Trusted Taxpayer Regime

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1. Introduction

1.1. My proposal for a Trusted Taxpayer Regime (TTR) uses the incentive of a discounted tax rate and removal of the end of year filing obligation to reduce compliance costs for small business taxpayers who opt into the regime. In return for these benefits, there is quid pro quo for Inland Revenue. Via real-time access to taxpayer financial information in their accounting software and receipt of quarterly tax assessments, Inland Revenue can have greater assurance that a taxpayer is complying with their tax obligations and can more easily verify this. This is intended to reduce administrative costs for Inland Revenue and discourage hidden economy activity in the small business sector.

1.2. This proposal will cover:

- The problem definition – what are the policy issues that this proposal will help to address;
- Eligibility – what criteria must be met to enter the regime;
- Mechanics of the TTR – how does the regime work and practical considerations;
- Assessment against the Tax Policy Scholarship judging criteria.

2. Problem definition and key benefits of the TTR

(a) Compliance costs

2.1. Small business taxpayers make up a large proportion of the New Zealand economy[1] and therefore a large proportion of taxpayers that are important to the tax system – both in terms of their contribution and their compliance. Compliance costs weigh heavily on small businesses as the costs of compliance are relatively fixed and do not grow in proportion to the size of the business.[2] Small businesses also lack the specialist expertise to deal with tax matters that larger firms have, so tax compliance can take up a proportionately larger amount of time. These

[1] Small businesses (defined as enterprises with fewer than 20 employees) contribute nearly 30 percent of New Zealand's GDP. The Small Business Sector Report 2014, Ministry of Business, Innovation & Employment, https://www.mbie.govt.nz/assets/a3f3ad1f01/small-business-sector-report-2014.pdf

[2] Ranjana Gupta and Adrian Sawyer, *Tax compliance costs for small businesses in New Zealand: Some recent findings*, 2015, Australian Tax Forum, 30(1)135-177

compliance costs reduce the funds and time that a small business has to devote to other more productive activity. [3]

2.2. If we view compliance costs with a wider lens to include the cost of the tax payment itself, reducing the tax rate for eligible small businesses is a viable option to have a direct impact on the burden of compliance for these taxpayers. The TTR achieves this directly via an incentive (discounted tax rate) and indirectly by removing the end-of year filing obligation. As a result, small business taxpayers will have a greater amount of time and resources to invest in their business, increasing the potential for small businesses to grow and expand.

(b) Administrative costs

2.3. As Inland Revenue has limited resources to effectively ensure taxpayers are complying with their obligations, it has limited assurance regarding the compliance of the small business sector as a whole. While Inland Revenue does have extensive power to audit taxpayers' compliance, given the number of taxpayers in the small business sector[4], it is difficult for Inland Revenue to ensure taxpayers across this sector are complying with their obligations. Inland Revenue's administrative costs investigating smaller businesses are also likely to be higher due to it being harder to gather information from such businesses who keep less formal documentation.[5]

2.4. The TTR reduces administrative costs by making information more accessible to Inland Revenue via a direct link to the taxpayer's accounting software and making it harder to hide data (due to use of accounting software and largely cash-free business model requirement – discussed at paras 3.8 to 3.13). Both factors lower the costs for Inland Revenue in enforcing the tax rules for TTR taxpayers.

2.5. Knowing that Inland Revenue has access to their financial information, TTR taxpayers are likely to engage in tax compliant behaviour. In turn, greater confidence that TTR taxpayers are tax compliant and reduced administrative costs for this subset of taxpayers will enable Inland Revenue to focus its efforts at higher risk areas. The administrative costs saved can be directed at non-TTR taxpayers at greater risk of non-compliance, which would increase all overall levels of compliance in the tax system due to the greater risk of detection for non-TTR taxpayers.

(c) Tax morale

2.6. Tax morale is defined broadly as "a moral obligation to pay taxes, a belief in contributing to society by paying taxes".[6] The higher that tax morale is, the more likely taxpayers are to comply.

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[3] Era Dabla-Norris, Florian Misch, Duncan Cleary & Munawer Kwaja, *Tax Administration and Firm Performance: New Data and Evidence for Emerging Market and Development Economies*, IMF Working Paper WP/17/95, April 2017, pg. 4

[4] Statistics NZ estimates that there is a total of 471,969 taxpayers who have sales between $0 - $5m. Stats NZ Annual enterprise survey: 2018 financial year (provisional), https://www.stats.govt.nz/information-releases/annual-enterprise-survey-2018-financial-year-provisional, Accessed 11 August 2019.

