Submission

By

BusinessNZ

To

Finance & Expenditure Select Committee

On the

Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill

19 August 2002

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TAXATION (ANNUAL RATES, MAORI ORGANISATIONS, TAXPAYER COMPLIANCE AND MISCELLANEOUS PROVISIONS) BILL

SUBMISSION BY BUSINESS NEW ZEALAND

19 AUGUST 2002

1. Introduction

1.1 This submission is made on behalf of Business New Zealand, incorporating regional employers' and manufacturers' organisations. The regional organisations consist of the Employers and Manufacturers Association (Northern), Employers and Manufacturers' Association (Central), Canterbury Manufacturers' Association, Canterbury Employers' Chambers of Commerce, and the Otago-Southland Employers' Association. Business New Zealand represents business and employer interests in all matters affecting those sectors.

1.2 Business New Zealand's key goal is the implementation of policies that would see New Zealand retain a first world national income and to regain a place in the top ten of the OECD in per capita GDP terms. This is a goal that is broadly shared by the Government. It is widely acknowledged that consistent, sustainable growth in real GDP per capita of well in excess of 4% per annum would be required to achieve this goal in the medium term. Continued growth of around 2% (our long-run average) would only continue New Zealand's relative decline.

1.3 The health of the economy also influences the ability of a nation to deliver on the desirable social and environmental outcomes that we all want. First class social services and a clean and healthy environment are possible only in prosperous, first world economies.

1.4 The tax system has a critical role to play in fostering a dynamic and innovative economy. Tax rates that are set at high levels, and compliance requirements that are complex and costly for businesses and individuals impose significant costs on the community. These costs include lower output, incomes, and employment as well as distortions in behaviour.

1.5 When it was elected, the Labour-Alliance Government undertook a number of policy actions to correct what it perceived to be 'failings' of the 1984-99 period's emphasis on market-driven economic reform. However, while Business New Zealand can understand the Government's wish to re-balance social and economic priorities, we submit that it is now time for the Government to concentrate on building the foundations for a strong and growing economy, without which desirable social and environmental outcomes are impossible.

1.6 Delivering such a strong and growing economy requires the adoption of a balanced, credible growth strategy. The Government's *Growing an Innovative New Zealand* (GAINZ) was a useful strategy statement in that it sets a goal of lifting New Zealand's OECD ranking and identifies the importance of innovation as a growth driver. However, we consider that its primary focus on encouraging innovation will not be sufficient on its own to lift New Zealand onto a higher path of sustainable economic growth.

1.7 This year's Budget continued along much the same theme as the GAINZ strategy in focussing on innovation. While the Budget was fiscally prudent and had a number of useful initiatives (particularly in research, education and skills development, and broadband roll-out), we are concerned about the abolition of the fiscal cap and the impact of the Super Fund on future spending pressures. As a result, it now seems unlikely that the level of government spending as a proportion of GDP will fall to below 30% in the short to medium term (this is important as the level of government spending generally provides the best overall measure of the tax burden).

1.8 The OECD in its recent review of New Zealand said that policies in all areas must have a growth promoting focus if we are to set the stage for higher living standards[1]. In practice though too many policies stifle growth and innovation, and too many spending initiatives divert scarce resources from more productive alternatives or are of dubious quality. In our view, there is often a conflict between growth promoting policies and initiatives and those that seek primarily to regulate activity and/or redistribute income. The OECD also commented on this.

1.9 We submit that a greater and more concerted focus on improving New Zealand's economic fundamentals is necessary – including efforts to improve the quality of government spending, reduce the burden of taxation, and more proactively address business compliance costs.

1.10 Business New Zealand has developed its own *Changing Gear* growth strategy and we assess all policy and legislation on consistency with the growth strategy. A copy is attached as Annex 1 to this submission. Those key growth priorities with direct relevance to this submission include:

2. Lower tax rates, with a priority of reducing the corporate tax rate in stages to 20% by 2010.

3. Reduce the proportion of government spending to GDP to less than 30% by 2005, to be achieved by ensuring that government spending grows at a rate slower than that for GDP.

6. Reduce business compliance costs, particularly for the SME sector, using both economy-wide and SME-targeted approaches to rationalising and improving the quality of business regulation, with particular emphasis on taxation issues and the Resource Management Act.

1.11 Business New Zealand is pleased to have the opportunity to comment on the Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill. After a brief discussion of the importance of tax simplification, this submission will largely focus on the annual rates of income tax (Part 1 of the Bill) and those provisions focussing on tax simplification, such as tax pooling, PAYE intermediaries, and depreciation (Part 2). We will also comment briefly on penalties (Part 3).

[1] *OECD Economic Survey of New Zealand*, OECD May 2002.

2. Tax Simplification

2.1 An important focus of this Bill is on tax simplification and reducing business compliance costs. This is a critical issue for the business community[2] and before commenting on specific measures in the Bill, it is important to provide a business perspective on the Government's tax simplification efforts.

2.2 Business New Zealand supports moves by the Government to reduce business compliance costs associated with the tax system. It is important to remember that 86% of New Zealand businesses employ fewer than 5 people[3], and these are the businesses that find it hardest to comply.

2.3 Reducing compliance costs would free businesses, particularly small businesses, from onerous and time consuming administrative burdens and would enable them to concentrate more on growing their businesses and thereby contribute to New Zealand's economic development.

2.4 An earlier tax simplification initiative came in 1999/2000 when IR5 tax returns and IR12s and IR13s were eliminated, and Employer Monthly Schedules and electronic filing were introduced, all measures designed to reduce the burden of PAYE obligations. A survey of employers undertaken for the IRD in November/December 2000 by AC Neilson found that these measures had considerably simplified employers' information requirements, although the impact on compliance costs (through reduced costs, reduced time spent complying, and reduced stress) was less marked. Overall, the majority of employers, taxpayers, and tax agents were found to prefer the new system[4].

2.5 The next phase of tax simplification occurred in April 2001 when the Government released *More Time for Business*, a discussion document on tax simplification focussed on small businesses. *More Time for Business* made proposals on simplifying provisional tax; further reducing PAYE obligations; reducing end-of-year adjustments; extending further the scope of non-filing for wage and salary earners; simplifying non-resident contractors' withholding tax, resident withholding tax, and imputation credit accounts; increasing the role of information technology; and improving IRD's administration.

