

Simplifying the Taxation of Small Business in New Zealand



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A brief introduction

In this paper, the New Zealand Institute of Chartered Accountants (NZICA) and Tax Management New Zealand Ltd (Tax Management NZ) provide a fresh look at the way New Zealand small businesses calculate and pay tax.

The proposals in this paper are designed from the small business owner's point of view and aim to make business income tax compliance simple and practical.

The Issue

In a nutshell, the tax process for small businesses in New Zealand is convoluted. The framework for taxing small business dates back to the 19th century, and while conceptually straight forward, it has been modified and amended so many times that it is now at the point when taxpayers need to be very tax literate to correctly comply.

But taxpayers do not go into business to learn about tax and how to fill out forms. Taxpayers now face elaborate processes when it comes to complying with tax laws. While the study of small business compliance costs has done much to add to our knowledge on what they are and how they impact on small businesses and the economy, little has been done to address how small businesses can better manage the tax process from start to finish.

Rather than sit on the sideline and snipe at Government to do something, NZICA and Tax Management NZ have decided to put this paper together as a constructive think piece to raise awareness and promote thought and discussion on some fresh approaches to tackling the ever wearisome tax compliance burden for small business.

The Purpose

The purpose of this paper is to help determine whether there is a mood with both policy makers and small business owners to tackle tax compliance costs: because we believe our proposals could help cut income tax costs for small businesses by approximately a quarter to a third.

So, who are we and why do we spend time thinking about tax compliance?

About the New Zealand Institute of Chartered Accountants (NZICA)

NZICA is a professional accountancy body with over 31,000 professionals as members. Our public practitioners are Chartered Accountants who are in contact with thousands of New Zealand businesses every day.

While many people probably think of stuffy white-headed old men with pencils behind their ears when they think about accountants and auditors, the Institute is a lot more than this. Unbeknown to many New Zealanders, the Institute has been heavily involved in commenting and making submissions to Government and Parliament on New Zealand's tax policy and practice for over 30 years.

Also a little known fact is that the Institute operates on a public interest mandate. This means that when it develops accounting rules, or advises Government or Parliament on tax matters, it looks to best practice and the best outcomes for New Zealand as a whole, not just those of our members.

Indeed, the ideas presented in this paper may generate less tax compliance and related work for many of our tax practitioner members. However, this is a natural corollary of making life simpler.

The benefit to small business owners is less time, money and hassle spent on mundane tax compliance. This also allows Chartered Accountants to spend more time doing what they do best: focusing on adding value to businesses to assist them to develop and grow. This is really where our members, your Chartered Accountant, want to focus their energies.

About Tax Management New Zealand Limited (Tax Management NZ)

Tax Management NZ was founded in 2003 by Ian Kuperus and was the first company in New Zealand to help businesses reduce their tax compliance costs by designing and developing a process for businesses to trade their over-payments of provisional tax.

Tax Management NZ has also developed Tax Finance which enables businesses to finance provisional tax at a low interest rate and provide additional cash flow flexibility for business growth.

Ian Kuperus is a member of the Institute of Chartered Accountants National Tax Committee and has a longstanding commitment to working to improve the business tax system.

The foundation of Tax Management NZ is a commitment to developing and maintaining excellent relationships with its key stakeholders, New Zealand businesses, Inland Revenue Department, and Chartered Accountants. Tax Management NZ is proud to be a sponsor and participant in the preparation of this discussion paper.

Our framework

Our goal

Our goal for small business is no more than one hour, one return, and one payment every month for income tax and GST compliance.

Characteristics of a good tax system for small business

We believe the following characteristics should apply in designing any tax system for small business and have used these as a guide in preparing the ideas presented in this paper:

Simplicity: The tax system should be easy to administer and comply with.

Proportionality: The tax compliance burden should not be disproportionate to the business size: a small business should have a correspondingly small compliance burden.

Certainty: Certainty of tax liability is important for small businesses that sometimes need to make “seat of the pants” decisions.

Trade-offs favour compliance friendliness: In designing any compliance friendly tax environment, decision paths invariably meet at the intersection of accuracy, tax base protectionism and simplicity. For small business, the trade-offs need to favour simplicity.

Tax neutral: Overall our intention is not to change how much is paid. However, simplicity does not equal less tax. Trade-offs invariably mean there are unders and overs. In some cases more tax will be paid, and in some cases less tax will be paid.

Fairness: Tax and compliance burdens should always be seen to adhere to principles of fairness. That is, all other things being equal, we should pay what our neighbour pays.

Tell us what you think

Before we go any further, we want you to know that we want your feedback. This discussion paper is your opportunity to help us effect changes in the tax policies for small businesses. There are a number of ways that you can provide feedback to us. These include contacting us directly or entering your feedback into the SME website:

- Email: carla.feaikin@nzica.com, Tax Team Executive Assistant
- Post: PO Box 11 342, Wellington 6142 by February 2010
- Phone: Stephen Rutherford, Senior Tax Manager at NZICA on (09) 917 5918
- Phone: Craig Macalister, Tax Director at NZICA on (04) 474 7860
- Website: www.smetax.co.nz

Following your feedback we will then finalise our proposals and formally submit them to Government for their consideration.



Executive summary

This report highlights two proposals to reduce tax compliance costs for small business taxpayers who have substantially active business income¹. Typically a small business is categorised by the number of people it employs. This discussion paper does not measure a small business by the number of employees it has, but rather by its levels of turnover.

The first proposal targets business activity that is operating on a very small turnover scale which we have termed the "Micro Business Taxation" proposal. The second proposal captures those small businesses whose turnover is up to \$1.2m which we have termed the "Small Business Taxation" proposal.

