

Tax Policy Charitable Trust
Tax Policy Scholarship Competition 2024

FROM **Matthew Seddon**
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Dear Selection Panel,

Extending Independent Contractor Withholding Taxes

1. Introduction

1.1 The 2018 Tax Working Group identified:¹

... the rise of the self-employed contractor as the most likely and significant challenge to the sustainability and integrity of the tax system.

1.2 New Zealand's self-assessment tax system is based on voluntary compliance. Opportunities for non-compliance are removed or minimised using withholding taxes such as pay-as-you-earn (PAYE**) by collecting tax at source when payments are made, as opposed to attempting to collect tax from the recipient of a payment once the payments have been made to them.**

1.3 The general absence of withholding on payments received by independent contractors, while employees have PAYE deducted on payments they receive, provides an explanation for the challenges identified above by the Tax Working Group in 2018.

1.4 Independent contractors experience significantly lower levels of compliance compared to employees. Independent contractors on average underreport 20% of their taxable income.² In contrast, employees experience non-compliance at rates of around 1%.³

1.5 Proposals to extend withholding taxes to payments received by independent contractors' date back to the Government's Economic Statement of 17 December 1987. The proposal was subsequently revisited in 1991 and 1998.

1.6 In 1998, a Committee of Experts on Tax Compliance recommended against implementing the proposal noting that:⁴

The committee, therefore, does not support this approach unless or until technological advances are available to reduce these [compliance and administration] costs so as to make this option viable.

¹ Tax Working Group *The Future of Work: Sustaining the tax system*, April 2018, at 7.

² Inland Revenue Policy and Strategy *Estimating the underreporting of income in the self-employed sector*, March 2018 at 6.

³ Inland Revenue, *The Future of Work: Sustaining the tax system: Presentation to the Tax Working Group*, February 2018, at 2.

⁴ Tax Compliance Report to the Treasurer and Minister of Revenue by a Committee of Experts on Tax Compliance, December 1998, at 11.10.

- 1.7 However, significant technological advances have taken place since then which make extending withholding taxes to payments received by independent contractors' a viable option:
- (a) In the more than a quarter of a century since such a proposal was last revisited, payroll software and systems have become commonplace and importantly, should only require minor configuration to provide for such a withholding mechanism.
 - (b) The Business Transformation Programme has been completed which has delivered Inland Revenue with a modern, digital and highly automated revenue system capable of administering such a withholding tax.
- 1.8 Moreover, 15% - 20% of New Zealanders now operate as independent contractors, outside the scope of withholding.⁵ Following overseas trends, a higher proportion of the labour force is forecast to become independent contractors. This will generate further compliance issues and put further pressure on Inland Revenue to be able to administer and recover taxes from these independent contractors.⁶
- 1.9 In response to such challenges and developments, the 2018 Tax Working Group recommended that "withholding be extended as far as practicable" to increase compliance.⁷
- 1.10 All statutory references are to the Income Tax Act 2007, unless otherwise stated.

2. **Proposal**

- 2.1 Extending withholding taxes to a broader group of independent contractors than is currently provided for in Schedule 4 is not only a viable option, but a necessity to maintain the integrity of the New Zealand tax base.
- 2.2 This proposal is a significant departure from conventional approaches to extending withholding taxes on payments received by independent contractors.
- 2.3 Traditionally, withholding taxes have been extended to independent contractors based off the industry in which an independent contractor operates.⁸ However, being able to accurately define the relevant class of independent contractor subject to the withholding tax has proven difficult and has limited the extension of withholding taxes.
- 2.4 Furthermore, there have been concerns that extending withholding taxes to all payments made to independent contractors would potentially impose a withholding obligation on persons who engage independent contractors in their personal capacity.
- 2.5 This proposal resolves these definitional issues that have previously been experienced. Withholding taxes are to be extended based on the profile of the payer, as opposed to the profile of the independent contractor. In doing so, the proposal ensures that no withholding obligation falls on persons who engage independent contractors in their personal capacity.

⁵ Tax Working Group, above n 1, at 6.

⁶ *Ibid.*

⁷ Tax Working Group *The Future of Tax: Final Report*, February 2019, at 100.