[5] Joel Slemrod and Shlomo Yitzhaki, *Chapter 22: Tax Avoidance, Evasion and* Administration, Handbook of Public Economics, Volume 3, 2002, Pg. 1447-1448.

[6] Bruno Torgler and Freidrich Schneider, *The impact of tax morale and institutional quality on the shadow economy,* Journal of Economic Psychology, 2009, Volume 30(2).

Tax morale is an important factor in a self-assessment system. Generally, the higher tax morale, the greater level of voluntary compliance.

2.7. By offering a reward to taxpayers who opt into additional oversight from Inland Revenue, the TTR can improve tax morale by rewarding compliant behaviour (i.e. opting into Inland Revenue having access to a taxpayer's financial information). To avoid taxpayers viewing the TTR tax discount as a 'right' and therefore not have an impact on tax morale[7], it is important that TTR taxpayers opt into something that goes beyond what is required of other taxpayers. The TTR achieves this by requiring TTR taxpayers to allow Inland Revenue digital access to their financial information.

(d) Reducing hidden economy and encouraging voluntary compliance

2.8. The hidden economy is a widespread problem and the resulting non-compliance reduces the amount of revenue that the Government has to fund its objectives. Hidden economy activity is more likely to occur with small business taxpayers given the opportunity to self-report income, compared to taxpayers who have their income reported to Inland Revenue by a third party (e.g. employees who receive PAYE income).[8]

2.9. Numerous factors influence tax compliance behaviour which include both economic and non-economic factors. Economic factors include tax rates, the risk of detection and enforcement and the level of penalties that would apply if caught. Non-financial factors include social norms, individual moral beliefs, levels of trust in the tax authorities and tax morale.[9]

2.10. The TTR can reduce hidden economy activity by influencing these factors to encourage taxpayers into voluntary compliance:

- A discounted tax rate can encourage compliance due to the lower overall cost associated with compliance;

- Inland Revenue can audit compliance in a more cost-effective manner – increasing the risk of detection and enforcement;

- TTR taxpayers are aware that Inland Revenue can view their financial information and are likely to take greater care in preparing their tax assessment;

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[7] Lars Feld and Bruno Frey, *Tax compliance as the result of a psychological tax contract: The role of incentives and responsive* regulation, Working Paper No 76, June 2005 Centre for Tax System Integrity Research School of Social Sciences, Australian National University, at 11

[8] This is known as the 'tax gap' – being the difference between actual tax collected and the potential tax that could be collected if full compliance would be achieved. The theory is that the self-employed have greater opportunity to hide income due to the lack of withholding of their income. In the New Zealand context, for evidence of this refer to Ana Cinta G. Cabral and Norman Gemmell, *Estimating self-employment income-gaps from register and survey data: Evidence for New Zealand*, Working Paper in Public Finance, Victoria University Press, April 2018

[9] Lin Mei Tan and Valerie Braithwaite*, Motivations for tax compliance: the case of small business taxpayers in New Zealand*, Australian Tax Forum, 2018 (33)

- Non-complaint or partially compliant taxpayers may be encouraged towards full tax compliance due to TTR incentives. These incentives could reinforce voluntary compliance as a social norm;

- "Good" taxpayers are rewarded with lower compliance costs, helping to reduce the competitive advantage that non-compliant taxpayers have over them due to understating income/overstating business expenditure. This increases tax morale (discussed further at paras 2.6 to 2.7);

2.11. To date, measures targeting non-compliance for small businesses and self-employed people have:

   a) Relied on taxpayer goodwill to voluntarily comply or choose to comply for fear of the consequences.

   b) Primarily used a 'stick' approach rather than a carrot - e.g. shortfall penalties.

   c) Imposed withholding tax obligations on particular sectors.

2.12. Rather than punishing small business taxpayers when they do not comply, an approach which has a combination of "carrots" (i.e. incentives) and "sticks" for small business could shift the needle on voluntary compliance. Incentives have not been widely used to promote voluntary compliance / discourage non-compliance. Psychological research demonstrates that positive incentives often work better than punishments at promoting good behaviour and an exclusive reliance on deterrence will not be as effective.[10] Experience to date suggests that neither (a) nor (b) will stop all hidden economy activity. Withholding tax is a blunt instrument to ensure certain sectors of the economy are paying tax. However, withholding tax imposes a cost on the payer and can only be targeted at particular sectors, rather than across the whole economy, due to the impracticality of imposing withholding tax obligations on consumer payers.