Each of the two proposals is discussed in more detail below:

Micro Business Taxation

We propose a very simplified basis of taxation for micro business taxpayers who are:

- Unregistered for GST
- Have no employees and have a turnover of less than \$60,000 at the time of opting to use this model
- Running a small business or in the process of business start up
- Those people earning periodic cash receipts from "under the table" income

The tax paid will substitute for income and fringe benefit taxes (if applicable). More specifically:

- A final income tax rate of 15 percent will be paid on business turnover
- Tax payments made monthly or at any time
- No filing of returns
- The micro tax of 15% includes a component for Accident Compensation levies
- Income for the purposes of social policy commitments (child support, student loans and working for families tax credits) is 50% of gross income
- The income will be transferred to the taxpayer's summary of earnings and no further income tax on this business income will be payable
- A transitional rule for people who earn cash "under the table" will give a 12 month window for people to enter the tax system without further repercussion for past year's earnings from undeclared income from these sources provided all tax is correctly accounted for going forward

Small Business Taxation

This proposal is a much simplified taxation model for small businesses with:

- Turnover less than \$1.2m
- Designed for more established businesses but could also be used for start ups if desired
- Income tax will be calculated on a cash basis on the GST return, as an adjustment to the GST result²
- Like GST, income tax will be paid every two months: there will be no year end adjustments, no provisional tax and no fringe benefit tax

More specifically:

- Small business that trades through a company or partnership will be taxed analogously to a sole trader by taxing the entity based on the personal marginal tax rate structure
- Transactions, such as dividends and salaries, between the business entity and its owners are eliminated, as is the need to maintain an imputation credit account
- Income tax and GST will be calculated and paid two monthly on a simplified cash basis
- No balance date and square up issues
- Trading stock (except for livestock) purchases are deducted on a cash basis – no need for stock takes for tax purposes
- No provisional tax, no fringe benefit tax and no entertainment tax
- Simplified rules for depreciation

Inland Revenue and the Accident Compensation Corporation systems will also have to be able to support the resultant processes. Concurrently and independently work is being undertaken by the Ministry of Economic Development which, among other things, is considering removing the statutory need for financial statements for smaller entities.

The micro and small business taxation models are discussed further below. As the objective is to reduce business compliance costs we need to know what businesses and others think. The more information we can provide policy makers about what you want, the better the outcomes are likely to be.

¹ The proposals are not designed for investment income or passive activities.

² This can be achieved because in many ways income tax and GST are calculated on very similar concepts, they just use different labels. That is, in a GST context we use the terms output tax and input credits and, in an income tax context, we call these things income and expenses. GST is paid on output tax less input credits, and income tax is paid on income less expenses.

Expanding the issues

The need for reform of small business taxation – defining the problem

It is well known that the complexity of a tax system has a detrimental effect on an economy. Complex tax rules:

- Reduce voluntary compliance
- Increase taxpayer and administrator error
- Increase taxpayers' perceptions that the tax system is unfair
- Undermine the integrity of the tax system
- Increase the economic drag on businesses as they divert resources away from their most productive uses

New Zealand's tax system was once a fairly straight forward affair, but over the years it has become increasingly complex. In the 1970s we had a single volume of income tax legislation and paid provisional tax twice a year. Following reforms such as fringe benefit tax, goods and services tax, international tax, imputation, and resident withholding tax, to name a few, we now have four large volumes of tax legislation.

Although the flatter 33% tax rate structure we enjoyed in the 1990s provided compliance benefits, these have been long since been eroded with the increase in the top personal marginal tax rate, which until recently was 39%. On top of a misaligned tax rate structure, we have also had layer after layer of patches and band-aids added to try and prop the tax system up and keep it running as intended. Further components of our tax system that add complexity are the linkages to the delivery of some social assistance measures through the tax system, and some of the behaviour drivers this creates³.

The introduction of harsh penalties, use of money interest charges for errors, and a costly disputes system, has heightened taxpayer's awareness of the complexity of our tax system and contributed to people's dissatisfaction with our current system.

Simplicity is regularly identified as a goal for our tax system, but it is all too rarely achieved. Too often the rhetoric of tax simplification accompanies various legislative amendments, but then quickly becomes more symbolic than real when the level of tax compliance costs fail to track downward⁴.



Does one size fit all?

As many people, including policy makers, are well aware, New Zealand business is largely comprised of small sized businesses. Statistical data shows that approximately 90% of New Zealand businesses have five or fewer employees with about two thirds of these businesses being run by owner-operators. Yet our "one size fits all" tax system design means we tax the corner dairy under the same rules as our largest corporate taxpayers.

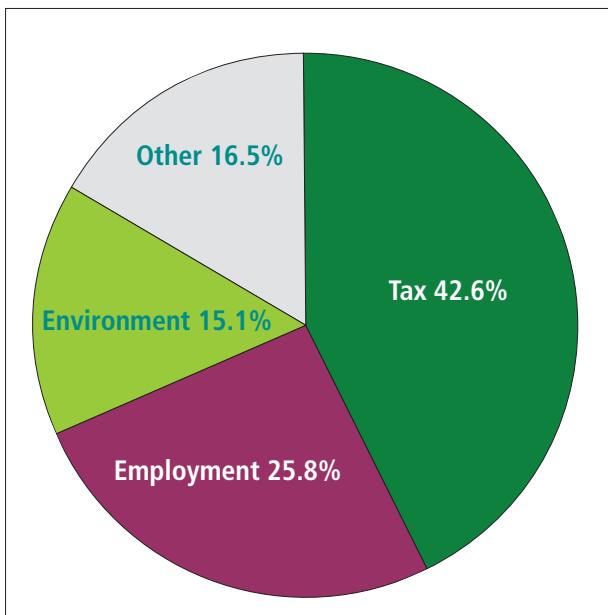
The one size fits all approach to taxation in New Zealand has given rise to complexity creep for smaller businesses. In the micro and small business context, rising complexity means rising costs. A recent example of this was the changes to our fringe benefit tax rules when the multi-rate method of taxing fringe benefits was introduced. So, much like wearing clothing that is two sizes too big, our tax system has become a bad fit for many of our businesses.

While a certain level of compliance costs is inevitable, excess compliance costs undermine productivity. For an economy such as New Zealand's that is seeking to foster a vibrant small business sector, it becomes even more important to keep compliance costs down. In terms of the overall compliance burden, taxation compliance costs are the largest single compliance cost businesses in New Zealand face, as the following pie chart shows⁵.

