Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

Release Document

September 2018

taxworkingroup.govt.nz/key-documents

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 7: Lower tax rates for small companies

Background Paper for Sessions 6 and 7
of the Tax Working Group

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The Tax Working Group will release its interim report containing its recommendations in September and the views of the Group will be informed by public submissions alongside Secretariat advice.

March 2018

Prepared by the Inland Revenue Department and the New Zealand Treasury

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1. Introduction

1.1 Background

1. A lower company tax rate on small businesses has been suggested both in the past and more recently. The Tax Working Group has been asked to consider whether a progressive company tax rate (with a lower rate for small companies) would improve the tax system and the business environment.

2. The case for and against a lower company tax rate across the board, including the efficiency implications, is discussed in Appendix 2.

1.2 Lower rate for small business

3. A lower rate for small businesses could be applied in a number of ways – for example, it could apply to business income below a certain threshold, or for a set number of years after a company has commenced business.

4. Some justifications for a split company rate are:

   - Small businesses would have more funds available to invest and grow, to the extent that they are making profits. This is often cited as the justification for a lower rate, emphasising that SMEs comprise the vast bulk of businesses.

   - Small businesses face relatively higher costs of compliance and it might be argued that as a result reducing their tax rate would make things fairer. Compliance costs impact on productivity.[1]

   - It might be argued that a lower SME tax rate would compensate SMEs if they have to pay higher labour costs because of a rise in the minimum wage.

5. There are significant drawbacks of a split rate:

   - A lower tax rate is a very poorly targeted way to compensate firms for compliance costs. The burden of higher relative compliance costs for SMEs can be more directly addressed, particularly through Inland Revenue's Business Transformation programme.

   - It would add significant complexity to the tax system given that it would involve a variety of boundaries and thresholds. For example, it would be necessary to share thresholds across groups of companies. Otherwise, firms could multiply their access to the low tax rate by breaking up their businesses.

[1] To the extent that a high compliance burden diverts resources from productive activities (e.g. investment in physical capital, productivity-enhancing innovation) and increases input costs without creating additional output, firm productivity can decline. See *Tax Administration and Firm Performance: New Data and Evidence for Emerging Market and Development Economies,* IMF Working Paper WP/17/95, April 2017.

- An increased differential between the top personal tax rates and the company rate would encourage tax planning/avoidance. As discussed in other segments of this paper, we are already seeing such behaviour when the differential is only 5%.

- A higher income individual may use a SME vehicle to earn significant income. If these situations are eligible for a lower company tax rate, horizontal and vertical equity can be reduced.

- Efficiency is likely to be reduced by advantaging SMEs over larger firms. While there are arguments that an across-the–board tax cut can increase efficiency, through increasing capital investment, a reduction for just some businesses will mean that business is not necessarily undertaken by the most efficient firms.

- Imputation means that lowering the tax rate for small businesses is less relevant when profits are paid out soon after they are earned.

- A threshold acts as a disincentive to business expansion. A company that crosses the threshold can find itself with a sizeable tax increase, which may be more than the increase in profits.

- If the concern is the higher costs associated with minimum wage legislation, this can be a cost to larger firms as well as smaller businesses, and any increase in wages gives rise to a higher tax deduction defraying part of the cost.

1.3 Progressive rates

6. If a purpose of a progressive company tax rate is to better reflect the tax rates of the underlying investors in small businesses, we note that there are a number of ways that investors can already achieve this under existing tax rules:

    - The look-through company option effectively applies individual or partnership tax treatment, by attributing the income, losses and capital gains made by the entity directly to the individual owners in accordance with their ownership shares.

    - Limited partnerships offer an alternative structure to achieve essentially the same outcome as a LTC. The partners can be companies but profits, losses and capital gains flow through to the individual partners.

    - Applying individual tax rates to business income can also be achieved by the owner(s) paying themselves a wage or salary.

7. This means, for example, that small business owners who have relatively low incomes because of the start-up nature of their business, are directly taxed at low

marginal rates if they operate through a look-through company, and can deduct any business losses against their other income.

1.4 Australian approach

8. In 2015 Australia introduced a lower company tax rate for SMEs, to support and encourage SMEs to grow, invest and employ more, given that they form a significant part of the business sector and economy. Like New Zealand over 90% of Australia's businesses are small businesses. The Government also provided a 5 per cent tax discount to unincorporated businesses with annual turnover of less than $2 million from 1 July 2015. The rate and threshold were subsequently raised for the 2016-17 tax year to, respectively, 27.5% and $10 million.

9. Last year the Australian Government announced its intention to progressively extend the lower corporate tax rate to all corporate entities through gradually increasing the turnover threshold each year. Under this plan, all corporates would be on a 27.5% tax rate by 2023-24, reducing to 25% by 2026-27. Legislation giving effect to these changes is still before the Australian Parliament.

10. Under this approach, the lower company tax rate for smaller businesses is more a temporary variation from a longer term objective to reduce the company tax rate across-the-board.

2. Conclusion

11. A lower company tax rate for small businesses is not recommended. A better approach is to reduce compliance costs more generally, and there is already a considerable move in this direction, particularly via Inland Revenue's Business Transformation programme. This can advantage all firms, but SMEs in particular. From a New Zealand welfare perspective, subsidising SMEs for compliance costs does not address the real problem, as the Government is then merely picking up a share of the costs via the subsidy. The better solution is to attempt to reduce the compliance costs, thereby reducing the cost to New Zealand as a whole.

12. The Tax Working Group may also like to note that there are already ways for small business investors to ensure that the income earned in the business is taxed directly at the investors' progressive marginal tax rates.