2.13. The incentive offered by the TTR is an important influencer for behaviour change at the margins. Gemmell and Hasseldine[11] note that changes to the effective marginal income tax rate do influence compliance. This encompasses not only the statutory tax rate paid but also the cost of compliance. In essence, the lower the tax rate and the easier it is to comply with the rules; the stronger the incentive for a taxpayer to comply. As the TTR contains these elements, it is expected it will have some impact at the margins in incentivising taxpayers to compliance over hidden economy activity. However, it is difficult to fully estimate the impact.

2.14. It is acknowledged that the TTR will not be a panacea to fixing the hidden economy, and there will be some hardcore non-compliant businesses that choose to pay little tax and escape the GST net. While the TTR is an incentive, the potential benefit from paying little/no tax is much higher. Further, there are also non-tax motivators for not declaring income to Inland Revenue which include where the income earning activity is illegal or where there are moral/cultural barriers to recording some income sources (e.g. cash jobs).[12] Recognising these limitations, it is

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[10] Feld and Frey, above n 7 at 12 – 13.

[11] Norman Gemmell and John Hasseldine, *Taxpayers' Behavioural Responses and Measures of Tax Compliance 'Gaps': A Critique*, Working Paper in Public Finance, Victoria University Press, February 2014.

[12] Cabral and Gemmell, above n 8.

acknowledged that the TTR is not a complete solution to the hidden economy but does adds another weapon in the arsenal in this battle. In any case, reducing hidden economy activity is only part of the justification for the TTR – along with encouraging small business growth, increasing tax morale, and reducing compliance costs and administrative costs for Inland Revenue.

3. Eligibility criteria

3.1. Taxpayers who meet the following criteria will qualify for the regime:

- Is a small business with turnover of less than $5 million in a year - either a company, partnership or self-employed individual.
- Has given consent for Inland Revenue to have digital access to its accounting information via its accounting software package.
- Has a predominantly cash-free business model.
- Uses TTR-approved accounting software.

(a) Small business

3.2. The types of entity that are eligible for TTR include individuals, partnerships and companies. There would need to be additional rules required for partnerships and look-through companies (LTC) to enable the partners/shareholders to receive the benefit of the discounted tax rate under the TTR.[13]

3.3. To be a TTR qualifying small business, you must be:

- Carrying on a business;
- Have turnover of less than $5 million.

3.4. The first criteria draws on the existing common law understanding of when business activity has commenced. While this would give rise to some uncertainty on the margins, this is a relatively settled area of law. To provide greater certainty, and to ensure the TTR is accessible to a layperson without needing to seek tax advice, the existing common law test could be codified to provide a definition of carrying on a business in the context of the TTR.

3.5. Most business taxpayers will be eligible for the TTR with the threshold set at turnover under $5 million. Stats NZ estimates that 97.5% of enterprises in New Zealand have turnover less than $5 million[14]. Turnover is defined as total income that a business derives in an income year per

[13] It is envisaged that the TTR entity would pay provisional tax on behalf of the partners/shareholders during the year and at year end, the taxable income, tax paid and TTR tax credit would be attributed to each partner/shareholder based on their percentage interest in the entity.
[14] Stats NZ Annual enterprise survey: 2018, n 4 above.

section CB 1 Income Tax Act 2007. This definition is intended to capture the common understanding of business income and is intended to exclude income that does not relate to the business' trading activities from the $5m threshold.

(b) Access to taxpayer accounting information

3.6. In order to access the TTR, the taxpayer must give consent for Inland Revenue to have digital access to its accounting information via its accounting software package. This is a quid pro quo for the benefits that the small business receives under the TTR.

(c) Taxpayer has a predominantly cash-free business model

3.7. Cash use is a concern because cash does not generate a paper trail and makes it easier to under-report income. Cash transactions also undermine the benefits of the TTR to Inland Revenue as they are more difficult to audit.[15] Evidence overseas regarding third-party information reporting suggests that mandatory information reporting had increased compliance on the income subject to reporting, but the effectiveness of this measure was compromised by firms' cash receipts not being covered by the information reporting regime.[16] The integrity of the TTR would be harmed if this requirement was not included as there is a risk that taxpayers could access the benefits of the TTR while not disclosing all their financial information because cash transactions are not included within in their financial information.

3.8. A predominantly cash-free business model is defined as 90% of the total dollar value of cash receipts being non-cash. A fully cashless business model is not a realistic option given that cash is still a popular payment method and discouraging its use entirely could hurt a business more than the benefit gained from a lower tax rate. Therefore, I have opted for a 90% cashless threshold to balance practicality with regime integrity.

3.9. I acknowledge that this requirement may give rise to some unfairness because businesses have limited control over the payment methods used by their customers. It would be difficult for businesses in particular industries with higher cash use (e.g. hospitality) and businesses in areas which serve the older demographic who are more likely to use cash.

