that pain is in actually the paying of provisional tax during the year rather than specific issues with the regime.

32. However, the recent changes have reduced the pain of provisional tax and the application of UOMI to situations that are beyond the control of the taxpayer. It is

⁷ Pay As You Earn – source deduction payments for salary and wage earners.

⁸ Resident Withholding Tax – resident withholding tax is deducted from payments of interest and dividends.

important that these changes are given time to bed down to determine if there are any other issues with the regime that could be addressed.

2.2 Policy problem or opportunity

33. Notwithstanding these improvements to the provisional tax regime, one issue with provisional tax that is raised by taxpayers is the level at which provisional tax applies. Currently a taxpayer who has residual income tax of \$2,500 or more is a provisional taxpayer. That represents \$8,929 of net income for a company and \$7,576 for an individual on the top marginal rate. Although these taxpayers are not subject to UOMI because of the application of the safe harbour, they are still required to pay provisional tax.

34. Historically, changes to the provisional tax regime have focused on removing the application of UOMI to taxpayers rather than reducing the number subject to provisional tax. This was on the basis that salary and wage earners have to pay tax during the year, and it was considered that those with income that was not subject to source deduction payments should do the same.

35. The issue is that since the level of residual income tax was reduced from \$3,000 to \$2,500 in 1991 the threshold has not been revisited and now it applies to what is, in today's terms, very low levels of income. The compliance costs of calculating, paying and being exposed to UOMI at these levels is disproportionate to the benefit of receiving the tax during the year. For the salary and wage earner at the same level of income there is no compliance cost as their tax obligations are dealt with by their employer.

2.3 Proposal

36. The Group was in favour of increasing the threshold at which taxpayers would be subject to provisional tax from \$2,500 to \$5,000 or \$10,000 dependent on the fiscal position of the Government.

37. This would mean that for a company, the amount of non-source deducted income that could be earned before the company became subject to provisional tax would be \$17,857 or \$35,714 respectively, and for an individual on the top marginal rate \$15,152 or \$30,303 respectively.

38. Assuming standard balance dates the approximate cost of changing the threshold would be:

Threshold	Cash Cost		Revenue Cost		Number of taxpayers
	<i>First Year</i>	<i>Subsequent years</i>	<i>First Year</i>	<i>Subsequent years</i>	
5,000	\$355m	\$3m	\$3m	\$3m	97,000
10,000	\$1,008m	\$8m	\$8m	\$8m	198,000

39. This could remove 97,000 or 198,000 taxpayers who earn modest levels of non-source deducted income from paying provisional tax. Such a change is likely to be well received by these smaller taxpayers.

40. However, not receiving funds during a tax year could result in smaller businesses having larger end-of-year payments, and if they have not sufficiently budgeted for this it may result in larger amounts of debt arising which should not be underestimated. This could increase the tension for taxpayers in cashflow management, which may be a particular issue for smaller taxpayers. For example, businesses who have a tax liability of \$9,000 will have one payment of \$9,000 under a \$10,000 threshold rather than three payments of \$3,000 spread across the year.

41. There is also a significant cash cost to either of these options which will result in a timing disadvantage to the Government which would need to be considered carefully when the Government makes a decision on any increase in the threshold.

3. Increase the closing stock adjustment threshold

3.1 Context

42. The Income Tax Act 2007 requires taxpayers to value their closing stock at the end of the tax year, as this amount is included in taxable income⁹. However, those taxpayers who have turnover of less than \$1.3 million and reasonably estimate the value of their closing stock to be less than \$10,000, can use the value of their opening stock as their closing stock for the year¹⁰.

43. Essentially, this adjustment allows the taxpayer to deduct the cost of their purchases for the year. The \$10,000 threshold was last increased from \$5,000 with effect from the 2009-10 income year.

3.2 Policy problem or opportunity

44. The current threshold may no longer be appropriate as it means that taxpayers who have relatively low levels of stock continue to have to undertake a stocktake at the end of the year. It may be appropriate to increase that amount to reduce the compliance costs of those businesses that have low levels of stock on hand, but may have high volumes of low value stock. The compliance costs of undertaking a stocktake may be disproportionate to the benefit of having an accurate amount.