⁸ For example, withholding is currently imposed on payments for commercial cleaning or maintenance work in Part D of Schedule 4 and payments related to the purchase of schedular natural products such as sphagnum moss in Part H of Schedule 4.

- 2.6 This paper proposes to extend withholding taxes to payments received by independent contractors:⁹
- (a) who are engaged by persons with an existing PAYE withholding obligation (**Employers**); and
 - (b) those who operate through electronic marketplaces.
- 2.7 Payments received by these two classes of independent contractors should be inserted into Schedule 4, and subject to withholding under the PAYE rules.¹⁰

3. **Design features**

Rate

- 3.1 A general rate of withholding of 20% should be set out in Schedule 4 and applied to payments received by independent contractors which are subject to this proposal.
- 3.2 The 20% rate of withholding aligns with the rate of withholding for voluntary schedular payments in Part W of Schedule 4 and recognises that independent contractors are allowed deductions for income tax purposes.
- 3.3 However, independent contractors would still be able to elect to have an alternative rate (of 10% or more) instead of the 20% rate set out in Schedule 4 provided that they provide their name, IRD number and elected rate to the payer.¹¹

In-scope services

- 3.4 The payments in-scope of this proposal are for supplies made by independent contractors that wholly or principally (greater than 50% of the supply) provide services to Employers or through electronic marketplaces.
- 3.5 An assessment should be made at the time the independent contractor is first engaged by the Employer or provides services through the electronic marketplace to determine whether payments received by the independent contractor should be subject to withholding under this proposal.
- 3.6 A re-assessment should be undertaken on an annual basis where the supplies made by the independent contractor have changed, to determine whether the supplies made by the independent contractor should still be subject to withholding.
- 3.7 The in-scope services subject to this proposal are designed to ensure that the extension of withholding taxes is appropriately targeted at independent contractors who are the equivalent to employees while minimising compliance costs for other independent contractors.

⁹ This also includes independent contractors who operate through a company. The company exception in section RD 8(1)(b)(iii) should be expanded to include payments that are within the scope of this proposal.

¹⁰ Sections RD 3 and RD 8.

¹¹ Section RD 10B(2)(a).

Independent contractors engaged by Employers

- 3.8 Payments received by independent contractors engaged by Employers should be subject to PAYE withholding. The withholding obligation would sit with the Employer. Employers would also be required to make employment income information filings.
- 3.9 Employers are best placed to administer PAYE withholding on payments made to independent contractors. Employers will already have payroll software and systems in place to administer PAYE on payments made to existing employees. Such payroll software and systems will already be used to process payments made to independent contractors. The payroll software and systems should only require minor configuration to provide for withholding on those payments.
- 3.10 In addition, Employers will already be making employment income information filings in respect of their existing employees. Employers will simply need to report the relevant information in respect of payments made to independent contractors in those filings.
- 3.11 While there may be some additional compliance costs for Employers, by leveraging off the existing PAYE rules and employment income information filings, this proposal has been designed to ensure that any additional costs imposed on Employers are minimised and should only be marginal costs.
- 3.12 However, consultation with Employers, payroll software providers and payroll service providers should be undertaken prior to implementing this proposal to ensure sufficient timeframes are provided to make the necessary changes to payroll software and systems to ensure that Employers are able to comply with their obligations under this proposal.¹²
- 3.13 As an integrity measure, PAYE withholding should also be imposed on payments received by independent contractors engaged by corporate associates of Employers. This prevents the following scenario:
- (a) Company A and Company B are wholly owned by Company C and are associated.
 - (b) Company A has employees. Company B has been incorporated in order to engage independent contractors.
- 3.14 In the absence of this integrity measure, Company B would be able avoid its withholding obligation outlined in this proposal. Where this integrity measure applies, in this example, Company B would have the withholding obligation and would also be required to make employment income information filings.