³ Although we note that addressing the linkages between the income tax and social assistance delivery mechanisms is outside the scope of this paper.

⁴ As the Business New Zealand KPMG compliance cost survey results for 2003 to 2008 show.

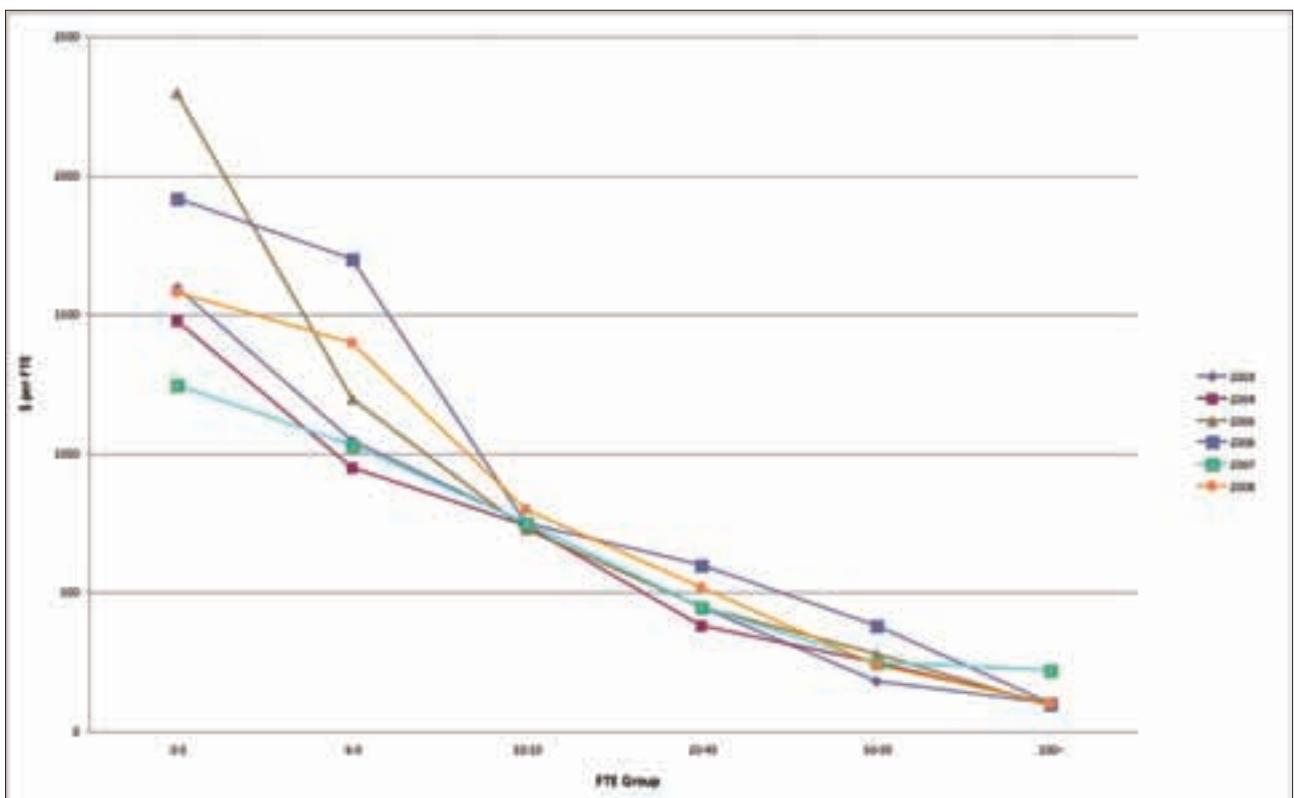
⁵ Source Business NZ/KPMG compliance cost summary report 2008



It is also well known that tax compliance costs fall disproportionately on small sized businesses. While larger businesses also face compliance costs - and are not to be overlooked - focusing on compliance cost reduction for small business is where the biggest gains to the New Zealand economy will be made in this context. This is highlighted in the graph below, that illustrates this over a six-year period, by looking at tax compliance costs per full-time equivalent (FTE) employee. In the graph, the FTE group refers to the size of the entity measured by the number of employees.

While New Zealand has put a strong focus on reducing tax compliance costs over the past 20 years⁶, tax compliance costs still feature as a major concern for business and Government. One of the limiting factors to simplification over the years has been the imposition of revenue neutrality. That is, successive Governments have been happy to simplify the tax system, but not at the expense of revenue. This constraint has often meant that tax simplification has taken a back seat to design features thought necessary to protect the tax base against potential revenue losses, whether hypothetical or real.

The strong message is that the one size fits all model of taxing New Zealand's businesses is no longer sustainable – hence our desire to simplify tax compliance for small business.



⁶ While simplification was not a foreign concept to New Zealand Governments, the 1990 Waugh Simplification Committee was the first Government initiated committee dedicated solely to tax simplification. Since that time there has been an increased emphasis on simplification by successive Governments.

Our goal

The initiatives outlined in this paper shake off paradigms of the past and start afresh against a framework of “no more than one hour’s tax compliance cost per month” for micro and small businesses. The principal objective is to minimise time spent by business owners (and their tax agents) on compliance matters, thereby helping provide business people with more time to spend in their business or with family.

Compliance costs defined

Compliance costs in a tax sense, as defined by the Ministry of Economic Development and the Business New Zealand KPMG Compliance Cost Survey, are the administrative and paperwork costs imposed on businesses complying with their tax obligations. However, the actual tax cost itself is not a compliance cost. Compliance costs also include non-monetary time spent by businesses including the additional stress and anxiety of tax compliance. Stress and anxiety could be related to a tax dispute, an income tax investigation, communicating with Inland Revenue or the pressure of getting the paper work completed and payments made in a timely manner.

In the Institute’s experience, the question often arises of whether the cost of preparing financial statements for businesses is a tax compliance cost. In the Institute’s view, in the context of a small business, when there is often no separation between governance and management, the cost of preparing annual financial statements is probably more of a tax cost. However, when there is a separation of management and governance, as you would expect with bigger business, the cost of financial reporting is less likely to be solely tax related.