45. This concession is not currently compulsory and those businesses who wish to may still undertake a stocktake. Practically, those businesses whose closing stock is less than their opening stock will be adversely affected by using the opening stock value.

3.3 Proposal

46. The Group recommends, subject to the fiscal cost, increasing this stock threshold from \$10,000 to \$20-\$30,000 while leaving the turnover threshold at \$1.3 million. This would remove approximately 13–20,000 taxpayers from having to undertake a stocktake at year end although only 5-7,600 would receive a benefit in terms of lower tax paid. At a maximum this could potentially have a maximum fiscal cost of between \$28m-64m on the assumption that those taxpayers have stock values at the threshold limit.

47. It is difficult to approximate the level of compliance cost that could be removed from extending the threshold. It is likely, not surprisingly, that those taxpayers with a small number of higher valued stock will incur few costs, whereas a taxpayer who has a large number of small valued stock will be more significant.

⁹ See section EB 3 of the Income Tax Act 2007

¹⁰ See section EB 23 of the Income Tax Act 2007

4. Increase and expand the automatic deduction for legal fees

4.1 Context

48. A compliance cost measure is contained in the Income Tax Act 2007¹¹ that allows taxpayers who have low levels of expenditure on legal fees to automatically be given a tax deduction for those fees whether the fees are incurred on capital projects or otherwise.

49. A taxpayer who has up to \$10,000 of total expenditure on legal fees (defined as fees for legal services as defined in the Lawyers and Conveyancers Act 2006) provided by a person who holds a practicing certificate issued by the New Zealand Law Society or an Australian equivalent may automatically deduct these fees. This threshold was set in the 2009-10 income year, the year the provision was introduced.

4.2 Policy problem or opportunity

50. There are two issues with this provision, firstly, the threshold may no longer be appropriate for the current economy and, secondly, the breath of the provision is extremely narrow and could be expanded to include other types of expenses such as other professional fees.

51. Officials have considered whether the provision could be expanded to other types of expenditure such as repairs and maintenance, however, we consider that type of expansion will have the same downsides as extending the under \$500 fixed asset threshold in that it will have significant fiscal implications and also provide more of a tax incentive rather than a compliance cost saving.

4.3 Proposal

52. The Group recommends, subject to fiscal constraints, increasing the threshold for the automatic deduction of legal fees from \$10,000 to a higher amount such as \$20-\$30,000 and the extension of that concession to other professional fees such as accounting fees.

53. This change will mean that businesses that have relatively low levels of expenditure on professional fees that may not be deductible because they relate to capital projects will not need to analyse that expenditure, and can claim a full deduction for that expenditure.

54. It is difficult to quantify the fiscal impact of such a change, as the level of such expenditure is not easy to isolate from information held by officials. It will also be dependent on how wide the automatic deduction is extended.

¹¹ See section DB 62 of the Income Tax Act 2007

5. Other compliance costs reduction measures

5.1 Context

55. There are a number of other compliance cost reduction measures that officials have had raised by small businesses as part of our previous consultation and the Group may want to consider whether it wishes to include some of these more wholesale reform items in its final report.

56. These suggested measures will need to be consulted on and, most importantly, the fiscal impact of these changes needs to be understood. For a number of these proposals the fiscal impact will depend on the final design of the proposals for others the impact is difficult to predict as this will depend on taxpayer behaviour.

5.2 Fringe Benefit Tax

57. In officials-facilitated workshops held around the country with medium business owners, the most common issue raised as compliance cost intensive was fringe benefit tax (FBT), particularly FBT on motor vehicles.

58. Comments from the workshops suggested that FBT was hard to comply with, expensive and there were high levels of non-compliance. One of the usual comments was that people understand that costs should not be deductible when they relate to private use but they fail to understand FBT and the concept of “available” for private use.