3.10. This unfairness is mitigated by the fact that the TTR is opt-in. Small businesses will need to weigh up the benefits they receive under the TTR against this requirement. Businesses do have some input into the payment methods chosen by their customers and can indirectly influence their choices by offering a variety of other payment methods given that most New Zealanders use non-cash methods of payment on a regular basis.[17] For example, mobile payment machines in a bar mean that the customer does not have to go to the bar where they could pay with cash. In addition, there may be a point where a business finds that losing some cash sales would cost less than the cost of maintaining cash handling infrastructure.[18] Businesses could also incentivise non-cash use via discounts or loyalty cards. It is also expected that as the use of cash

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[15] Black Economy Taskforce, *Australia Black Economy Taskforce Final Report*, October 2017, pg. 71

[16] Joel Slemrod, Brett Collins, Jeffry L Hoopes, Daniel Reck, Michael Sebastiani, *Does credit-card information reporting improve small business tax compliance?* Journal of Public Economics 149 (2017), 1-19.

[17] In a 2017 Reserve Bank study, 89% of survey respondents who use cash had also used a non-cash method of payment in the previous seven days. See Reserve Bank of New Zealand Cash use in New Zealand Study, 2017, question 3 - results, https://www.rbnz.govt.nz/notes-and-coins/how-we-use-cash

[18] Reserve Bank, *The Future of Cash Use – Te Whakamahinga Moni Anamata: Issues Paper*, para 3.2

as a payment method continues to decline over time[19], this requirement will become less of an issue.

3.11. As digital accounting software is used, bank feeds should automatically link information from a taxpayer's financial institution to the accounting software so that this threshold can be monitored. There are three sub-requirements in the TTR in relation to bank feed information:

- Taxpayer must verify that all their bank accounts are linked to the accounting software;
- Accounting software has the ability to verify that bank information is complete and no financial information has been deleted from the software.
- Accounting software must distinguish electronic and cash transactions in the bank feed information (to verify the 90% non-cash transaction requirement).

3.12. By linking bank feed information in the accounting software, Inland Revenue has greater assurance that the financial information in the accounting software is complete and can audit the 90% non-cash receipt requirement.

3.13. Businesses could side-step this by not putting the money in the bank, however the business is taking a risk by holding larger sums of cash which could be stolen or destroyed. It should also be noted that the usual penalties will apply to any business engaging in tax evasion by under-reporting income in this manner.

(d) Use of TTR-approved accounting software

3.14. For accounting software to be TTR-approved, it is envisaged that the software would:

- Enable Inland Revenue to have secure digital access to the taxpayer's accounting information at general ledger level.
- Be capable of calculating year-to-date taxable income with built-in automatic adjustments for items such as depreciation, provisions, and private expenditure.
- Be able to be linked to bank feeds from the taxpayer's bank account/s and authenticate the accuracy of the feed information (discussed above under (c) above).

4. Mechanics: How does the TTR operate?

(a) What is required of the taxpayer?

(i) File tax statement

4.1. The taxpayer must file a tax statement with the Inland Revenue on a quarterly basis. The tax statement is intended to be a mini income tax assessment that summarises the financial activity

[19] The Reserve Bank envisages that this is likely to be the future state of affairs. See *The Future of Cash Use*, above n .

of the taxpayer over the period. The tax statement will act as the assessment of the taxpayer's filling obligations for that quarter, rather than the annual income tax return. The reason for requiring quarterly assessments is because it is easier for Inland Revenue to audit and run analytics over data that is in a standard format, and because some form of assessment is still required in order for the taxpayer to verify that the tax statement produced by the accounting software is accurate.

4.2. The TTR-approved accounting software automatically maps data to the tax statement fields based on the data and mapping criteria loaded into the accounting software. The software would do most of the work for the taxpayer and calculate automatic tax adjustments, and the taxpayer would only input any additional non-standard tax adjustments. An example of an automatic tax adjustment would be adding back 50% of entertainment expenditure to taxable income or automatically grossing up interest income for RWT.

4.3. The main fields for the tax statement would be similar to the IR10 Financial Statements summary that is filed annually with the income tax return, except the statement of activity would include additional fields for major tax adjustments which either add to or subtract from taxable income, such as:

- Private use expenditure including vehicle use;
- Tax depreciation, depreciation loss and depreciation recovery income;
- Home-office expenses;
- Entertainment;
- Grossing up interest and dividends for imputation credits and RWT.