Independent contractors operating through electronic marketplaces

- 3.15 Electronic marketplaces provide an ideal opportunity to extend PAYE withholding on payments received by independent contractors, given their size and scale.
- 3.16 A significant number of independent contractors operate and provide services through electronic marketplaces. However, such independent contractors may not be within the scope of the above proposal. Most electronic marketplaces are located offshore and do not have a New Zealand presence. Therefore, it is unlikely that they would have an existing

¹² See for example The Treasury and Inland Revenue *Regulatory Impact Statement: Personal income tax relief*, April 2024, at 16 – 17. Consultation was undertaken with payroll software providers and payroll service providers to implement the personal income tax changes proposed in Budget 2024 and enacted in the Taxation (Budget Measures) Act 2024. A two-month timeframe was provided for payroll software providers and payroll service providers to implement the changes.

PAYE withholding obligation and would therefore not be brought within the scope of the above proposal.

- 3.17 Therefore, PAYE withholding should separately be extended to payments received by independent contractors operating through electronic marketplaces.
- 3.18 The withholding obligation would generally sit with the electronic marketplace.
- 3.19 However, to align the income tax and GST treatment of independent contractors operating through electronic marketplaces, an electronic marketplace may agree with a listing intermediary¹³ that the listing intermediary will withhold PAYE on payments made to independent contractors, instead of the electronic marketplace.¹⁴
- 3.20 Electronic marketplaces (or listing intermediaries, as the case may be) would be required to provide a simplified form of employment income information filing in respect of the PAYE withholdings undertaken on payments made to independent contractors.
- 3.21 Electronic marketplaces will likely already be required to report similar information to tax authorities under the *OECD's Model Rules for Reporting by Platform Operators with respect to Sellers in the Sharing and Gig Economy* (the **OECD Model Rules**). As most electronic marketplaces are located offshore, Inland Revenue would only be able to access this information by way of an information exchange with other tax authorities.
- 3.22 While a simplified form of employment income information filing may generate some additional compliance costs for electronic marketplaces (or listing intermediaries, as the case may be), this would provide Inland Revenue with more timely information to be able to administer the PAYE withholding instead of having to request such information from other tax authorities on a more infrequent basis. Furthermore, electronic marketplaces (or listing intermediaries, as the case may be) should already have the information needed to complete the simplified form of employment income information filing based on the information needed to comply with the OECD Model Rules.

4. Evaluation against judging criteria

Compliance and administration costs for taxpayers and Inland Revenue

- 4.1 The proposal would result in a significant reduction in compliance and administration costs.
- 4.2 Extending withholding to a larger number of independent contractors should result in a significantly higher level of compliance for those independent contractors. Payments received by independent contractors would be reported to Inland Revenue through employment income information filings, minimising the ability of independent contractors to underreport income through the self-assessment system.
- 4.3 The number of independent contractors needing to file income tax returns or to engage accountants or other third-party providers would also be significantly reduced. Employment income information filings made by Employers and electronic marketplaces (or listing intermediaries, as the case may be) would allow Inland Revenue to prepare pre-populated accounts for independent contractors subject to this proposal.¹⁵ Pre-populated accounts will

¹³ Adopting the definition in section 60CB(8) of the Goods and Services Tax Act 1985 for consistency.

¹⁴ An electronic marketplace and a listing intermediary can agree that the listing intermediary will return GST on supplies made through the electronic marketplace under section 60CB(7) of the Goods and Services Tax Act 1985.

¹⁵ Inland Revenue should be able to automatically populate any other statutory deductions such as ACC levies or student loan repayments based off the information in the employment income information filings.

be of particular benefit for those independent contractors who have no or minimal deductions. However, for independent contractors who do have significant or complex deductions, engaging accountants and other third-party providers would still prove to be an efficient means to ensuring that they were compliant with their tax obligations.