59. FBT provides a buttress to the PAYE system in ensuring that employers cannot pay employees in benefits rather than cash and avoid taxation. It accounts for approximately \$500 million of government revenues but its support of the PAYE system has more value. If FBT did not exist it is likely the revenue from PAYE would diminish significantly.

60. Generally, the costs of complying with FBT are incurred in reducing the amount of FBT payable, particularly around the supply of vehicles to employees. The various exemptions when vehicles are work-related vehicles or are unavailable for private use incur compliance costs in reducing the overall amount of FBT payable to an amount that better reflects the true availability for private use.

61. Another source of compliance costs, in particular for larger businesses, is identifying any benefits that are provided to staff as other benefits, such as gift cards etc. There are significant compliance costs incurred in identifying these transactions through thousands of other transactions.

62. If the Group were to consider the simplification of FBT officials would suggest that two areas which could be further investigated are:

- simplification of FBT on motor vehicles by simplifying the classification of vehicles to more focus on the level of availability for private use¹² to better reflect the private use of the vehicle, removing the exemptions that apply to vehicles¹³ and consequently reducing the rates to reflect that the charge would be calculated on a “close enough is good enough” basis which may have over and underpayments compared to actual use; and
- simplifying the calculation of FBT on other benefits with a view to reducing the compliance costs of identifying every last benefit provided which may have a private element at the margin, for example increasing the de-minimis threshold may be appropriate.

63. The other two major categories of fringe benefit are subsidised transport and low interest loans. Officials consider there may be a few small things that could be adjusted but it is likely that there are a small number of employers who provide these benefits who would tend to be larger businesses. These employers will have established systems to deal with the calculation of these benefits and this may be less of a priority than motor vehicles and other benefits.

64. The fiscal cost of this measure will depend on the final design but combining a broadening of the number of vehicles and offsetting this by lowering the rates could result in a minimal fiscal impact.

5.3 Simplify the deduction for entertainment

65. The second most raised compliance cost issue is compliance with the restriction on the deduction for entertainment expenditure.

66. Entertainment expenditure is generally only 50% deductible¹⁴. Entertainment expenditure includes expenditure on:

- corporate boxes;
- holiday accommodation;
- pleasure craft; and
- entertainment off the business premises (excluding light refreshments).

67. A number of exclusions apply to those categories. The main exclusions are expenditure on business travel and conferences.

68. In many larger businesses, a “close enough” approach is taken to calculating the entertainment tax adjustment and that is just to take 50% of any expenditure coded to entertainment accounts in their financial statements. Although this might overpay in

¹² For example vehicles could be classed into high, medium, low or no availability for private use and be assessed FBT on that basis.

¹³ Such as work related vehicles, emergency call out vehicles and unavailable for private use days.

¹⁴ See section DD1 of the Income Tax Act 2007

connection with some items it will make up for any entertainment expenditure coded to non-entertainment expense accounts.

69. Accurately calculating the deduction, however, can incur substantial compliance costs for larger businesses and also for smaller businesses.

70. Prior to the introduction of the entertainment regime, such expenditure was treated the same as any other type of expenditure in that the normal rules for deductibility and non-deductibility would apply, particularly the prohibition on private expenditure.

71. It may be possible to simplify the entertainment regime or even move it back to normal deductibility principles. The entertainment regime was introduced in the 1990's when corporate entertainment was a large feature of business. Times may have changed to the extent that businesses are more focused on costs and keep entertainment to a minimum.

72. However, even if the rationale for the regime remains officials consider there may be some redesign of the regime that could result in a reduction in compliance costs and again look to apply more of a "close enough is good enough" approach.

73. Since the entertainment classification in the IR10 was removed in 2012 we do not have current data on the amount of entertainment deduction that is being denied. However, as a rough guide based on IR10 data from 2012 uplifted by GDP, the fiscal cost of removing the income tax and GST adjustment on entertainment at a minimum would be around \$100-110 million per year. This is an underestimate as it does not include information from taxpayers who do not file an IR10 which is the majority of the larger corporate taxpayers who are likely to have material amounts of entertainment.