4.4. The tax statement would also include fields for the taxpayer to include any tax adjustments that are also relevant to their business. A prototype example of the tax statement is included in Appendix One.

4.5. Even though Inland Revenue will have direct access to the taxpayer's financial information, it is important that the taxpayer does file a tax statement because they or their tax agent need to confirm to Inland Revenue that their assessment is accurate and relevant tax adjustments have been made.

4.6. As the tax statement is essentially a quarterly income tax assessment, this will have flow-on consequences that need to be considered given that our tax system is based on an annual assessment. I propose a hybrid approach to deal with this:

- Where the law requires a carry-forward from period to period, its application under the TTR would be modified so that the quarter would be treated as the assessable period. For example, tax losses would carry forward from quarter to quarter rather than on an annual basis.

- Where the law has an annual approach, the TTR method would use a wash-up approach in the fourth quarter to account for this. For example, the tax rate that applies to an individual taxpayer subject to progressive marginal tax rates would be calculated based on the previous year's average tax rate each of the first three quarters (taking the 10 percent TTR

tax discount into account). In the final quarter, a wash-up income tax calculation would calculate the taxpayer's final taxable liability across all four quarters less tax paid in the first three quarters (calculated automatically in the accounting software).

- Any other rules that have an annual limit would be examined in the fourth quarter with a wash-up calculated if necessary. For example, a taxpayer who incurred $3,000 of legal expenses a quarter would be allowed a deduction in each quarter on the basis that these are below the $10,000 limit. In the final quarter, a wash-up adjustment may be required if the total $12,000 of legal expenses across the entire year are capital in nature. In this case, the total $12,000 would be added to taxable income in the fourth quarter TTR tax calculation.

(ii) Pay tax on a quarterly basis

4.7. Once the tax statement has been filed, the taxpayer would be required to pay the tax assessed per the tax statement at the end of the following month. An extra month would be provided for filing the quarter 4 tax statement and paying the final instalment, given that there are wash-up adjustments in quarter 4 (i.e. Tax statement calculation would be due on 31 May). This differs from the frequency of tax payments under the AIM provisional tax method, because quarterly strikes a better balance between frequent reporting and compliance costs.

(b) What benefits does the taxpayer receive?

(i) Discounted tax rate via a tax credit

4.8. TTR taxpayers receive a 10% discount on their quarterly income tax payments. The discount applies similarly to companies or individuals/partnerships who include a share of a small business' net income in their assessable income, although the mechanism will differ for each. The mechanism to deliver the discount is aimed at minimising complexity in a way that integrates TTR taxpayers with the existing tax rules.

4.9. The 10% discount is applied by way of a non-refundable tax credit (called the TTR credit). This has been chosen over a lower tax rate primarily because a lower tax rate would be difficult to integrate with the existing company and personal income tax systems which apply the same tax rate to everyone within that class and all types of income.

4.10. Key features of the TTR credit are:

- The credit would be applied based on 10% of the taxpayer's income tax liability. For an individual or partnership, this would be calculated based on the taxpayer/s marginal tax rates.

- The credit is applied to each quarterly tax statement assessment. For an individual, look-through company or partnership, the discount is based on 10% of the tax liability – calculated based on the taxpayer's prior year average tax rate. A wash-up will occur in the Q4 calculation based on the actual average tax rate across the entire year.

- The TTR credit is treated as a refundable tax credit because it is intended to reduce the small business' tax bill each quarter. In most quarters this would reduce the tax payable, however it is envisaged that the credit could be refunded where the Q4 wash-up calculation reduces the total tax liability for the year.

- Corporate TTR taxpayers will receive an imputation credit equal to the TTR credit calculated across all four quarters. This will ensure that TTR companies have the same amount of imputation credits available as a company subject to the ordinary corporate tax rate. Without this feature, the incentive impact of the TTR would be hindered as shareholders (particularly in the closely held company context) would have a lower amount of imputation credits to shield their individual tax liability due to the discount on tax paid.

4.11. The Tax Working Group has recently recommended against the idea of a progressive company tax rate with a lower tax rate for small business.[20] The TTR is progressive due to the $5m turnover threshold. However, the TTR is different because it rewards a subset of small business taxpayers with a discounted tax rate in exchange for greater oversight over their tax affairs, rather than offering a tax cut for all small business taxpayers. The argument for a lower tax rate under the TTR is stronger given that a TTR taxpayers are providing Inland Revenue something in exchange for the discounted tax rate - access to their financial information and greater assurance over their tax compliance.