- 4.4 However, third-party providers are not necessarily more efficient at undertaking withholding on payments received by independent contractors compared with an extension of PAYE withholding as set out in this proposal. Independent contractors who currently engage accountants and third-party providers are likely to be compliant with their tax obligations. However, independent contractors who are currently underreporting their income and who are not compliant with their tax obligations, will likely not be engaging accountants or third-party providers. This proposal therefore ensures that non-compliance and underreporting can be minimised across the board for all independent contractors by way of a comprehensive extension of PAYE withholding.
- 4.5 In addition, this proposal may also result in increased levels of compliance among persons who are not subject to this proposal. Compliance by taxpayers is often influenced by their perception as to whether other taxpayers are complying with their tax obligations. By ensuring that independent contractors subject to this proposal comply with their tax obligations, this proposal may result in taxpayers more broadly complying with their tax obligations because of the perception that a broader class of independent contractors (who are known for higher levels of non-compliance) are in fact complying with their tax obligations.
- 4.6 There is currently a high level of tax risk associated with misclassifying an employee as an independent contractor. The failure to withhold PAYE where an independent contractor is in fact an employee can result in a significant tax shortfall and accompanying shortfall penalties. Imposing a withholding obligation instead of currently no withholding on payments to independent contractors means that any tax shortfall and accompanying shortfall penalties are much lower in the event of a misclassification. This should minimise the current level of risk, and reduce compliance costs for persons engaging independent contractors. Tax incentives to misclassify employees as independent contractors to mitigate a PAYE withholding obligation should also be minimised by implementing this proposal.
- 4.7 Inland Revenue should find it more efficient to be able to engage with, and audit Employers and electronic marketplaces (or listing intermediaries, where applicable) in respect of any failure to withhold rather than each independent contractor. Inland Revenue are more likely to be able to recover any tax that was not withheld by Employers and electronic marketplaces (or listing intermediaries, where applicable) compared to independent contractors.
- 4.8 By extending withholding to a larger number of independent contractors, Inland Revenue would also be able to divert significant resources currently put towards recovering debts from independent contractors who have failed to satisfy their tax liabilities and instead, such resources could be put to more productive uses. For example, Inland Revenue could put more resources into investigating and auditing the compliance of independent contractors who are claiming deductions which are excessive compared to industry norms.
- 4.9 While implementing this proposal would impose some additional costs on those persons with a new withholding obligation, as noted above, any costs are likely to be marginal. This is particularly so where consultation with affected parties ensures that sufficient time is provided to configure payroll software and systems. Employers already have the existing payroll software and systems in place, so that costs can be minimised. In addition,

electronic marketplaces (or listing intermediaries, where applicable) have sufficient size and scale to be able to undertake the PAYE withholding.¹⁶

Impact on the New Zealand economy

- 4.10 Research commissioned by Inland Revenue found that the average 20% underreporting of income by independent contractors imposes an estimated cost \$850 million per annum of lost tax revenue, as at 2018.¹⁷ This \$850 million per annum of lost tax revenue represents the 'tax gap'.
- 4.11 Broadly, the tax gap refers to the difference between the tax that Inland Revenue collects and the tax that should be collected if taxpayers fully complied with their tax obligations.¹⁸
- 4.12 Implementing this proposal would significantly reduce the level of underreporting and would also capture a significant proportion of this lost tax revenue, minimising the tax gap. These tax revenues could then be invested into the New Zealand economy.
- 4.13 While alternative proposals may suggest that non-compliance and underreporting can be reduced by only reporting income earned by independent contractors to Inland Revenue, such alternatives still require that the independent contractors do in fact, pay the tax that they are liable for. In contrast, this proposal involves both reporting of the payments made to independent contractors which prevents underreporting while also withholding PAYE on the payments to help recover the tax from independent contractors. In doing so, this should support minimising the tax gap in a way that an alternative reporting regime could not.
- 4.14 There should be a more efficient collection of tax revenue by extending PAYE withholding to payments received by independent contractors, compared to current collections which only take place through the provisional tax system.
- 4.15 In addition, this proposal does not impact on the commercial, non-tax drivers provided to business models that adopt the use of independent contractors. While the proposal extends PAYE withholding to independent contractors which are equivalent to employees and thereby more closely aligns withholdings between the two groups, it does not impose other obligations that come with creating an employment relationship such as more extensive employment law protections and KiwiSaver obligations. Therefore, the proposal should not undermine existing business models adopting the use of independent contractors for commercial, non-tax reasons and should not adversely impact the New Zealand economy in that respect.
- 4.16 Furthermore, independent contractors may enjoy the relative freedom which comes from operating as an independent contractor. This freedom provided to independent contractors is not undermined by this proposal. In fact, this proposal may provide independent contractors with more freedom to put time into the services that they provide by minimising the time that they spend on complying with their tax obligations.