5.4 Review the thresholds for unexpired expenditure

74. In a similar vein to the thresholds for provisional tax, closing stock and legal expenditure, officials consider it may reduce compliance costs for smaller taxpayers to review the thresholds for unexpired expenditure.

75. These thresholds mean that taxpayers can deduct prepayments made up to certain levels without having to apportion those across income years. The main cost which results in apportionment for smaller businesses is likely to be insurance costs which are generally prepaid for a year.

76. Raising some of these thresholds may result in taxpayers not having to undertake apportionment for prepayments which should result in compliance cost savings to them.

77. Again the fiscal cost of this measure is difficult to measure as it will depend on the final design but we do note this will be a timing difference only.

5.5 Resident withholding tax on related party debt

78. The advisor to the Group requested that we also include some discussion of the submission made by Federated Farmers relating to resident withholding tax (RWT) on intra-family transactions. In their submission, Federated Farmers noted that:

“There would be reasonable compliance costs savings for SMEs if RWT on SME intra-family entity interest and dividends was abolished. It would be replaced by provisional and terminal tax. We do not think that there would be a fiscal risk in this area.”

79. Officials last looked at the issue of RWT on close company interest and dividends in September of 2015 in an officials’ issues paper on closely held company taxation issues¹⁵. This review was not specific to farmers but reviewed the issue for all closely held companies.

80. The RWT rate on dividends is a flat 33%. The actual RWT deducted will depend on the level of imputation credits attached to the dividend. The lowering of the company tax rate to 28% means that even fully imputed dividends must have RWT deducted. This creates a compliance burden on companies, and, in particular, closely held companies that pay fully imputed dividends. It also creates over-taxation for corporate shareholders who suffer RWT deductions from fully imputed dividends and for individual shareholders who are not on the top personal tax rate. Any excess RWT then needs to be claimed as a refund when the tax return for the relevant income year is filed, which not only means refund delays but also a compliance burden on those individuals who may not otherwise have had to file a return, or otherwise engage with Inland Revenue.

81. The interest RWT rate varies according to the shareholder’s marginal tax rate. It is common for close companies to pay interest to associated persons. Again, if RWT on this interest did not need to be accounted for there would seemingly be compliance savings for the payer.

82. There would be both compliance cost savings for the paying company and very likely administration cost savings for Inland Revenue with this approach, especially when returns are manually prepared. However, some compliance costs may just be switched from the payer to the recipient although it is likely that compliance costs will reduce overall. Some recipients of the dividends or interest may face increased compliance costs through having to file a tax return or engage with Inland Revenue when they would not otherwise have to do so and/or through having to pay provisional tax when they are currently under the provisional tax threshold.

83. Historically the issue of removing RWT on related party transactions has had significant fiscal costs from the deferral of tax which officials considered outweighed the savings in compliance costs. Some of this deferral is transitional, involving the deferral of tax that would have been paid in the first year of the change as RWT to its

¹⁵ Closely held company taxation issues – an officials’ issues paper – Policy and Strategy, Inland Revenue and the Treasury – September 2015

being paid as a combination of terminal tax and higher provisional tax payments in the following year.

84. In the time available, we have not been able to forecast the fiscal impact of such a change to be included in this paper, however, some changes to the way in which tax is accrued for accounting purposes may have reduced these since the last time these were considered. In general, officials consider this may be a worthwhile compliance reduction suggestion subject to the fiscal and cash cost of proceeding.

5.6 Recording expenditure

85. When Inland Revenue conducts surveys of SMEs, the largest effort in compliance by far is the effort required to record information. This is not specific information for tax purposes, as financial information is required for good business management, however, SMEs see this as largely a tax compliance exercise.

86. There are a number of ways in which SMEs can reduce the time it takes to record information with perhaps the most helpful way to reduce costs in this area is using a software accounting package, and using it well.

87. The use of a software accounting package can assist the SME by making the recording of information and categorising of expenses easier than keeping paper records or a manual spreadsheet. The development of artificial intelligence within those products will also assist people who have limited knowledge of accounting to classify expenses.