2.6 Business New Zealand largely supported the proposals contained in the discussion document as they signalled an encouraging start to offering a more equitable tax system for small businesses in particular. We were concerned though that the proposals on provisional tax did not go far enough and we considered that further work needed to be done on depreciation rates. Also, the discussion document did not address the fundamental issue of tax rates and need to reduce the overall tax burden.

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[2] Business New Zealand's 2002 election survey found very strong support from members for initiatives to simplify tax, particularly through lower and flatter tax rates.

[3] *Business Demographic Survey*, Statistics New Zealand, February 2001.

[4] *Evaluating the Success of the Tax Simplification Changes Among Employers*, AC Neilson for the Inland Revenue Department, March 2001.

2.6 This Bill implements a number of the proposals contained in *More Time for Business*.

2.7 At around the same time as *More Time for Business*, a separate compliance cost exercise was being undertaken – the investigation by the Ministerial Panel on Business Compliance Costs. In July 2001 *Finding the Balance*, the Report of the Ministerial Panel, was released. It made a number of recommendations on tax, despite the Panel's terms of reference specifically excluding taxation from its consideration of compliance costs. The Panel, however, felt that tax issues simply had to be considered, and their inclusion was a reflection of the business community's frustration with the volume of regulation, its complexity, and the compliance load on taxpayers. 11 of the Panel's 162 recommendations were on tax.

2.8 In December 2001, the Government released *Striking the Balance*, the Government response to the Ministerial Panel's report. While it was encouraging that around 40% of the Panel's recommendations were either 'agreed' or 'already implemented', it was disappointing that a significant portion were either 'not agreed' (around 15%) or only agreed in part or in principle. It is significant that the areas that were of most concern to business, such as tax, RMA, accident insurance, and HSNO, had the most 'not agreeds'.

2.9 The Government's response to the Panel's tax recommendations was particularly disappointing – a significantly higher proportion of the tax recommendations (or parts of recommendations) were 'not agreed' than for any of the other sections. A copy of the relevant pages from *Striking the Balance*, containing the tax recommendations and Government response to each, is attached as Annex 2.

2.10 We urge the Government to revisit the report of the Ministerial Panel and reconsider the 60% of recommendations that were either 'not agreed', 'agreed in principle', or 'agreed in part', so that better and quicker progress can be made on easing the compliance burden on businesses, especially those small and medium sized enterprises that are so important to our economy. This applies particularly to the recommendations on tax, but also the RMA, accident insurance, and HSNO.

2.11 To date the Government and its officials have been concerned to ensure that tax simplification initiatives do not endanger existing revenue levels. This is an understandable concern, but we consider that initiatives should not be discounted simply because there is estimated to be a small revenue cost in the short term. The following simple question should be asked across the range of tax compliance issues: is the benefit (i.e., the revenue raised or protected) worth the costs of compliance?

2.12 Business New Zealand submits that meaningful tax simplification requires the Government to consider a wide range of initiatives, even those that might reduce revenue in the short term. The longer-term benefits to businesses and the economy as a whole from the reduction in compliance costs should more than offset short-term fiscal losses.

3. Regulatory Impact and Compliance Cost Statement

3.1 The Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill contains a Regulatory Impact and Business Compliance Cost Statement. All legislation must include such a statement to show that compliance cost implications have been considered by officials and Ministers in the policy development and approval process.

3.2 While supporting the good intentions behind requiring such statements to be published, Business New Zealand has expressed concern that they have often lacked analysis and can appear to be written almost as an afterthought, justifying or defending a particular decision that has usually already been made.

3.3 In particular, we have seen very little quantitative analysis in any of the regulatory impact and compliance cost statements attached to legislation we have submitted on. Not only has there been a lack of information on how much compliance costs would rise or fall in dollar terms for individuals and businesses, but there has also been a distinct lack of analysis of the impacts on the economy as a whole.

3.4 Unfortunately, the same can be said for the Regulatory Impact and Compliance Cost Statement accompanying this Bill. Apart from comments that various changes in the Bill will reduce, have no impact, or increase compliance costs, there has been no attempt to quantify the impacts. It is therefore difficult for submitters to assess the financial and economic impact on compliance costs either individually or in aggregate. There is also no indication of how compliance costs would be affected in either the short or longer term.

3.5 Business New Zealand therefore submits that officials should be asked to provide best quantitative estimates on the financial and economic impacts of the changes contained in this Bill for the Committee's consideration.

3.6 More fundamentally, we consider that our experience with regulatory impact and compliance cost statements has strengthened the argument for a Regulatory Responsibility Act. A Regulatory Responsibility Act, with an independent agency overseeing the process, would force officials to improve their analysis of compliance costs, and encourage Ministers and MPs to take them more seriously.

3.7 The remainder of this submission comments specifically on the provisions contained in the Bill.

4. Part One – Annual Rates of Income Tax for 2002-03

4.1 This Bill confirms the annual income tax rates that will apply for the 2002-03 income year – these are the same as those that applied for the 2001-02 year.

4.2 Business New Zealand considers that the overall tax burden is too high and the business community overwhelmingly supports reducing personal and business tax rates[5].

4.3 The level of government spending generally provides the best overall measure of the tax burden. In New Zealand, core Crown operating expenses as a proportion of GDP are around 31% (this figure excludes large items of capital spending such as the Super Fund and Air New Zealand)[6]. Including State Owned Enterprises and Crown Entities, total Crown expenses are over 40% of GDP. The Budget did not forecast any reductions in these proportions in out-years[7].

4.4 The Government has a target for core Crown expenses of 35% of GDP. We consider that this target is too high, and instead we consider a target of less than 30% of GDP to be more appropriate[8]. Over recent years, most countries that have recorded the rates of rapid growth we need to improve our OECD ranking have done so with proportions of government expenses to GDP of less than 30%.

4.5 One example of a country that has grown its economy but not its government is Ireland. According to OECD statistics, Ireland's general government outlays as a proportion of GDP in 1985 was 50.7% and its real rate of GDP growth in 1986 was –0.4%. As recently as 1994 government outlays were 41.1% of GDP, but by 2000 had fallen to 29.3% of GDP as the economy grew in real terms by an average of 10% per annum from 1995-2000.