The suggestions within our proposals remove the need for financial statement preparation for tax purposes for small business. Businesses may still desire annual accounts for commercial reasons, however, when they do, this will be because the business owners choose to incur this cost for reasons other than tax.

The Proposals

Micro Business Taxation

A new basis of taxation is proposed for active micro businesses. This targets business start ups, but could equally be used by people who run micro businesses and never intend, or want, the business to develop beyond that size.

The other category of people who will be able to make use of this approach to paying tax are those who earn small amounts of income outside of their principal source of income, such as earnings as an employee or a beneficiary. That is, the model also gives some incentives and better opportunities for people who derive some money “under the table” to meet their tax obligations.

Who are we calling micro?

Like most things in tax we need a definition of what we regard as a micro business. The Ministry of Economic Development defines small business based on an employee count. However, we believe we also need a turnover rule to capture the right sized entity.

We have defined an active micro business as a business or activity that employs no staff and has a turnover (gross income) that does not exceed the GST registration threshold of \$60,000 in a 12 month period. That is, a cash turnover of \$5,000 gross a month. We have not limited our proposals to any particular entity type at this stage. That is, there is no reason in principle why a company should not qualify.

Because we are principally concerned with business tax compliance costs, we have excluded investment income from the ambit of the proposals. Therefore, rental income or interest receipts will not be eligible to be taxed under these rules. However, if you disagree, please tell us.

To avoid excluding people from these rules when their income fluctuates around the \$60,000 threshold, we propose to allow businesses a safe harbour of 40% of this figure. This would allow businesses to remain in the micro rules until their turnover exceeds \$84,000 or \$7,000 per month. A flexible threshold also avoids the irony associated with a fixed threshold, that an increase in compliance costs arises when the threshold is exceeded or when people unnecessarily monitor it.

Thus, the idea would be that a business could not, as of right, enter the micro taxpayer rules if their annual income was over \$60,000 in a 12 month period, but if they entered the rules when turnover was below this figure, say at start up, they could remain within the micro taxation until turnover exceeded \$84,000.

Another way of looking at the turnover test would be to focus on the monthly turnover. That is, a person would be eligible to use the micro rules if their monthly turnover was less than \$5,000 and they would continue to be eligible until monthly turnover exceeded \$7,000. We would be particularly interested in your views on this.

In any event, for those people growing their business, we hope that it will be inevitable that they do exceed the micro business threshold. When this happens, we have an easy way to move into the small business taxpayer rules (as discussed below). The small business model is very compliance friendly and will provide business owners good commercial information about their businesses also, so some businesses may prefer to be in the small business model in any event.

As with our other proposal, adoption of the micro business rules would be optional. It could include those in receipt of income subject to withholding tax deductions and IR 56 payers (home help people if you are wondering who that is). As above, it could also be used by those people who do cash jobs in their spare time.

What will be paid and when?

What will be paid?

Micro entities would pay a final flat tax of 15% of turnover. The thinking underpinning this is based on assuming micro businesses spend 50% of their turnover on business-related expenses and the balance taxed at 30%.

The 15% tax is a final tax, and no actual deductions are available. The lower rate reflects the fact that the business would otherwise have been entitled to claim tax deductions for business expenses. Because you cannot claim deductions, you pay a lower rate.

This single final tax would be a substitute for income tax, including entertainment tax and fringe benefit tax obligations. The tax would also cover accident compensation levies but exclude social policy commitments,⁷ as discussed below.

When will it be paid?

The tax would be paid monthly, but could be paid at any time, such as on receipt of the income.

Payment will be by way of electronic transfer, but payments by cheque, credit card, eftpos or cash can be made through Westpac or an Inland Revenue office. That is, a micro business owner could go into Westpac when they happen to be passing, fill in a pay-in slip, tick the micro business box and pay the tax – end of story.

Another option is whether the banking system could account for the tax to Inland Revenue from all business banking. That is, when money is deposited, 15% is automatically transferred to Inland Revenue through the banking system. Obviously this would require agreement with the major trading banks.

In the case of an individual, the income amounts on which the tax is paid will be transferred to a summary of earnings. The SOE will recognise the source of the income from the payment code and no further income tax will be payable.

Social policy taxes

Child support, student loans, working for families tax credits and the like, all work off 12 months' (a tax year's) income. The income for the micro business will be taken into account for social policy purposes. However, only 50% of the income will be counted. This is because we have assumed 50% of the income is actually spent in deriving the income. In other words, it's not appropriate to tax the gross income for these purposes.

Also, given that the tax is a final tax (and assuming no other earnings) it may be possible to use the month's income for the purposes of calculating tax credits, such as working for families, and obligations such as student loans and child support. This is the model we have adopted for our small business proposal, and could be adapted for the micro business rules.

Accident compensation levies

At present people in business pay two main accident compensation levies; a work place levy for work accidents and an earner levy for accidents outside the work place. Accident compensation levies are based on the income returned for tax purposes. For micro businesses the levies can be confusing and the levy bill unexpected. This is particularly so in the first year of business. Further, as with income tax, it is unlikely ACC levies are paid on intermittent cash earnings.

Under our micro business proposal, a portion of the 15% tax paid will be transferred to ACC to provide cover under the CoverPlus scheme. The minimum level of cover under this scheme for the year ended 31 March 2009 was \$21,320.

This will provide cover from day one which means that self-employed people will, as a minimum, be entitled to the 80% of their micro business earnings if they are incapacitated.

This will also go some way to legitimising accidents arising from some cash jobs. At present, many of these accidents may well be covered by the earner levy when the person also works full-time.



⁷ Child support and working for families tax credits and the like.

Inland Revenue audits

As there are no expenses to check, nor FBT or GST considerations, any income tax audit will generally be straight forward. Inland Revenue audit activity will be essentially confined to checking that the correct amount of income is accounted for. For this reason we will be recommending a tax audit guideline of three months from start to completion of a tax audit.