4.12. The Tax Working Group also noted that small businesses can already access progressive taxation through look-through company structures and therefore a progressive company tax is less necessary.[21] However, the look-through company rules are limited due to the eligibility criteria (e.g. five of fewer owners). Further this does not address the core concern with high compliance costs for small businesses and compensation for these costs via the look-through company structure provides no tax saving unless the owners are in lower marginal tax brackets. The same reasoning applies to a small business operated by a sole trader individual.

4.13. The Tax Working Group and supporting material provided by Inland Revenue and Treasury argued that the better approach to support small business was to reduce compliance costs more generally[22]. I agree that simplifying the tax system to reduce compliance costs is important and is the reason for removing the end-of-year filing obligation under the TTR. One of the core aims of Inland Revenue's Business Transformation is to reduce compliance costs for taxpayers. However, in my view, measures aimed at business taxpayers to-date[23] have largely tinkered around the edges of the tax rules rather than fundamentally reduced compliance costs for small businesses.

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[20] Future of Tax: Interim Report, Tax Working Group, September 2018, page 8.

[21] Future of Tax: Interim Report, above n at para 42.

[22] Inland Revenue Department and the New Zealand Treasury*, Appendix 7: Lower tax rates for small companies: Background Paper for Sessions 6 and 7 of the Tax Working Group.*

[23] For instance, the Taxation (Business Tax, Exchange of Information and Remedial Matters) Act 2017) was directed at simplifying tax for business. Aside from the changes to the provisional tax and UOMI rules, the other changes in the Act would have a minor impact on small business compliance costs. For more information see *Simplified business tax processes: A special report from Policy and Strateg*y, Inland Revenue, February 2017.

4.14. Simplifying the tax rules / tax administration will have a variable impact on small businesses depending on what changes are made. By contrast, a lower tax rate is a much more direct way of reducing total costs associated with tax compliance for all TTR-eligible small businesses (regardless of whether they are a partnership, company or individual), to compensate these small businesses for the relatively higher burden of tax compliance costs.

(ii) Removing the end of year filing obligation

4.15. This is the second primary benefit from the TTR for small businesses. The end of year tax return is no longer required because TTR taxpayers file four mini income tax assessments during the year.

4.16. At first glance, four mini income tax assessments may appear to increase compliance costs compared to a taxpayer who is filing an income tax return on an annual basis. However, many small businesses would have few tax adjustments and by using accounting software, their financial information is more likely to be up to date than an annual tax filer who prepares a tax return from scratch at year end. In addition, small businesses may already be estimating their taxable income if they pay provisional tax under the AIM or estimate method, so a quarterly calculation of taxable income may not be too dissimilar to the process that a small business already undertakes. Like AIM, the taxpayer may also benefit from paying tax based on the income actually earned during the quarter, with a lower tax payment frequency than AIM.

4.17. The use of accounting software is central to the reduction of compliance costs for the taxpayer, as the accounting software would automate most of the tax adjustments based on the data mapped from the general ledger. I acknowledge that there will be some additional set-up costs to ensure general ledger codes are appropriately mapped to the correct tax adjustment, however over the medium term it is expected that overall compliance costs would be lower due to removal of the end-of-year filing obligation.

(c) Other design considerations

(i) Rules for firms exceeding the turnover threshold

4.18. Small businesses will need certainty about the circumstances where the business is no longer eligible for TTR based on their turnover threshold. The turnover limit needs to operate in a way that minimises the impact on business growth because tax rules should not be a barrier to a business growing beyond the $5 million TTR threshold. Furthermore, a firm should not be pushed out of the TTR after one year of exceeding the $5 million turnover threshold, if it is expected that they will be under the threshold in future years. To mitigate the risk that one great year would push a business out of the TTR, it is proposed that annual turnover threshold for TTR eligibility would be based on an average of the past three year's taxable income. A small business would no longer be eligible for the TTR once this limit is exceeded.

4.19. A safe harbour rule would also apply so that a business would not be penalised if they exceeded the turnover threshold due to exceptional growth and lose the benefits of the TTR in that year. A small business would remain in the TTR in the current year provided that one of the following criteria are met:

- Total turnover did not exceed 125% of the maximum turnover threshold, i.e. $7.5 million;

- Business has taxable income of less than $1 million (to avoid penalising high growth, low margin businesses who may have exceeded the 125% threshold).

(ii) Applying the TTR credit to business income

4.20. As the TTR is aimed at small business activity, other types of income should not generate a TTR credit. For instance, a small business generating significant amounts of passive income that is not part of its core business should not be able to claim a TTR tax credit for this income. However, the rule also needs to be easy for most small business taxpayers to apply to avoid introducing unnecessary complexity into the regime. For instance, it would be a poor outcome if a taxpayer receiving a minor amount of interest income was required to exclude this income from the calculation of the TTR tax credit.