4.6 The comparison with New Zealand is interesting. The same OECD statistics show New Zealand's general government outlays as a proportion of GDP in 1985 was 51.8% and its real rate of GDP growth in 1986 was 0.6%. In 1994, New Zealand had reduced its proportion of government outlays to GDP to 42.4%, a similar rate of progress to Ireland's, but this is where the similarity ends. By 2000 government outlays were still stubbornly high, at 40.6%[9], and our economy grew in real terms by an average of 2.7% per annum from 1995-2000 – respectable, but not enough to make up lost ground on those above us in the OECD rankings.

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[5] Business New Zealand's 2002 election survey found that 88% of members supported reducing business and personal tax rates, with 9% opposed.

[6] Changes to accounting changes have resulted in changes to the way Crown financial statements are prepared – this has resulted in removing GST from Crown expenses and has resulted in core Crown expenses for 2002 reducing from 32.5% of GDP to 31.2%.

[7] Refer to *Budget 2002 Fiscal Strategy Report*, pg. 25.

[8] This view is supported by Business New Zealand's 2002 election survey result, which found that 71% of members supported reducing the proportion of Government spending to GDP to under 30% by 2010, with 11% opposed.

[9] It would appear that the OECD's definition of 'general government outlays' is similar to the Government's 'total Crown expenses' (including SOEs and Crown Entities).

4.7 Although there are unique circumstances behind Ireland's particularly spectacular rise its performance is relevant because it only recently overtook New Zealand on the OECD league table (early 1990s) yet it is now in 8th place whereas New Zealand has stayed at around 20th place. Ireland shows what can be achieved.

4.8 High spending is usually reflected in high taxes. High taxes impose very large costs on the economy and the community. Such costs include lower output, incomes, and employment than otherwise would be the case, and often result in distortions in behaviour. High taxes also erode international competitiveness, especially for an open economy, such as New Zealand, that is dependent on trade and has a mobile workforce.

4.9 While New Zealand's income tax rates do not compare unfavourably with the OECD average, our top rate of income tax (39%) takes effect from a relatively low level of income – only $60,000. It is also important to note that among OECD countries, the continental Europeans generally have very much higher tax rates (and therefore push up the OECD average) compared to the likes of Australia, Canada, Ireland, Japan, New Zealand, the United Kingdom, and the United States. Many of our major trading partners and competitors are also developing countries with considerably smaller governments, and lower tax burdens.

4.10 The OECD's recently published document *Taxing Wages*[10] has found that most OECD countries have cut income tax and social security contributions over recent years. The following table shows the progress at reducing taxes since 1995 for New Zealand and some OECD countries we like to compare ourselves with:

Income Tax plus Social Security Contributions (% of total wage) 1995-01

Country	1995	1997	1999	2001	% Change 1995-99	% Change 1999-2001
Australia	24.0	24.8	25.9	23.1	+1.9	-2.8
Canada	27.1	27.7	26.5	25.3	-0.6	-1.2
Finland	38.0	35.8	33.7	32.4	-4.3	-1.3
Ireland	29.2	26.0	24.3	16.9	-4.9	-7.4
Netherlands	40.5	39.3	35.4	33.0	-5.1	-2.4
New Zealand	24.5	21.6	19.4	19.6	-5.1	+0.2
United Kingdom	26.7	25.2	26.4	23.3	-0.3	-3.1
United States	25.8	25.8	25.8	24.6	0.0	-1.2

4.11 For New Zealand, this table shows the effect of the 1996 and 1998 tax cuts on reducing the average tax burden for wage and salary earners from 24.5% to 19.4% from 1995-99. However, it also shows that since 2001 New Zealand has gone against the overall OECD trend of reducing income tax rates and we were one of only 9 of 29 OECD countries to have shown an increase from

[10] *Taxing Wages 2001 Edition*, OECD 2002

1999-2001 (the others being Czech Republic, Greece, Iceland, Japan, Korea, Mexico, Spain, and Turkey).

4.12 A similar competitiveness story can be told for corporate tax rates. In 1988, New Zealand reduced the corporate tax rate from 48c to 33c. At the time, this was a move that was highly competitive and, rather than reduce revenue (as one might expect with a cut in tax rate), corporate tax revenue actually increased from an average of around 3% of GDP over the decade prior to 1988 to an average of around 4% of GDP over the decade after 1988. In the year ended June 2001 corporate tax raised $5.4 billion[11].

4.13 Since 1988, New Zealand's corporate tax rate has remained unchanged while other countries have reduced theirs, some now to rates below New Zealand's, so impacting upon our international competitiveness. Last January, KPMG released a survey on corporate tax rates, which found that the average corporate tax rate for OECD countries fell from almost 38% in 1996 to around 31% in 2002. Over the same period, the European Union's average fell from 39% to 32.5%.

4.14 New Zealand's average rate of corporate tax is now higher not only than the OECD average but also that of Europe, and now also Australia (reduced recently from 34% to 30%). New Zealand companies are not faced with the high additional payroll and social security taxes that are a feature in Europe in particular, but it is the downward international trend, and New Zealand's failure so far to respond, that is important.

4.15 The Government's McLeod Tax Review produced what was in our view an excellent report and made some useful recommendations that we commend to the Government. In reference to personal income tax rates, it suggested that New Zealand should adopt a two-rate scale with a threshold of around $30,000 per annum with rates of 18% below and 33% above. This would raise approximately the same amount of revenue as the existing four-rate scale. However, we consider that the Government already collects more than enough revenue as a proportion of GDP and that instead the income threshold would be better set a higher level (closer to $40,000) with the top income tax rate reduced, over time, to below 30%.

4.16 While the McLeod review suggested that the corporate tax rate and the top personal income tax rate should be as close together as possible, we believe that there is a case to reduce the corporate tax rate further, and we note that many OECD countries have large gaps between the two rates (e.g., Australia's top personal income tax rate is 47%, yet its company tax rate is 30%). We consider that a steady reduction in the corporate tax rate to around 20% in the medium term would be beneficial for international competitiveness and business investment, and would not impact detrimentally on the Government's overall fiscal position[12].