Some transitional issues

Taxpayers who may have previously found the hurdle and frustration of paying tax on income a barrier to compliance, will be able to declare income under this model and know that once the tax is paid that is the end of the matter. Thus, people who have earned income "under the table" in the past may well be encouraged to pay the 15% tax to contribute their part to the schools and hospitals our taxes pay for.

However, they may be worried about tax on income earned in prior years. If they start paying tax under the micro rules then Inland Revenue may well ask about prior years. For this reason, we would propose a transitional measure that if Inland Revenue has not previously identified undeclared income from the source to which the business activity relates, they will be statutorily precluded from chasing prior year's income from these sources. That is, a form of amnesty for prior year's undeclared earnings provided tax is paid going forward on that income source, such as tax on "cashies" for example. Without such a rule taxpayers may be dissuaded from entering the tax system. This rule provides an incentive for people to start paying tax and legitimising their earnings.

We propose that the transitional rule be available for a period of 12 months to ensure people are given every incentive to enter the rules.

Benefits

The compliance burdens freed up by these rules are material. The record keeping requirements would be minimised, the entity would not need to comply with rules in relation to income tax filing, expense deductibility (including entertainment tax), balance dates adjustments, FBT, ACC levies and so on: all it requires is payment of 15% of the gross turnover.

The flexible threshold figure, (whether a monthly or annual threshold is used) allows micro businesses to exceed the threshold by an additional \$24,000 for a 12 month period (or to trade between \$5,000 and \$7,000 per month) before being pushed out of the rules because they hit the threshold.

This almost completely removes the compliance obligations except for the "shoe leather" costs of the actual payment of the tax.

Further, if Inland Revenue audit a micro business, the issue will only be whether all income and associated tax payments are accounted for. Taxpayers who have pocketed cash for small jobs will be incentivised to use these rules and legalise their earnings for tax, ACC and social policy purposes.

We have researched the international use of these taxes based on turnover for small and micro businesses. Anecdotally the use of a single tax for the taxation of micro business is an effective simplification measure (particularly in relation to the compliance burden on taxpayers with very low turnovers) and can go some way toward combating small business tax evasion, which happens when the compliance costs are disproportionately expensive or time consuming when compared to the tax involved⁸.

Interestingly South Africa introduced a turnover tax model this year. Businesses with turnover below R1,000,000 (approximately NZD190,000) could apply to pay tax on their gross turnover. A further criteria required businesses not to be registered for GST, even if they would have been otherwise required to. Anecdotally it appears that this latter requirement has impacted the take up, as we understand businesses in South Africa do not like to deal with those businesses that are not GST registered.



⁸ An example of a similar approach is that adopted by Slovakia for entrepreneurial activities. This allows either a 40% or 60% flat deduction for expenses, but applies the normal tax rates. Tax receipts have increased under this model. Empirically it cannot be proven that this relates to the simplified tax system, but anecdotally we were advised this is the case.

Disadvantages

Under standard rules tax liability is more accurately assessed. Within the proposal tax is based on turnover with the rate adjusted to reflect an assumed level of expenses. Thus, if costs exceed revenues, no loss under this model arises.

However, this is the trade off for simplicity. People can still use existing standard rules if they wish to incur the extra compliance costs of doing so.

Micro business examples

Casual earnings – Burt, the Plumber

Burt is a plumber employed by a local plumbing company. Burt is often asked to help friends and acquaintances with plumbing work. He has installed showers, baths, toilets and the like.

If it is a big job Burt will charge about \$200 for a day's work. Burt does not file income tax returns and has little to do with Inland Revenue as he pays PAYE through his main job. Burt has checked the Inland Revenue website for information on his obligations that informs him that he has to file an IR 3 tax return. However, Burt has no idea what an IR 3 is and he has not kept full records. What's more, Burt cannot be bothered with all this form filling stuff. The result is that Burt just does not bother to pay tax on this income: it's all too hard.

We agree that it's too hard. Under the proposed micro business rules Burt can pay \$30 (\$200 @ 15%) for his day's work and that will satisfy his core tax obligation on that income, as well as relieving him from ACC obligations. There is no further tax payable and thus Burt knows that if Inland Revenue call he has nothing to worry about.

Half the income amount (\$100 in this case) will count towards any child support, student loan or other social policy obligations. However, under current policy settings this is the right result. Quite possibly this may put Burt off paying tax, but that is Burt's decision. What the micro rules do is remove the paper work and associated hassle that goes with meeting his legal obligations. They also legitimise

Burt's income such that the risk of Inland Revenue detecting the income and assessing tax, interest and penalties (of up to 150% for evasion) is removed - the rest is up to Burt.

Self employed – Angela, the Barrister

Angela is a self employed barrister returning to work after starting a family. Her annual income for the year to 31 March 2010 was \$55,000. The income is largely derived from legal aid and private client work. Her expenses are her practicing certificate, motor vehicle, phone, fax, stationery, photocopying, insurances, ACC, continuing education, office in the home and accounting. These total \$6,000pa, which includes \$950 for tax return preparation and some related advice.

Angela pays provisional tax every 4 months and pays ACC under CoverPlus, when she is invoiced after her tax return is furnished.

Her tax position is thus:

Income	\$55,000
Expenses	\$6,000
Net income	\$49,000
Tax on income 2010	\$9,220
ACC levy 2010	\$1,048
Income after tax and ACC levy	\$38,732

Under the micro business rules the outcome is:

- Angela would pay 15% on the gross income for tax and ACC. This is \$8,250 for the equivalent 12-month period. Her net income after tax and ACC is \$40,750.
- Angela could pay this monthly, when her monthly invoice is paid by legal aid, or she can pay the tax at anytime – for example if she received a cash payment from a client.
- If she decides to pay the tax when the cash is received, she pays the obligation across to Inland Revenue (through Westpac or an Inland Revenue office) as a tax payment in the normal manner. However, she could pay this with her monthly payment if she preferred.

Angela no longer gets financial statements prepared. However she has retained her accountant to prepare budgets and income forecasts for the family so they can monitor their financial situation. Angela can request a summary of earnings from Inland Revenue as further evidence of her income if required. Angela's bank can rely on this information to make lending decisions as her income declared for tax purposes can all be reconciled back to her bank statements.