4.21. It is proposed that there will be a safe harbour: If more than 80% of the taxable income earned by the taxpayer is business income, then the taxpayer's entire taxable income can be subject to the TTR credit. If below the 80% threshold, the taxpayer's TTR credit would be limited to business income as a percentage of total taxable income calculated as:

10% x income tax liability x (business income / total taxable income).

This avoids complexity as it is envisaged that most small business taxpayers would be well above the 80% threshold and would not need to calculate the TTR tax credit limitation.

(iii) Regime integrity

4.22. A risk with a concessionary regime of this nature is that taxpayers may structure their affairs to access the concession. An obvious example is larger companies being broken up into smaller units with turnover below the $5m threshold. To prevent this, the TTR will include an anti-avoidance rule that group sales across groups of commonly controlled groups of taxpayers when determining whether a business is below the $5m threshold.

4.23. Rules may be needed to restrict access to taxpayers who have had a previous or current record of tax non-compliance. The policy rationale for this is that public confidence in the TTR would be undermined if taxpayers are seen to be getting the benefits of the TTR despite past non-compliance. However, there would need to be a balance so that taxpayers who have been subject to penalties in the past but are now reformed, can participate in the TTR. It is suggested that taxpayers who are otherwise TTR-eligible (or a person associated with them), who have been subject to a shortfall penalty at the level of gross carelessness or above in the past three income years would be ineligible to join the TTR.

5. Assessment against judging criteria

(i) Impact on the New Zealand economy, including GDP and business growth

5.1. The core features of the TTR will increase the funds available to TTR-eligible small businesses and reduce compliance costs, having a positive impact on business growth and GDP:

- A lower tax rate for small businesses would reduce a business' cash outlay on tax and in turn increase the funds that these businesses have available to invest in their businesses.

- As noted at para 2.1, small businesses are disproportionately impacted by tax compliance costs. Simplifying the tax rules and reducing the overall tax administration burden (in this case, by removing the end of year filing obligation) will also have a positive impact on firm performance.[24]

5.2. While a lower tax rate for smaller businesses could encourage businesses not to grow beyond the TTR turnover threshold of $5 million, the regime is designed so that there are safeguards to ensure that businesses are not penalised if they exceed the turnover threshold in one particular year (refer to paras 4.18 to 4.19). While there could be some clustering around the business turnover threshold, in the long term, the rewards of business growth should override the benefit of a discounted tax rate in most instances.

5.3. The TTR will have an additional economic benefit through a modest reduction in hidden economy activity. By rewarding "good" taxpayers and reducing the total costs for TTR taxpayers (both tax paid and compliance costs) to comply with their tax obligations, taxpayers at the margins of hidden economy will be incentivised towards full compliance (refer further to the discussion in paras 2.8 to 2.144 above).

(ii) Social (including distributional equity) and environmental acceptability

5.4. There is a risk that the TTR would be viewed as unfair. Horizontal equity would be reduced because an individual salary and wage earner cannot access a discounted tax rate, whereas a self-employed individual taxpayer in the TTR regime earning a similar level of income can. This means that the TTR could have a negative impact on distributional equity.

5.5. Concerns with the horizontal and distributional equity impact are offset somewhat by the public acceptability of Government assistance for small businesses in New Zealand (discussed below at paras 5.7 to 5.9). In addition, a strong argument can be made that a discounted tax rate for small businesses is justified given the additional tax compliance costs these businesses are subjected to compared to a salary and wage earner.

5.6. The TTR does not have a direct environmental impact so this is not a factor in assessing the proposal.

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[24] Dabla-Norris et al., above n .

(iii) Feasibility of introduction, including political and public acceptability

5.7. Feasibility of introduction is enhanced by the prevalence of small businesses in New Zealand and the degree of public support for small business. Statistics NZ data[25] estimates that 97% of enterprises in New Zealand are small businesses. I anticipate that there is a reasonable degree of support for favourable treatment of small businesses in New Zealand, given the prevalence of these business in New Zealand and the current political climate.[26] A lower tax rate for small business has already gained some traction in the political sphere as a progressive tax rate for small business was specifically included in the terms of reference for the Tax Working Group[27] (albeit rejected in the Working Group's interim report).

5.8. The public is also likely to be more accepting of the benefits given to business taxpayers under the TTR, considering the quid pro quo for Inland Revenue's enhanced access to TTR taxpayers' financial information compared to taxpayers who are not in the regime.