[11] Tax receipts data 1978-2001 supplied on request by The Treasury.

[12] This view is backed up by Business New Zealand's 2002 election survey, which found that 69% of members supported reducing the corporate tax rate to 20% by 2010, with 23% opposed (most of those opposed wanted the rate cut to 20% by earlier than 2010 or to a lower rate by 2010).

4.17 This is simply because corporate tax is primarily a withholding tax and is not necessarily a final tax. That is, income tax paid by companies is attributed to shareholders in so far as profits are distributed as dividends. Shareholders can use the associated imputation credits to reduce their personal tax payments, but the tax paid by companies on their behalf is seen as the individual's tax liability.

4.18 Dividends attract imputation credits, but these would be worth less if the corporate tax rate were cut, so leaving shareholders to pay more tax directly at whatever their marginal rate. Reducing the corporate tax rate would therefore increase the revenue collected from personal income tax, although probably not to the extent of fully offsetting the direct reduction in corporate tax revenue.

4.19 The major contributor to protecting revenue levels would be the result of the increased business investment and subsequent economic activity generated by the cut, which would ultimately result in higher taxable incomes (both corporate and personal). Increased job growth would also reduce transfer payments, so reducing Government expenses.

4.20 If businesses receive a tax cut, they are likely to 'save' the cut by investing in new plant and equipment and therefore increase their future potential output – surely a potent lever to lifting New Zealand's rate of sustainable economic growth. Also, the business sector is already a significant source of 'savings' in the economy and we believe that reducing the corporate tax rate would increase these savings further, so helping to lift overall national savings.

4.21 We asked economic researchers Infometrics to model the effects of a cut in the corporate tax rate to 20%, progressively over a 5-year period. Infometrics found such a cut would be positive for business investment, increasing full-time jobs (up 17,000), and lifting GDP (up 1.1%), while being fiscally neutral once the impact of increased employment and economic activity is factored in[13]. We have been discussing this work and the underlying assumptions with Treasury officials.

4.22 Overall, we believe that there are sound cases for reductions in both personal and corporate tax rates.

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[13] *General Equilibrium Analysis of a Lower Corporate Tax Rate*, Infometrics Consulting for Business New Zealand and Employers and Manufacturers Association (Northern), August 2001.

5. Part Two – Amendments to the Income Tax Act 1994

Taxation of Maori Organisations

5.1 Business New Zealand is pleased that the Government has agreed to reduce the income tax rate for Maori organisations from 33% to 19.5% to reflect the rate that applies to the majority of individuals that derive benefits from Maori organisations.

5.2 However, we consider that if treated in isolation, different treatment of Maori organisations, simply because they are 'Maori organisations', is inequitable. Therefore, on the basis of equity, we submit that this favourable treatment should be extended to all, and superannuation schemes would seem to be a good place to start – it has long been recognised that New Zealanders paying the lower marginal tax rates (e.g., 19.5%) have been disadvantaged because superannuation and investment funds pay tax on their earnings at the higher rate of 33%. Addressing this anomaly would not only be fairer for all, but it would also encourage more people to take greater responsibility for saving for their retirement[14].

5.3 While we are not in a position to comment with authority on the taxation of Maori authorities, we have been advised by KPMG that a potential downside of the proposed approach is the complexity of the imputation system, especially when taxing organisations that are more akin to a trust than a corporation. There are likely to be traps in adjusting to the proposed regime that will need to be carefully managed.

Tax Pooling

5.4 Tax pooling was proposed in *More Time for Business*. Currently, business payers of provisional tax must estimate their tax liability for the upcoming year and would normally pay IRD in three equal payments per year. If, at the end of the year it is found that underpayments were made, IRD will charge 11.93% on the difference, but for overpayments, IRD will pay only 4.83%.

5.5 *More Time for Business* recognised that income streams often fluctuate and that they can often bear little resemblance to the timing of when provisional tax payments are due. For many businesses small changes in turnover can result in large changes in profits, which can make estimating provisional tax a hazardous undertaking.

5.6 Tax pooling was one option identified to simplify provisional tax. It would appear that the Government has rejected an alternative option (floated in *More Time for Business*) of businesses nominating a set percentage of revenue to be taken aside and deposited into a special bank account, which would in turn have been paid by the bank to the IRD.

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[14] This view is backed up by Business New Zealand's 2002 election survey, which found that 90% of members supported changes to the tax system to encourage higher savings and more business investment. Tax incentives for retirement savings was cited as a key area for the Government to address.

5.7 Under tax pooling, businesses would be permitted to pool their provisional tax with other businesses, which would see underpayments being offset by overpayments within the pool. The arrangement would be made through an intermediary (probably a financial institution) who would arrange for the businesses to be charged or compensated, as appropriate, for the offset. According to the Government, pooling could lead to interest paid to or paid by businesses becoming more favourable than the existing differential rates applied by IRD and would be an option worth considering for some larger businesses that are currently disadvantaged by the relatively high rate charged by IRD for underpayments.

5.8 Business New Zealand supports this initiative, particularly if it reduces costs through the use of more realistic use of money interest rates. However, we believe that the success of tax pooling will be dependent on its uptake by financial intermediaries and the confidence taxpayers have in these intermediaries to correctly manage their payments, as well as a need for each 'pool' to have a 'balance' of over and under payers. It will also be challenging for intermediaries and taxpayers alike to deal with the existing complexities of the tax system and how they will be coped with under a pooling system.

5.9 For those businesses that decide not to opt for tax pooling, or are unable to join a pool, the existing provisional tax regime will remain largely unchanged. Therefore, for those businesses, the fundamental compliance cost issues with respect to provisional tax will remain.

5.10 We are particularly concerned about the rates IRD has for use of money interest, especially the very large interest rate differential between underpayments and overpayments – i.e., the IRD charges currently 11.93% for underpayments but will only pay 4.83% for overpayments.

5.11 We also consider that there would be merit in allowing businesses to adjust their provisional tax estimates more readily without penalty during the year if, for example, volatile trading conditions significantly changed their original estimates. Moving to quarterly, rather than the existing three-yearly payments, might also help businesses, most of which operate on a quarterly basis. We understand that quarterly tax returns have been successfully introduced in Australia and that some New Zealand businesses are interested in filing quarterly tax returns to remove the need for provisional tax estimates.