88. Software products also have the benefit of being able to automatically link to the SME's accountant or bookkeeper to allow them to keep a watching brief on the business of their client as well as interfacing with Inland Revenue's systems to allow the digital upload of information directly.

89. A major contribution to compliance cost reduction for SMEs could be easing the transition onto accounting software and ensuring those who do transition know how to use the technology effectively.

90. The Group could recommend that the Government consider how it could incentivise SMEs to move to cloud based accounting software and how they could assist to educate SMEs in the use of that software. This will help businesses to get it right from the start in terms of not only tax compliance but having the tools to assist them to run and grow their business.

91. If the Government were to consider subsidising the accounting software itself for those new to accounting software, based on current growth rates the cost of such a subsidy could be in the ballpark of \$3 million to \$29.5 million for a 10-50% subsidy (dependent on the level of product subsidised - e.g., basic or most popular). However, a targeted subsidy may be difficult to apply in practice. A more general subsidy to all users could range from \$16-160 million for a 10-50% subsidy depending on the level of product.

92. In addition, the most benefit from some measure in this area would be in educating users in how to maximise the use of the product whether that be done through accountants, MBIE or Inland Revenue education programmes. The cost of that is difficult to estimate as it will depend on the level of support provided.

93. This is potentially a concept that could be considered by the Small Business Council as part of its more general work on small business.

6. Conclusion and recommendations

6.1 Concluding thoughts

94. The Government has recently made substantial changes with a view to reducing compliance costs for businesses and in particular small businesses.
95. Notwithstanding this the Group considers there are more changes that could be made to reduce compliance costs.
96. The Group has made a number of recommendations in the interim report and is looking to expand on these for the final report.
97. The recommendations the group will make to the Government will be included in the final report.

Appendix A - suggested text for final report

Introduction

1. In the interim report, the Group considered whether a progressive company tax rate should be introduced and decided against that option as the cost of such a system was likely to outweigh any benefits in terms of faster small business growth. Similarly changing the basis of taxation for smaller businesses to a cashflow or turnover tax was not supported due to administrative and threshold issues. It was considered that a better approach for supporting small businesses would be to focus on reducing compliance costs.
2. The Group identified three areas where the Government could take immediate action to reduce compliance costs. These were:
 - Increasing the \$2,500 threshold for paying provisional tax to \$5,000-\$10,000;
 - Increasing the \$10,000 year-end closing stock adjustment to \$20,000-\$30,000; and
 - Increasing the \$10,000 limit for the automatic deduction for legal fees, and potentially expanding the automatic deduction to other types of expenditure.
3. The Group did not consider that altering thresholds around fixed assets (such as the low value write off threshold) should be progressed as they can have large fiscal costs relative to the practical compliance cost saving.
4. For this report the Group explored further options to simplify and reduce compliance costs, and that work is presented below.

Work to date

5. A significant number of changes have been made in the last two years which had the aim of reducing taxpayer compliance costs. These included changes to provisional tax and in thresholds for annual filing of fringe benefit tax returns.
6. The Group recognises that there is also a strong push from an all-of-government perspective to lower compliance costs for small businesses which includes work on the New Zealand Business Number, e-invoicing and Business Connect which increases co-ordination across government services. The Group supports all of these measures to reduce compliance costs for small businesses.
7. Since the interim report, the Government has also set up a Small Business Council (SBC) which has the task of developing a small business strategy which includes tax policy as part of its brief. This should also ensure that there is a clear strategy for small business, and the Group has been engaging with the SBC to identify any common ground with its terms of reference.
8. Inland Revenue is also part way through its business transformation programme which has the objective of reducing the time it takes to comply with tax

requirements by 18 to 26 hours, which equates to \$1.3-\$2.3 billion in economic value. To date, the time savings due to the business transformation changes are tracking ahead of those estimates.

9. These latter items are important to consider in an overall discussion of compliance costs as these are changes which are being made that have no preferences or concessions attached to them. They simply make life easier for taxpayers and the Group commends these programmes.
10. However, the Group does consider there are some areas where compliance costs across the board for taxpayers could be reduced because although compliance costs disproportionately fall on smaller businesses they are likely to gain a greater saving than larger taxpayers who have better systems and scale to deal with costs of compliance.