Simplicity of the tax system

- 4.17 Imposing a withholding tax on all payments received by independent contractors without consideration for the nature of the payer would undermine the simplicity of the tax system.

¹⁶ This has recently been seen following the imposition of GST on supplies of listed services since 1 April 2024.

¹⁷ Inland Revenue Policy and Strategy, above n 2, at 6.

¹⁸ Public Service Commission *Performance Improvement Review of Inland Revenue*, June 2024, at 60.

For example, such a withholding would require people to withhold tax on payments made to a painter who was engaged to paint their personal home.

- 4.18 This proposal minimises the tax obligations of independent contractors while only imposing a withholding obligation on Employers and electronic marketplaces (or listing intermediaries, as the case may be), who are best placed to deal with such obligations.
- 4.19 While there may be some increased complexity in determining when a mixed supply of goods and services “principally” involves the supply of services so as to be within the scope of this proposal, such issues are likely to be on the boundary.
- 4.20 Legislation enacting this proposal and guidance published by Inland Revenue could specifically set out common examples of services provided by independent contractors which would be in-scope of the proposal to minimise the complexity of determining when a mixed supply “principally” involves the supply of services.
- 4.21 The restriction on independent contractors principally providing services ensures that only those independent contractors equivalent to employees are subject to PAYE withholding. This minimises overreach in terms of which independent contractors are subject to PAYE withholding, in order to maintain the simplicity of the tax system.
- 4.22 Allowing independent contractors to elect an alternative rate of withholding to the general rate of 20% may add an extra layer of complexity for payers to administer the withholding as opposed to simply applying the 20% rate. However, independent contractors will be in a better position to elect an alternative rate which more appropriately recognises their expected income tax liability. This would support the simplicity of the tax system by allowing independent contractors to manage their cash flows and would also minimise the number and amount of refunds that would need to be undertaken by Inland Revenue in the event of an over-withholding.

Political and social acceptability

- 4.23 The new Government has placed a focus on improving compliance in the tax system.¹⁹
- 4.24 Budget 2024 has allocated \$116 million over the next four years to increase Inland Revenue’s tax compliance activities.²⁰ Over that four-year period, Inland Revenue is expected to raise \$702 million of additional revenue from the increased compliance activities.²¹
- 4.25 Inland Revenue has recently announced that it will be targeting those taxpayers who have not met their tax obligations, including by “taking a closer look at a range of areas including the hidden economy”.²²
- 4.26 This proposal aligns with the Government’s increased focus on tax compliance activities, and in particular, on one of Inland Revenue’s specific focus areas, the hidden economy.
- 4.27 As noted above, the proposal targets the tax gap, which as at 2018, resulted in \$850 million of lost tax revenue each year. Even if this proposal only captured a fraction of this lost tax

¹⁹ Hon Simon Watts *Government provides support to tackle tax debt and compliance*, July 2024.

²⁰ Hon Nicola Willis *Budget 2024 Summary of Initiatives*, May 2024 at 85.

²¹ *Ibid.*

²² Inland Revenue *Inland Revenue funding used to support compliance*, July 2024.

revenue, it would go a long way to satisfying the \$702 million of additional revenue that Inland Revenue is expected to raise across the next four-year period.

- 4.28 The proposal should generate political and social support by more closely aligning withholdings for independent contractors with employees, thereby enhancing fairness and horizontal equity between the two groups, while minimising the ability of independent contractors to underreport income and not pay tax.
- 4.29 Furthermore, the proposal does not involve the introduction of a new tax but is merely a collection mechanism for existing tax liabilities of independent contractors. As such, the proposal should not prompt politically charged debates in the same way that a new tax would. In doing so, this enhances the political feasibility of implementing this proposal.

5. **Conclusion**

- 5.1 I look forward to presenting my proposal on extending withholding taxes to a broader class of independent contractors in Wellington in October.

Yours faithfully



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