Small Business Taxation

Aimed principally at taxpayers with active business income, the small business taxation model substantially simplifies taxation of income tax and fringe benefit tax (and GST to a lesser extent) by effectively putting small business on a cash accounting system for income tax, merging the GST and income tax obligations, eliminating FBT and entertainment taxes and simplifying some deductions such as depreciation. The taxation of companies⁹ is further simplified by merging company and shareholder taxation.

There are three main streams to our proposals:

- Introduction of a cash basis of accounting for income tax and merging the GST and income tax calculations so they are undertaken on the same forms, at the same time, using the same timing rules
- For companies, the taxation of the company and the shareholders will be merged by levying tax on the company earnings at a tax rate that is equivalent to that faced by the shareholders
- Eliminating fringe benefit and entertainment taxes and replacing these with private use adjustments.

Who are we calling small?

While many people seem to understand the concept of a small business, defining a “small business” for these purposes is not an easy task¹⁰. The main features will be a business when ownership of the business is generally held by one or two persons, long and short-term debt is secured by the business owners (in many cases over their own home), and the objectives of the business will be aligned with the objectives of the owners. Small business is also likely to not be a large employer.

For the purposes of our discussion, we believe a clear and easily managed rule is required to fit with our overall objective of a compliance cost friendly environment. Thus we prefer a turnover definition and do not propose that it be supplemented with an employee number count.

For this purpose we have defined a small business as a business with a turnover of less than \$1.2m for a period of 12 months – that is gross income of less than \$200,000 every two months. The threshold for this business taxation model is based on the previous threshold used for paying GST on a payments basis. The structure of the threshold also allows access to the rules to be monitored by turnover in a monthly or two-monthly period, much in the same way as the GST registration threshold works.

However even if turnover exceeds \$1.2m in a 12 month period, we won’t force you out in the cold once income is above this figure. As with the micro proposals, we propose a safe harbour buffer of 40% of turnover. Thus, taxpayers will be allowed to continue to trade under this model, as long as their annualised income does not exceed \$1.68m¹¹ (or 280,000 every two months) at which time they will have to revert to the standard basis of taxation from the commencement of the next tax year.

Cash basis accounting for income tax and merging GST and income tax calculations

Simplifying the tax system for small businesses to a cash payments basis for accounting for income tax has the advantage of being inherently simple. Being on a cash basis, also means that income is represented by cash inflows so businesses have the ability to meet their obligations as they arise.

Further, a cash accounting basis for income tax means that income tax and GST (payments basis) calculations can be merged. Merging the GST and income tax returns can be achieved because, at a fundamental level, the income tax and GST bases are very similar. That is, they both tax amounts that have come into the business (“income” in an income tax sense and “outputs” for GST) and allow deductions for outgoings (“expenses” in income tax parlance and “input tax credits” in the GST sense).

The income tax position can be determined by using the timing rules used for the GST payments basis of accounting for GST and making adjustments to the two-monthly GST return for things that are not taken into account for GST: such as depreciation, wages and interest, and for things that GST taxes or allows as a deduction but income tax does not, such as capital items. An adjustment would be required to recognise that income tax is calculated exclusive of GST, but this would be incorporated into the return filing software.

Merging the taxation of income tax and GST will only work when the two are measured on the same basis. That is, when the timing of recognising income and expenses is the same for both GST and income tax. The GST payment-basis timing rules would apply for both GST and income tax. This also removes any ambiguity for some small businesses that account for GST on a payments basis, but prepare annual accounts on an accruals basis.

GST and income tax could also be merged in principle for people who use invoice / accrual to account for GST and income tax respectively. However, with an invoice / accrual basis, potential issues with prepayments and bad debts and the like arise. While these are not insurmountable, we believe that merging GST and income tax for people using the invoice / accrual basis may quickly become complicated and undermine our objective of having a system that remains as simple as possible. We would be interested in views on this.

At the present time then, we propose the use of linking payments basis for GST, and cash basis for income tax, simply because we believe on balance, that this is the better model for the reasons stated above. It also aligns better with our view of how a small business should be defined as discussed below.

⁹ The discussion and analysis in this paper, as it relates to companies, is also relevant to partnerships. That is, the income tax of the partners could be accounted for at the partnership level and paid every two months along with GST.

¹⁰ *The Tax Compliance Costs of Small and Medium-Sized Business*, Evans and Tran-Nam, 2004.

¹¹ With the threshold for accounting for GST on a payments basis now at \$2m, the upper threshold of \$1.68m should not create any problems in this respect.

Merging the two calculations would mean that provisional tax would not be payable and instead it would be replaced with actual tax payments every two months. It would also allow for GST and income tax offsets, for example, a GST credit could offset an income tax payment. Potentially also, income tax losses could be offset against GST payments¹².

As we have stated, our goal is to reduce tax compliance time down to one hour per month and give small business owners more time to spend being productive. We think this goes some way toward this. Again, your feedback would be most appreciated.

Entry to the new entity type will be optional. Taxpayers will make the decision on whether the compliance costs trade-off of the new model suits them or not.

Merging the taxation of shareholders and their company

Shareholders of close companies will be merged with their company for tax purposes. This is achieved by taxing the company similarly to that of a natural person. The effect of this is to break down the legal tax barriers between the company and its shareholders so that in theory transactions between the two no longer have tax consequences. This also buttresses the proposals to eliminate FBT.

Obviously a big question is the tax rate that will then be used.

The tax rate cost

The tax rate changes are a key consideration. Companies currently pay tax at 30%, but income distributed to natural person owners of the company by way of salary or dividend is taxed at the personal tax rates of the shareholders that top out at 38% over \$70,000 income. This causes considerable incentives to restructure to chase the lower tax rate. Commensurately, there is an increase in compliance costs with a risk of Inland Revenue attention as such arrangements are a known Inland Revenue audit risk.