5.12 Business New Zealand therefore supports the tax pooling provisions, but urges the Government to consider additional initiatives to further simplify provisional tax requirements, including reduction in the large differential in use of money interest rates.

PAYE Intermediaries

5.13 Again, PAYE intermediaries were mooted in *More Time for Business*. Permitting employers to use an accredited intermediary (such as payroll firms) to calculate and pay PAYE has merit, as it would reduce their exposure to penalties and interest and should enable them to get on with running their businesses. However, we would have preferred for the IRD to be more forthcoming in providing advice and assistance, and this proposal seems to be an admission that the compliance difficulties faced by businesses has reached the point where it has become necessary for the engagement of expert intermediaries.

5.14 While supporting this initiative, we also recognise that it would be up to the employer to ensure that the information it provides to the intermediary is correct. Intermediaries will also charge for their services, so there are likely to be costs for businesses using them, although these might be outweighed by not having to spend us much time and energy on complying with PAYE administration and compliance requirements 'in-house'.

5.15 Greater use of expert intermediaries might also help businesses cope better with some of the more complex PAYE issues, such as student loan repayments and liable parent contributions.

5.16 Business New Zealand therefore supports the provisions on PAYE intermediaries.

Charities

5.17 Business New Zealand supports the simplification of the thresholds for the deductibility of donations by companies.

Depreciation and Amalgamation

5.18 The provisions on depreciation in the Bill are described as being largely technical but helping to reduce compliance costs related to depreciation deductions for those companies that amalgamate. We understand that the amendments do two things:

(i) Amend the amalgamation rules to prohibit a step-up in the depreciable value of assets to market value upon non-qualifying amalgamations; and
(ii) Allow the amalgamating company to claim depreciation up to the time of amalgamation.

5.19 The effect of the first of these amendments will be to require companies transferring assets on amalgamation to value the assets at historic cost rather than at market value. We cannot see any credible policy reason for this change other than to maximise tax revenue. Consistent with the approach that non-qualifying amalgamations are akin to arms-length disposals, we submit that valuing assets at market value should continue to be permitted for companies that amalgamate.

5.20 However, we support the second proposition that would allow depreciation on assets in what is effectively the year of sale. This would be consistent with an underlying approach of the tax amalgamation rules to facilitate amalgamations at least tax cost.

5.21 We would also have supported more initiatives on depreciation. For example, some manufacturers have expressed concern about the regime that applies to the depreciation of equipment for businesses working multiple shifts. We believe there are significant compliance issues which need to be addressed and a serious lack of information for the business sector on the depreciation options available.

5.22 There have been complaints that manufacturers are unable to depreciate their equipment more quickly when multiple shifts are being worked at their plant. However, it has also been pointed out that the economic life approach adopted in the early 1990's means that businesses may now apply to the IRD for a determination allowing their equipment to be depreciated at a higher (therefore faster) rate. Few businesses seem to be aware of the opportunity to apply for a faster depreciation rate – IRD should be more proactive in informing businesses of this opportunity.

5.23 We are also concerned that the application process itself seems overly bureaucratic in that each firm that works beyond the standard 35 hours per week must apply individually with evidence that their equipment is wearing out more quickly. With more firms working multiple shifts or longer shifts to improve capacity utilisation, it seems timely to consider whether the application process could be simplified. For example, it would seem possible for businesses to use a standard adjustment formula when their factory is used more than 35 hours per week. Businesses would only then need to apply for an assessment if they were not happy with the standard formula.

5.24 A survey of manufacturers (with more than 20 staff) undertaken in 1994 by the Australian Manufacturing Council showed that at that time New Zealand manufacturing plants were operating on average 10 hours per week more than their Australian counterparts. In 1997 the Ministry of Commerce updated the survey, but the question on hours was deleted, so we do not have a more up-to-date number. Feedback from companies, however would suggest that average hours worked has increased significantly since 1994.

5.25 Business New Zealand raised this particular depreciation issue in its submission to *More Time for Business*. The familiar response we received was that it would be too difficult to do away with the application process and that ‘significant revenue’ would be at stake. We are unsure about this latter point as depreciation rules affect timing and flows of tax rather than the overall amount, and in any event, we do not believe that our proposal would have applied to a large number of businesses, so revenue implications should not have been ‘significant’.

5.26 There are currently depreciation rates for around 2,800 separate asset categories. Business New Zealand would support moves to reduce the number of depreciation rates in the interests of simplification.

6. Part Three – Amendments to the Tax Administration Act 1994

6.1 The provisions contained in Part Three of the Bill regarding compliance standards and penalties were contained in the discussion document *Taxpayer Compliance, Standards and Penalties: a Review*.

6.2 While some of the provisions in this Part are positive, there are others that are less so and could even increase compliance costs.

6.3 Business New Zealand supports the following initiatives:

- 'Good Behaviour': The rate of shortfall penalty for lack of reasonable care and unacceptable interpretation will be reduced to 10% if, within the previous four years, the taxpayer has not been liable to pay a shortfall penalty for the same type of offence.

  While this is a positive initiative, we believe that a broader and more strategic approach to penalties would better recognise the objectives of encouraging compliance and penalising certain behaviour. Therefore, we submit that this approach should have been extended to all shortfall penalties or deliberate actions, except those targeted at the very worst behaviour. We would also argue that four years is too lengthy a 'probationary' period – we would prefer a shorter period, such as two years.

- 'Capping the penalty for lack of reasonable care': The cap will be set at $50,000 per tax position. There is currently no cap, so this is a positive move.

- 'Onus of Proof': if a taxpayer proves on the balance of probabilities that the assessment is wrong by a specific amount, a court would be required to reduce the IRD assessment by that amount.

- 'Tax in Dispute': The requirement to pay 50% of tax in dispute at the beginning of the dispute will be removed. However, there is a 'fishhook' in the form of clause 100 where the Commissioner of Inland Revenue would be able to require all the tax in dispute to be paid if there is a risk the revenue would not be paid. We are concerned that this clause could be used unreasonably and defeat the intent of the amendment. Clause 100 should be amended to at least require such an assessment to be made on reasonable grounds.