Fiscal position

11. Whilst the Group has considered a number of ways to further reduce compliance costs for businesses it is very mindful of the fiscal position of the Government. Reducing compliance costs may come with a cost to Government, whether this be in fiscal or cash terms, and it is paramount that in assessing the merit of these recommendations, the Government carefully considers the fiscal and cash cost of these and only proceed with them where there is a positive return for New Zealand overall.

Recommendations in the interim report

12. In the interim report the Group recommended three measures that the Government could consider to reduce compliance costs. The Group has continued to consider those and expand on them. Those recommendations are:

Increasing the \$2,500 threshold for paying provisional tax to \$5,000-\$10,000

13. The provisional tax regime is designed around the premise that people should pay tax as they earn their income. Our pay-as-you-earn (PAYE) and resident withholding tax (RWT) regimes are also designed around that premise. Provisional tax is the option for those people who earn income where tax is not deducted at source, such as business income.
14. Over the last few years a number of positive changes have been made to the provisional tax regime to reduce taxpayer compliance costs and this includes:
 - the removal of use of money interest for most taxpayers for the first two instalments of provisional tax;
 - the introduction of the accounting income method for paying provisional tax which allows businesses with volatile or seasonal income to better match their cashflows; and

- the increase and expansion of the safe harbour from use of money interest from \$50,000 to \$60,000 of residual income tax¹⁶ and to non-individuals.
15. Together these changes removed around 19,000 taxpayers from exposure to use of money interest which reduces the compliance costs and takes a lot of the guesswork out of provisional tax.
 16. Despite this, the Group considers that the threshold for paying provisional tax is set too low. At \$2,500 this represents around \$9,000 of income for a company or \$7,500 for an individual on the top marginal rate. This adds a compliance cost to those who have relatively small amounts of income.
 17. However, balancing this is that for those taxpayers on lower incomes making three small payments during the year may have much lower compliance costs than making one large payment sometime after the end of their income year.
 18. There is a fine balance between ensuring that compliance costs are reduced whilst ensuring that it does not throw too many into a debt situation which could have been managed with more frequent payments.
 19. In addition, while the increase in the threshold has limited fiscal cost it does have a significant cash cost to the government. An increase in the threshold to \$5,000 is estimated to have a cash cost of \$355 million whilst an increase to \$10,000 would be closer to \$1 billion.
 20. Overall the Group continues to prefer an increase in the threshold for provisional tax from \$2,500, but considering the fiscal cost and the debt issue, we consider that an increase to **[\$5,000 of residual income tax is more appropriate and that is our recommendation to Government] TO BE DECIDED.**

Increasing the \$10,000 year-end closing stock adjustment to \$20,000-\$30,000

21. The Income Tax Act requires taxpayers to value their closing stock at the end of the year as that amount is included in taxable income. However, taxpayers who have a turnover of less than \$1.3m and reasonably estimate the value of their closing stock to be less than \$10,000 can use their opening stock as their closing stock for the year. This essentially gives the taxpayer a deduction for their purchases.
22. The \$10,000 part of the threshold was last adjusted with effect from the 2009-10 income year. The Group considers that this threshold may no longer be appropriate and has recommended that it be increased to \$20,000-\$30,000.
23. Whilst the Group recognises that this will only affect around 13-20,000 taxpayers from having to undertake a stocktake for the year it is likely only those who gain a benefit from that (ignoring the compliance costs of undertaking the stocktake) will

¹⁶ Residual income tax is the tax liability left after deduction of any tax credits such as PAYE.

use this option which may mean that only 5-7,600 would be affected by the change as it is optional.

24. However, the Group considers the cost of undertaking a stocktake should not be underestimated, especially for those taxpayers who have high volumes of low cost stock and we continue to recommend this change to Government.