This business tax model proposes looking to the personal tax rates as a proxy for the tax rate that the persons who have overall control of the business affairs of the company would suffer if they owned the business directly. Thus, the personal tax rates will apply even if these individuals hold the shares through intermediaries such as other trusts and companies.

By using the personal marginal tax rates, all the complexities associated with dividends, imputation, and shareholder salaries disappear. This is a significant saving, particularly also if the company were to be later wound up or sold as no further tax liabilities would arise. In some ways this would actually make selling companies more commercially viable.

The down side is that instead of paying the company tax rate of 30%, the company will pay tax on the personal marginal tax rates of the shareholders. One way of doing this is just to tax the income using the following personal marginal tax rate structure as it applies to a single person of:

- 12.5% to \$14,000
- 21% to \$48,000
- 33% to \$70,000
- 38% thereafter

However, in many cases in New Zealand, the company comprises a two-shareholder type structure with both shareholders actively engaged in the business. If the above rates were applied to the company income we would be unfairly overtaxing the company income compared to the present rules which spread the income across both shareholders by way of shareholder salary. While this is arguably a cost of simplicity, we also want fairness. Thus, to ensure we allow the benefits of the lower personal marginal tax rates on the same basis as would have been the case under the current standard model, we propose that the marginal tax rate thresholds be doubled, provided both shareholders are full time (more than 30hrs a week) engaged in the business.

Thus, when both shareholders are engaged full time in the company's business, the company would be taxed as follows:

- 12.5% to \$28,000
- 21% to \$96,000
- 33% to \$140,000
- 38% thereafter

This gives the same result as that achieved now by way of shareholder salary paid to both shareholders. However, if there is a better way of achieving the same outcome we would be interested.

Any extra tax costs (over the existing company rate of 30%) will be offset to a significant degree by lower overall compliance costs and less risk of Inland Revenue audit attention¹³. The opportunity cost that is lost when a business owner spends time or other resources on tax compliance as opposed to the business itself is also an important consideration to bear in mind: that is there is a non-tax cost saving.

Under imputation, the company tax paid is in effect a withholding tax, and the final tax is paid when the company income is distributed. Under this model, there is no deferred tax liability at the shareholder level for retained company earnings.

However, when the effective tax rate exceeds 30% (which we hope it will as more people have time to focus on their business) we believe the trade off is worthwhile because of the simplicity and certainty of the new rules. If you think we have this wrong we want to know your thoughts.

An important point to ponder is trust ownership. Many people have a family trust owning the company shares. This is normally for creditor protection and estate planning reasons, which is entirely appropriate. Under our model the tax rate is set by using the personal tax rates of the ultimate natural person controllers of the company, up to two persons. When the shares are held by a trust there is

¹² This would need a formula to convert income tax losses to GST values.

¹³ Arising from Inland Revenue's audit activity focussing on personal services income and the use of intermediaries.

a view that the rate should be the trustee tax rate, currently 33%. While this is consistent with our model, it breaches our rule of fairness as it would allow some people to lower their tax by simply inserting a trust, while other people who are not established through trusts may pay more. Our preference is simplicity. Also, to the extent possible, tax rules should not drive behaviour. People can then still use trusts to own the company, but this will be for genuine commercial or family reasons not tax planning. Thus, we propose that the personal marginal tax rate structure always be used as a basis. If you think we have our heads in the sand on this point you may wish to tell us.

Other consequences

This will allow sole traders to become incorporated yet remain taxed much the same as if they were a sole trader.

By removing the legal barriers between the company and its shareholders for tax purposes there will be no need to pay shareholder salaries or dividends, so no more dividend and imputation issues. Once the income is taxed, it (including any realised capital gains), will be able to be distributed tax free.

Because all income will have been taxed effectively at the personal tax rates, overdrawn current accounts will no longer present any issues in normal circumstances¹⁴.

All income will be taxed on the one form. Any other income derived by the shareholders can also be included on a cash receipts basis and tax paid at the same time.

Further, this change would also do away with the income attribution anti-avoidance rules designed to stop individuals inserting companies between themselves and their employers to avoid the top personal tax rate.

Eliminating fringe benefit tax and other enhancements

Removing fringe benefit tax is consistent with the merging of the company and the shareholders for tax purposes: essentially a sole trader model.

Under our proposal, fringe benefit tax is replaced by non-deductible adjustments. That is, if a benefit is provided to a shareholder or an employee, the value of the benefit is denied as a deduction.

Because the company is taxed at the same rate as the principal shareholders, any benefits provided are effectively taxed under the multi-rate approach. This rests on the assumption that the expense add-back is equivalent to the fringe benefit tax cost, which is not always true due to the way the value of some fringe benefits is determined, for example, the value of the use of a motor vehicle. However, on the whole it is approximate to the fringe benefit tax cost.

We have also proposed that entertainment tax (that denies 50% of the deduction and GST input) does not apply for this class of taxpayer. These rules are complicated and compliance among small taxpayers likely to be low. As with fringe benefit tax, the same non-deductibility rule could apply.

The nuts and bolts

Key points under consideration for the small business rules are:

- Shareholders of close companies will be merged for tax purposes with their company, and the company taxed as though it were a natural person. This will allow sole traders to become incorporated yet taxed much the same as if they were a sole trader.
- There will be no need to pay dividends, so no more dividend and imputation issues.
- Shareholder salaries also disappear as there is no need to pay them either. This would also do away with the income attribution anti-avoidance rules designed to stop individuals inserting companies between themselves and their employers to avoid the top personal tax rate.
- Distributions (including realised capital gains) will be tax free as all tax is paid at the company level.
- Income tax and GST will be calculated and paid two monthly on a simplified cash basis. This will also accommodate GST and income tax set off, when there is an amount owing under one base and a credit under the other.
- Balance date issues and square ups will go.
- Trading stock (not being livestock) deductions arise on a cash basis. Thus there will be no need for stock takes and trading stock adjustments.
- Provisional tax will not be necessary when the tax liability is met every two months.
- Losses stay within the company and carry forward to the next two-month period and so on. Because tax is determined every two months, there is a lesser need for loss continuity rules. However, to protect loss trading we propose that only shareholding changes between associated persons be excluded from the current continuity rules.
- FBT and entertainment tax rules vaporise. Under the new rules private benefits (to either shareholders or employees) will not be deductible. There is a remaining issue with low or interest-free loans that may need further thought as denying deductions on interest could be more difficult than levying FBT.
- Simplified rules for depreciation. For example, items of depreciable property (excluding buildings) will be pooled and depreciated at the pool default rate of 20%. Because there is no tax year end as such, depreciation deductions commence from the next two-month period.
- Some private expense adjustments will be by way of a fixed allowance, for example, the private motor vehicle adjustment will be added back as a fixed allowance of 25% of motor vehicle costs.
- Deduction for shareholder loss of earning insurance and ACC CPX xtra premiums.