6.4 Business New Zealand is concerned, however, by the following initiatives:

- 'Penalties for Unacceptable Tax Positions';
- 'Information Gathering Powers';
- 'Promoter Penalties'

6.5 Our concerns are discussed in further detail below.

Penalties for Unacceptable Tax Positions

6.6 This provision broadens the nature of the penalty from a breach that required a culpable act to one that is more akin to strict liability – i.e., innocent misinterpretation of the legislation is now regarded to be in the same category as a deliberate act of evasion. This broadening of the penalty is unwarranted, inappropriate and unfair and it would punitively punish those businesses, particularly small businesses that act honestly and in good faith.

6.7 The 1999 Finance and Expenditure Committee Inquiry into the IRD had this to say about unacceptable interpretation:

> *"We…understand that the (Inland Revenue) Department's policy is that if a taxpayer or adviser has not interpreted legislation, a penalty for unacceptable interpretation cannot apply. We recommend the department publicise this policy both internally and to the taxpaying public."*[15]

Therefore, if anything the law should have been clarified to make it clear that the penalty for unacceptable interpretation (now 'unacceptable tax position') should not apply when a taxpayer has not interpreted the law. This amendment would appear to fly in the face of the Committee's recommendation.

6.8 While the associated increase in the unacceptable interpretation threshold is to be welcomed, and we accept that penalties should appropriately punish those that deliberately abuse the system, inadvertent errors should not be subject to such heavy penalties.

6.9 Business New Zealand therefore recommends that the provisions regarding penalties for unacceptable tax positions should not proceed and instead the rules be clarified, as recommended by the Finance and Expenditure Committee in its 1999 report.

Information Gathering Powers

6.10 The Bill's Regulatory Impact and Compliance Cost Statement considers that the provisions on information gathering powers would reduce compliance costs by removing uncertainty. Although uncertainty might indeed be removed, we are concerned about the increase in the of power the IRD to:

- Require assistance of third parties (without any reimbursement);
- Enter premises (without requiring separate warrants for each staff member);
- Remove documents for copying (particularly those subject to legal privilege);
- Require information held offshore to be provided (which raises complex issues of international jurisdiction); and

[15] *Inquiry into the Powers and Operations of the Inland Revenue Department*, Report of the Finance and Expenditure Committee, October 1999, pg 27.

- Require documents to be sent to specified IRD offices (without any reimbursement).

6.11 The IRD already has significant information gathering powers and these additional provisions would seem not only to be heavy handed but also have a real potential to significantly increase business compliance costs, not only for those businesses being investigated, but also for third parties.

6.12 Business New Zealand therefore recommends that the provisions on information gathering powers should be reviewed in light of the need (not just desire), the compliance costs they would impose on businesses, and existing IRD powers. We suggest that the IRD should justify broadening its powers by providing the Committee with actual examples of where their existing information gathering powers have not been sufficient.

Promoter Penalties

6.13 The Government is taking steps in this Bill to stop the promotion of mass-marketed schemes offering tax benefits. The Government argues that promoters would become more accountable for their actions and take more care to ensure that the tax effects of the arrangements they offer are correct.

6.14 We are concerned about that these provisions seem to be heavy handed and target the wrong people – those who take a position should be accountable for their actions. An analogy might be *disqualifying* from driving for 6 months a person who had been caught driving under the influence of alcohol, but also *imprisoning* the person who had sold the alcohol to the driver as well as taking action against the company marketing the beverage.

6.15 In any event, we understand that the current law already allows the IRD to take action against people, such as promoters of mass marketed schemes, who ‘aid and abet’ those taking unacceptable tax positions. We therefore ask whether this law change is really necessary.

7. Part Four – Amendments to Other Acts

7.1 Part Four of the Bill would make amendments to the following Acts:

- Goods and Services Tax Act 1985, regarding the GST treatment of telecommunications services and international passenger cruises;
- Income Tax Act 1976, regarding depreciation and amalgamation; and
- Student Loan Scheme Act 1992, Child Support Act 1991, and Injury Prevention, Rehabilitation, and Compensation Act 2001, to enable PAYE intermediaries to make non-tax deductions.

7.2 Business New Zealand has no comment on the amendments to the GST and Income Tax Acts. Consistent with our support of PAYE intermediaries, we support the amendments that would enable intermediaries to make non-tax deductions.

8. Conclusion

8.1 Business New Zealand generally supports the provisions contained in this Bill. In particular, we see tax pooling and PAYE intermediaries as useful first steps towards simplifying the tax system for businesses. However, Business New Zealand submits that the overall tax burden is too large and that more should be done to meaningfully reduce the compliance burden, including addressing more of the recommendations made by the Ministerial Panel on Business Compliance Costs.

9. Recommendations

9.1 Business New Zealand recommends that the Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill should proceed.

9.2 However, notwithstanding the above recommendation, Business New Zealand recommends the following:

(a) The Government should reconsider the 60% of recommendations of the Ministerial Panel on Business Compliance Costs that were neither ‘agreed’ nor ‘implemented’, particularly those made on tax.

(b) The Government should consider meaningful tax simplification measures even if they have fiscal costs.

(c) Officials should be asked to provide best quantitative estimates on the financial and economic impacts of the changes contained in this Bill, both in the short term and the longer term.

(d) The Government should take action to reduce the overall tax burden, by:

(i) Adopting a goal of reducing and holding government spending to less than 30% of GDP; and
(ii) Reducing tax rates, particularly the corporate tax rate, which should be reduced in stages to 20%.

(e) The Government should reduce its ‘use of money’ interest rate differential between what IRD charges for underpayments and what it pays for overpayments.

(f) Businesses should be allowed to adjust their provisional tax estimates more readily if, for example, volatile trading conditions significantly changed their original estimates.

(g) The filing of quarterly tax returns should be introduced for those businesses that wish to opt out of the provisional tax system.

(h) Valuing assets at market value should continue to be permitted for companies that amalgamate.

(i) The IRD should be more proactive and better inform businesses of the opportunity to depreciate their equipment more rapidly when multiple shifts are being worked at their plant.

(j) The IRD should consider adopting a standard formula for firms operating over the ‘standard’ 35 hours per week rather than requiring an overly bureaucratic application process for more rapid depreciation.