5.9. Broad public acceptance of small businesses in contrast to public perceptions of larger businesses is a reason why there is a turnover limit for the TTR regime. This acknowledges the reality that a discounted tax rate for all businesses (including large firms) is less likely to gain political traction and would also be substantially more expensive (which would also reduce the likelihood of adoption).

(iv) Impact on simplicity of tax system

5.10. It is acknowledged that the TTR (particularly the discounted tax rate) will impact the simplicity of the tax system. However, the TTR has been designed to minimise complexity and to integrate within the existing tax system, and to apply to existing entities, rather than creating an entirely new set of rules for TTR-eligible small businesses. These features that minimise complexity include:

- Building on existing concepts from the AIM provisional tax method – similar eligibility requirements, requirement to file tax statements[28].

- TTR tax discount is delivered via a tax credit, rather than a discounted tax rate for TTR entities and individuals which would be more complicated to apply given that TTR taxpayers

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[25] Of a total of 484,185 enterprises in the Statistics NZ 2018 Enterprise Survey, 471,960 enterprises have a turnover of less than $5 million = 97.4% of total enterprises. Refer to Stats NZ Annual enterprise survey: 2018 financial year, above n 4. This aligns with MBIE statistics on small business which provide that 97% of enterprises are small business (defined as fewer than 20 employees). See *Small Business in New Zealand – How do they compare with larger firms*, Ministry of Business, Innovation & Employment, June 2017, https://www.mbie.govt.nz/assets/30e852cf56/small-business-factsheet-2017.pdf

[26] The political climate was evidenced during the recent capital gain tax debate following the Tax Working Group's report where the Government specifically asked Officials for advice on options for a tax-free threshold or exemption from a capital gains tax. *Extending the taxation of capital gains: response to Ministers' requests on business impacts*, Inland Revenue Policy & Strategy, 11 January 2019, https://taxpolicy.ird.govt.nz/sites/default/files/2019-ir-tax-working-group-04-report-ir2019-015-t2019-18.pdf

[27] *Terms of Reference: Tax Working Group*, 23 November 2017, Released by Hon Grant Robertson, Minister of Finance, https://taxworkinggroup.govt.nz/resources/terms-reference-tax-working-group

[28] These are called a statement of activity under the AIM provisional tax regime.

only receive a tax discount on their business income (subject to safe harbour noted at para 4.21).

- Minimising the extent to which new tax rules are created specifically for the TTR, favouring modifying existing tax rules where possible (as discussed at para 4.6).

- Safeguards for TTR taxpayers that exceed the $5m turnover threshold in a particular year (discussed at paras 4.18 to 4.19).

5.11. Other aspects of the TTR such as encouraging use of accounting software to calculate taxable income and removal of the end of year tax compliance will simplify the tax system for businesses.

(v) Ease of administration by taxpayers and Inland Revenue and impact on compliance costs

5.12. Refer to commentary in section 2 above.

Appendix One: Tax statement example

Small business company
Tax statement
Quarter ended 30 September 2019

	$	
Gross income from sales/services	450,000	
Cost of goods sold		
Opening stock	200,000	
Purchases	60,000	Financial statement fields automatically mapped to these fields from general ledger codes
Closing stock	150,000	
Gross profit	340,000	
Other gross income		
Interest received	2,000	
Dividends received		
Rental, lease and license income		
Other income	60	
Total income	342,060	
Expenses		
Bad debts	(500)	
Depreciation	(12,560)	
Insurance	(3,000)	
Interest expense	(1,000)	
Motor vehicle	(8,600)	
Professional and consulting fees	(4,250)	
Rental and lease payments	(10,000)	
Repairs and maintenance	(250)	
Associated persons' remuneration	(60,000)	
Salaries and wages	(120,000)	
Contractors	0	
Other expenses	(14,500)	
Total expenses	(234,660)	
Exceptional items	0	
Net profit / loss before tax	107,400	
Tax adjustments		
Entertainment	200	These fields are populated automatically by accounting software based on general ledger mapping but can be edited by the taxpayer
Private use vehicle	2,500	
Private use other	250	
Depreciation adjustment	(1,500)	

Home office expenses	0	
Gross up RWT and imputation credits	660	
Taxpayer manual adjustments		
Non-deductible penalties/fines	250	Taxpayer can use this field to add any additional tax adjustments not automatically calculated
Tax depreciation	(15,000)	
Accounting depreciation	12,560	
Taxable income	107,320	
Tax to pay at 28%	30,050	
Tax credits		
RWT	(660)	
TTR credit	(3,005)	10% of Tax to pay
Imputation credits	0	
Tax to pay	**26,385**	