Increasing the \$10,000 limit for the automatic deduction for legal fees and potentially expanding this to other types of expenditure

25. A compliance cost measure currently exists that allows taxpayers an automatic deduction for legal fees where their total legal fees are less than \$10,000. This means that those taxpayers do not need to assess whether those fees are incurred in connection with a capital project and may be non-deductible.
26. The Group considers that the threshold for this expenditure should be adjusted to a higher level and that the breadth of the provision be expanded to other types of expenditure such as accounting fees.
27. The Group has not decided on where the threshold should be set and what types of expenditure should be included due to the timeframes of reporting, however, we consider that it should be limited to professional fees and should not be expanded to other potentially capital expenditure such as repairs and maintenance.

Further Recommendations

28. In the interim report the group undertook to explore further options for simplification and reducing compliance costs for small businesses. The Ministers of Finance and Revenue also asked us to provide them with some guidance on what other measures we saw could be progressed and detailed below are some further recommendations for the Government to reduce compliance costs for businesses.
29. Given the timeframes we have not been able to fully form the detail of some of these measures, however, officials could progress the detail of these. It has also not been possible to provide costs for these as the ultimate cost will depend on the design features. The Government could also consider how the work of the Small Business Council could include assisting to progress the detail of these recommendations.

[ITEMS BELOW TO BE DELETED IF NOT APPLICABLE]

Fringe benefit tax

30. The Group understands from officials that at workshops they have held with taxpayers that fringe benefit tax (FBT) is one of the most common compliance cost intensive taxes mentioned by taxpayers.
31. FBT plays an important role in our tax system, not only does it raise around \$500m in revenue for the Government it has a more important role as a buttress to the

PAYE system so that employees are not paid in benefits rather than cash. If FBT did not exist it is likely the revenue from PAYE would diminish significantly.

32. Generally, however, the largest costs of complying with FBT are incurred in not paying FBT but applying the various exemptions to lower the FBT liability. Another source of compliance costs, especially for larger taxpayers, is the category of other benefits such as provision of gift cards to staff. There can be significant costs incurred in identifying these low value items.
33. The Group recommends that the Government consider simplification of FBT by investigating:
 - simplification of FBT on motor vehicles by simplifying the classification of vehicles to better reflect the private use of the vehicle, removing the exemptions that apply to vehicles and consequently reducing the rates to reflect that the charge would be calculated on a “close enough is good enough” basis which may have over and underpayments compared to actual use;
 - simplify the calculation of FBT on other benefits with a view to reducing the compliance costs of identifying every last benefit provided which may have a private element at the margin.

Entertainment adjustment

34. The entertainment adjustment generally only permits the deduction of 50% of costs incurred on “entertainment”. Entertainment expenditure includes expenditure on corporate boxes, holiday accommodation, pleasure craft and entertainment off the business premises (excluding light refreshments). A number of exclusions apply to those categories. The main exclusions are expenditure on business travel and conferences.
35. To accurately calculate the adjustment can incur significant compliance costs and many businesses simply take a broad-brush approach and adjust for half of all entertainment expenditure.
36. It may be possible to simplify the entertainment regime or even move it back to normal deductibility principles which existed prior to its introduction. The entertainment regime was introduced in the 1990’s when corporate entertainment was a large feature of business. Times may have changed to the extent that businesses are more focused on costs and keep entertainment to a minimum.
37. However, even if the rationale for the regime remains the Group considers there may be some redesign of the regime that could result in a reduction in compliance costs and again look to apply more of a “close enough is good enough” approach.

Review the thresholds for unexpired expenditure

38. In a similar vein to the thresholds for provisional tax, closing stock and legal expenditure, the Group considers it may reduce compliance costs for smaller taxpayers to review the thresholds for unexpired expenditure.
39. These thresholds mean that taxpayers can deduct prepayments made up to certain levels without having to apportion those across income years. The main cost which results in apportionment for smaller businesses is likely to be insurance costs which are generally prepaid for a year.
40. Raising some of these thresholds may result in taxpayers not having to undertake apportionment for prepayments which should result in compliance cost savings to them.