(k) The ‘good behaviour’ approach for lack of reasonable care and unacceptable interpretation contained in this Bill should be extended more strategically across all penalties, with the exception of those for the worst behaviour.

(l) The four-year ‘probationary’ period of ‘good behaviour’ for lack of reasonable care and unacceptable interpretation should be reduced to two years.

(m) The provisions regarding penalties for unacceptable tax positions should not proceed and instead the rules be clarified, as recommended by the Finance and Expenditure Committee in its 1999 report.

(n) The provisions on information gathering powers should be reviewed in light of the need (not just desire), the compliance costs they would impose on businesses, and existing IRD powers.

(o) The provisions on promoter penalties should be deleted.

ANNEX 1.

CHANGING GEAR: BUSINESS NEW ZEALAND'S 20 KEY GROWTH STRATEGY PRIORITIES

All New Zealanders want higher incomes, better social services, and a clean environment. However, we simply will not achieve these important outcomes without a strong, vibrant, growing economy. We need a balanced set of policies that will promote our international competitiveness, foster innovation and encourage entrepreneurs to do great things for New Zealand. While by no means an exhaustive list, we believe that the implementation of the package of key priorities listed below would go a long way to delivering a better New Zealand for us all.

Policy Integration – Economic/Environmental/Social

1. Formulate a sustainable development strategy that (a) recognises economic growth as a precursor for social well-being and effective environmental management, and (b) fosters a climate of innovation and competitiveness.

Economic Fundamentals

Fiscal and Monetary Policy

2. Lower tax rates, with a priority of reducing the corporate tax rate in stages to 20% by 2010.

3. Reduce the proportion of government spending to GDP to less than 30% by 2005, to be achieved by ensuring that government spending grows at a rate slower than that for GDP.

4. Reduce the level of gross Crown debt to below 15% of GDP by 2010.

5. Pursue the adoption of a common currency with Australia.

Microeconomic Reform

6. Reduce business compliance costs, particularly for the SME sector, using both economy-wide and SME-targeted approaches to rationalising and improving the quality of business regulation, with particular emphasis on taxation issues and the Resource Management Act.

7. Improve the efficiency and effectiveness of local government, with a view of reducing local government spending to less than 3% of GDP by 2005.

Infrastructure

8. Increase investment in transport infrastructure, with an emphasis on eliminating those roading constraints that are impeding economic growth and development.

9. Improve New Zealand's broadband penetration rate to among the top 10 of OECD countries by 2005.

Trade and Exports

10. Pursue policies that would encourage export growth and increased trade, including the negotiation of a free trade agreement with the United States by 2005.

Innovation

11. Increase and improve linkages between research and commercialisation of ideas, and increase the amount of private sector funded research and development to the current OECD average of 1.5% of GDP by 2010.

12. Ensure that the regulatory framework is innovation-friendly and encourages the use of technology.

Human Capital

Education and Skills Development

13. Increase skill levels in the current workforce, by increasing the numbers of people involved in formal industry training from 80,000 to 160,000 per annum, and significantly increase the number of people with industry skill standards, by 2005.

14. Eliminate 'very poor' literacy and numeracy in the population (i.e., reduce the number of people with IALS Level 1 literacy to fewer than a statistical margin of 5%), by 2010.

15. Improve the outcomes of compulsory education, so that all completing compulsory education achieve basic literacy and numeracy standards, and attain at least NCEA Level 1, by 2005.

16. Improve the relevance of post-compulsory education, by more rigorous quality assurance, greater partnership with business, and a greater proportion of learning taking place within industry and on-the-job, by 2005.

Labour Market

17. Maintain the focus on the individual enterprise and ensure the flexibility necessary to promote employment growth, particularly in the SME sector, by recognising the need to respect freely bargained agreement terms and conditions whose integrity is respected by third parties.

Population Policy

18. Increase the number and proportion of highly skilled, talented, and motivated immigrants with good English language skills so that the ratio of working age to retired age population returns to 1990 levels by 2010.

Business Excellence

19. Develop a Best Practice Management and Governance Demonstration Project, delivered by business and industry associations with support from central government; and promote best practice and sector co-operation through key supply chain linkages.

20. Promote positive public attitudes towards wealth creation, business success and entrepreneurship.

Annex 2.

BUSINESS COMPLIANCE COST PANEL RECOMMENDATIONS ON TAX (PLUS GOVERNMENT RESPONSE)

Recommendation 146

The Government should consider:

- Requiring that a Business Compliance Cost Statement (BCCS) together with the existing requirement for a Regulatory Impact Statement (RIS) become mandatory for all tax policy initiatives and be supported by a publicly available cost/benefit analysis (CBA). This extends the function of the BCCS to a formal comparison of expected tax revenues and other benefits with compliance costs.
- Consulting with business and other stakeholders earlier in the tax policy process by requiring the drafting of a BCCS/CBA in association with the preparation of the RIS. This should commence during the discussion document stage of the Generic Tax Policy Process (GTPP), and be updated throughout the consultation, drafting and review stages.
- Requiring that the RIS/BCCS/CBA be subject to independent review to provide an objective assessment and ensure compliance costs are not simply shifted from Government to business.
- Strengthening the existing GTPP requirement for a broad CBA by publishing the RIS/BCCS/CBA at the same time that the proposed policy initiative is announced to improve transparency and demonstrate that simplicity has been considered.

<u>Response: Agreed in part.</u>
There is an ongoing programme to expand and formalise the role of the RIS, BCCS and CBA. IRD will work with ICANZ on ways to do this. Consultation has begun and there will be a report back on how this can be implemented. The new process will be used for tax legislation in 2003.

Recommendation 147

That the Government notes:

(i) The Panel supports a voluntary system of aligning the payments of GST and provisional tax. This best serves the interests of small business.

(ii) Alternatively, introduce a pay-as-you-go system, whereby income tax is paid or set aside as income earned by the taxpayer, based on their periodic financial reports. Any tax adjustments appropriate to the period could be subsequently applied to arrive at taxable income. This would more accurately match the business's ultimate tax liability and capacity to pay.

<u>Response: (i) Agreed.</u>
This proposal has been included in the discussion document 'More Time for Business'. IRD will provide a report to the Government on submissions made on the proposal by mid-2002.