Resident withholding tax on related party debt

41. One submitter asked the Group to consider the issue of RWT on close company related party interest and dividends. This was last looked at by the Government in September of 2015 in an officials' issues paper on closely held company taxation issues¹⁷.
42. RWT is applicable to related party interest payments and also dividend payments. Within a close company environment when the tax compliance is usually completed by a single person this creates a large compliance cost for what can be little benefit.
43. Withholding taxes are designed to both ensure that income is returned and also to assist in removing taxpayers from being liable to pay provisional tax. In the case of a close company situation with related party debt these issues are not as prevalent as the scope to under-declare is limited and the recipient of the interest or dividend is likely to be subject to provisional tax in any case.
44. There would be both compliance cost savings for the paying company and very likely administration cost savings for Inland Revenue with this approach, especially when returns are manually prepared.
45. Historically, the issue of removing RWT on related party transactions has had significant fiscal costs from the deferral of tax which officials considered outweighed the savings in compliance costs. Some of this deferral is transitional, involving the deferral of tax that would have been paid in the first year of the change as RWT to its being paid as a combination of terminal tax and higher provisional tax payments in the following year.
46. In the time available, we have not been able to forecast the fiscal impact of such a change to be included in this paper, however, some changes to the way in which tax

¹⁷ Closely held company taxation issues – an officials' issues paper – Policy and Strategy, Inland Revenue and the Treasury – September 2015

is accrued for accounting purposes may have reduced these since the last time these were considered. In general, the Group recommend this may be a worthwhile compliance reduction subject to fiscal costs.

Recording expenditure

47. When Inland Revenue conducts surveys of SMEs, the largest compliance effort by far is the effort required to record information. This is not specific information for tax purposes, as financial information is required for good business management, however, SMEs see this as largely a tax compliance exercise.
48. There are a number of ways in which SMEs can reduce the time it takes to record information with perhaps the most helpful way to reduce costs in this area is using a software accounting package, and using it well.
49. The use of a software accounting package can assist the SME by making the recording of information and categorising of expenses easier than keeping paper records or a manual spreadsheet. The development of artificial intelligence within those products will also assist people who have limited knowledge of accounting to classify expenses.
50. Software products also have the benefit of being able to automatically link to the SME's accountant or bookkeeper to allow them to keep a watching brief on the business of their client as well as interfacing with Inland Revenue's systems to allow the digital upload of information directly.
51. A major contribution to compliance cost reduction for SMEs could be easing the transition onto accounting software and ensuring those who do transition know how to use the technology effectively.
52. The Group considers this is a worthwhile measure that could significantly reduce compliance costs to smaller businesses and recommend to the Government that they consider how they could incentivise SMEs to move to cloud based accounting software and how they could assist to educate SMEs in the use of that software. This will help businesses to get it right from the start in terms of not only tax compliance but having the tools to assist them to run and grow their business.
53. This is potentially a concept that could be considered by the Small Business Council as part of its more general work on small business.

Recommendations

54. The Group recommends that the Government investigate the following measures to reduce compliance costs of businesses, in particular, smaller businesses:

[Delete as applicable]

- increase the threshold for paying provisional tax from \$2,500 to \$5,000 of residual income tax;
- increase the \$10,000 closing stock adjustment to \$20,000-\$30,000;

- increase the \$10,000 automatic deduction for legal fees and potentially expanding the automatic deduction to other types of professional fees but not to other potentially capital expenditure such as repairs and maintenance;
- investigate the simplification of fringe benefit tax with a focus on the motor vehicle and “other” benefits categories;
- investigate the simplification or removal of the entertainment adjustment;
- review the thresholds for unexpired expenditure;
- investigate the removal of resident withholding tax on close company related party interest and dividend payments;
- investigate incentives to get smaller businesses using cloud based accounting software and educating business owners to use it well.

55. The Group is particularly interested in the last measure as we consider that will have spin-off benefits to businesses in general and not just tax compliance. This is something that the Government’s new Small Business Council could look at progressing.

56. The Group consider that these measures address the main compliance cost issues that small businesses raise with advisors and Inland Revenue and believe that the recommended measures could reduce these costs significantly.