<u>Response: (ii) Not agreed.</u>
This recommendation has already been considered as part of the policy development for the Government discussion document 'More Time for Business'. It has been dismissed as an option because taxpayers could manipulate payment of their tax throughout the year without exposing themselves to 'use of money' interest for underpayment. This raises a revenue risk.

Recommendation 148

The Government should consider:

- The introduction of a Government intermediary to calculate and determine tax and other required employee deductions.
- Compensating business for their collection of employee tax and other deductions on behalf of the government, for example student loans, court fines etc.

Response: Not agreed.
Businesses are already indirectly remunerated through the cash-flow advantage of retaining tax deductions before paying them to the Government. Remunerating businesses would raise the issue of compensating individuals. If a Government intermediary were to be introduced for calculating PAYE, the same treatment would have to be extended to other intermediaries in the tax system, such as banks.

Recommendation 149

The Government should consider:
(i) Undertaking a first-principles review of Fringe Benefit Tax (FBT).
(ii) The levying of FBT at a single rate and basing FBT on the depreciated cost of motor vehicles should be considered as part of the review.

Response: (i) Agreed in part.
A review of FBT rules is scheduled for 2002. The recommendation relating to motor vehicles will be considered as part of the review.

Response: (ii) Not agreed.
Reinstating the 49% flat rate would allow high-income earners to avoid the top marginal tax rate by receiving fringe benefits. It would also increase the FBT rate applying to those on lower incomes. The rules already allow employers to pay tax at a single rate, albeit one equivalent to the top marginal tax rate.

Recommendation 150

The Government should consider:
(i) Taking active measures to reduce compliance costs in the area of depreciation and reduce the number of depreciation rates.
(ii) Increasing the threshold for low value assets for immediate tax deduction.
(iii) Further developing online depreciation calculation tools.

Response: (i) Not agreed.
This would be inequitable and inefficient for taxpayers. Simplification initiatives require trade-offs between competing considerations of equity, revenue, efficiency, and administrative costs. As stated in the discussion document ('More Time for Business'), however, the government will survey small businesses to identify ways of reducing compliance costs of depreciation calculations.

Response: (ii) Not agreed.
This was considered as part of the policy development for the discussion document 'More Time for Business'. It was dismissed as an option due to the high revenue cost.

Response: (iii) Implemented.
IRD has already made available online depreciation calculation tools. These will be developed further as part of an ongoing project designed to provide taxpayers with more certainty in their tax calculations. By December 2001, IRD will have identified all services to be made available through the Government portal, including online depreciation calculators.

Recommendation 151

The Government should consider taking a more pragmatic view to aligning tax and accounting practices to ensure that simplification is achieved.

Response: Agreed in part.
Alignment has been considered in tax policy development for some time and has, to some extent, been adopted in the tax rules relating to R&D and trading stock. Opportunities to further align tax with accounting will be taken up on an issue-by-issue basis. A paper is being prepared for the Government to consider in earl 2002. The proposal that trading stock be valued at a lower cost or net realisable value has, however, been ruled out as it would be inappropriate for tax purposes.

Recommendation 152

The Government should consider the development of a variable concession base for trading stock valuations for small business according to stock worth and turnover of the different business types.

Response: Not agreed.
This proposal has already been considered as part of the policy development for the Government discussion document 'More Time for Business'. It has been dismissed as an option due to the associated high revenue risk.

Recommendation 153

The Government should consider undertaking an independent CBA of the entertainment expenditure regime and repeal it if no clear benefit is found for the tax.

Response: Not agreed.
A review of this area is not appropriate. Tax policy resources can be better utilised in advancing other simplification projects.

Recommendation 154

The Government should consider exploring the concept of a separate simplified tax regime for small business. The Australian Simplified Tax System should be researched with a view to developing a New Zealand model. In particular, consideration should be given to:

- A simplified depreciation scheme including the revision of the threshold for immediate deductability for assets costing up to $1,000 and a pooling arrangement for assets with effective lives of less than 25 years.
- A move towards (voluntary) cash accounting for small business thereby aligning financial accounting with GST accounting.

Response: Agreed in part.
This issue has already been raised in the discussion document 'More Time for Business'. The Panel's comments will be treated as a submission. Officials are currently working through submissions made on the proposals raised in the discussion document and are reporting to the Government as policy recommendations are developed.

Recommendation 155

The Government should consider:

(i) Requiring IRD to extend the use of e-file technology to all forms, returns and correspondence.

(ii) Providing for voluntary alignment of tax payment dates.

<u>Response: (i) Agreed.</u>
IRD is progressing the extension of e-file technology. The initial phase (redesign of its website) was completed in September 2001. As well as offering new services and information this provides a stable platform from which future e-opportunities can be launched.

<u>Response: (ii) Not agreed.</u>
This proposal has been considered in the past and rejected. Consultation with businesses revealed voluntary alignment would increase compliance difficulties and costs. It would also be complex administratively. Other options are being developed to reduce the transactions costs associated with multiple tax payments.

Recommendation 156

The Government should consider:

(i) That IRD give priority to the improvement of customer services and report on the progress made in the 2001/02 Departmental Annual Report.
(ii) Amending the Tax Administration Act 1994 to reduce the requirement for the holding of records to four years including the year in which the income is earned.
(iii) That IRD take a broader and active view of its powers under the care and management provisions, and apply them for the benefit of taxpayers.

<u>Response: (i) Agreed.</u>
IRD already gives priority to improving customer service. This is a continuous process. The Commissioner will report on progress made in the 2001/02 and subsequent annual reports.

<u>Response: (ii) Agreed in part.</u>
Further analysis is required of the potential for increased risk to revenue through the decreased opportunity for detection of avoidance/evasion. This work will be undertaken as part of the forthcoming review of the disputes legislation. A discussion document on disputes will be released in mid-2002.

<u>Response: (iii) Agreed in part.</u>
The Commissioner currently applies care and management consistently with advice from the Solicitor-General and guidance from the Courts. Introduction of wide discretionary powers for the Commissioner would make application of tax law more uncertain and complex. A review is being undertaken as part of an ongoing project to provide taxpayers with more certainty in their tax calculations. Officials will report by March 2002.