The return will be electronic and will automatically pre-populate certain key information from the businesses' bank statements.

¹⁴ Although it may be necessary to think about excessive drawings funded by borrowings.

Small business example

Burt again

Burt decides to cease work as an employee and go into business on his own account. Burt incorporates a company, Burt's Plumbing Limited, with \$10,000 equity and a floating overdraft. Burt purchases a Falcon utility for \$10,000, welding plant for \$7,000 and ladders for \$500. He already has most loose tools required. Burt's only other outlays are consumables, trading stock and motor vehicle expenses. He elects to use the uniform private use expense adjustment for the motor vehicle and adds back 25% of the vehicle costs (which automatically adjusts for income tax).

Burt's accountant prepares cash flow forecasts for a business overdraft. His accountant advises Burt that he should use the small business model to calculate and pay his GST and income tax.

Burt's Plumbing Ltd GST and Income Tax return for the two-month period to the end of March 2010

Return period	February	March
GST		
Sales (output tax)	\$5,000	\$10,000
Expenses (input credits)		
Truck	\$10,000	-
Plant	\$7,000	-
Ladders	\$500	-
Purchases	\$1,000	\$2,000
Consumables	\$300	\$600
Motor vehicle (less 25%)	\$400	\$600
Net cash position	(\$14,200)	\$6,800
GST (refund) / tax to pay	(\$1,577.78)	\$755.56
		\$822.22
Income tax		
Add back non-deductible items		
Truck	\$10,000	-
Plant	\$7,000	-
Deduct		
Depreciation	\$503.70	\$503.70
GST adjustment ¹⁵	\$311.11	\$755.56
Interest on overdraft	\$42	-
Assessable income	\$1,943.19	\$5,540.74
Tax		\$1,373.13
Total income tax and GST for the two-month period		\$2,195.35

Burt's Plumbing Ltd income tax is calculated based on the annualised amount of the cumulative two-monthly result. In the example, the income for the two-month period was \$7,483.93, which is an annual income of $(\$7,483.93 \times 6)$ \$44,903.58. No one else is engaged in the business so the tax on \$44,903 for the standard tax year in which the GST period falls (2010) is \$8,239.63 (based on the personal marginal tax rates), which gives a tax rate of 18.35%.

This rate is applied back to the income of \$7,483 for the two-month period to give \$1,373.13. This amount is the final income tax liability for that period. Once this is paid, all other things being correct, Burt's Plumbing Limited has clear retained funds that can be used by Burt for any purpose without any further tax implications to think about.

As above, the tax rate used is that applicable for the tax year in which the GST period falls. In this case, the GST period was to the end of March 2010, so the personal rates for 2010 are used. Had the period ended in April 2010 the rates for 2011 would be used. If these rates were not available, the 2010 rates would still apply. However, there is no income year as such: each two-monthly period represents a final assessment for that period. No FBT liability arises in respect of the company vehicle¹⁶. Instead a private use allowance adjustment is made of 25%.

Trading results may be required for other reasons, such as banking or finance obligations. Under this approach the results for any trading period (ending on a GST return date) required will be able to be extracted. However, Burt could still engage his Chartered Accountant if he desired a full set of financial statements.

Burt will prepare his company's two-monthly return based on his bank statements for the period, or he could have his Chartered Accountant prepare the return.

Importantly, our goal of no more than one hour per month needs to be achieved or we have not succeeded. The question is, can Burt or his tax agent complete the two-monthly GST and income tax return within two hours?

¹⁵ This converts the GST inclusive figures used in the GST return to the GST exclusive figures used for income tax purposes. For January the adjustment is on \$2,800 being net cash position of \$14,200 adding back \$17,000 of capital items). For February, it is the GST payable figure of \$755.56.

¹⁶ Note, even if it were a "work-related vehicle" Burt drives it in the weekends and evenings so technically it would be subject to FBT for these times.

Accident compensation

The current ACC system could continue on a 12 month period basis, or the system adapted so that ACC levies could be calculated on the two-monthly result. If that were the case, in the example above the plumbing company would have paid a levy of \$1,960.89, which is \$326.82 for the two month period based on the 2009-10 levy rates.

Inland Revenue audits

Inland Revenue tax investigations could be conducted on these returns on the same basis as is currently, except that the GST model would be used. That is, once an audit has started Inland Revenue will have time frames within which the investigation is to be completed. For refunds, the current GST rules will apply. That is, if the refund is delayed by 15 days Inland Revenue will pay interest. For other issues, we propose a guideline within which to complete an investigation of 6 months. The only exception will be if evasion is alleged.

Social policy considerations

The two-monthly cash net profit (plus or minus non cash adjustments for tax purposes) is used as the income amount for child support, working for families tax credits (WFTC), and student loan repayments.

This means the liability or entitlement will increase or decrease if the income fluctuates. Thus for example, in the case of seasonal work, when the income is high, any child support and student loan obligations will increase to match the income and in the off season any child support or student loan obligations will decrease. Similarly, WFTC will be less when income is high and more when income is low.

Overall there should be a much better matching of obligation to the income than is the case presently. This will allow people in business to claim their WFTC every two months. Currently many business people wait until their year end accounts are prepared to ensure they can then claim what they are entitled to. Under this proposal, because the two-monthly results are available, the WFTC entitlement is also known.

Relationship with accounting

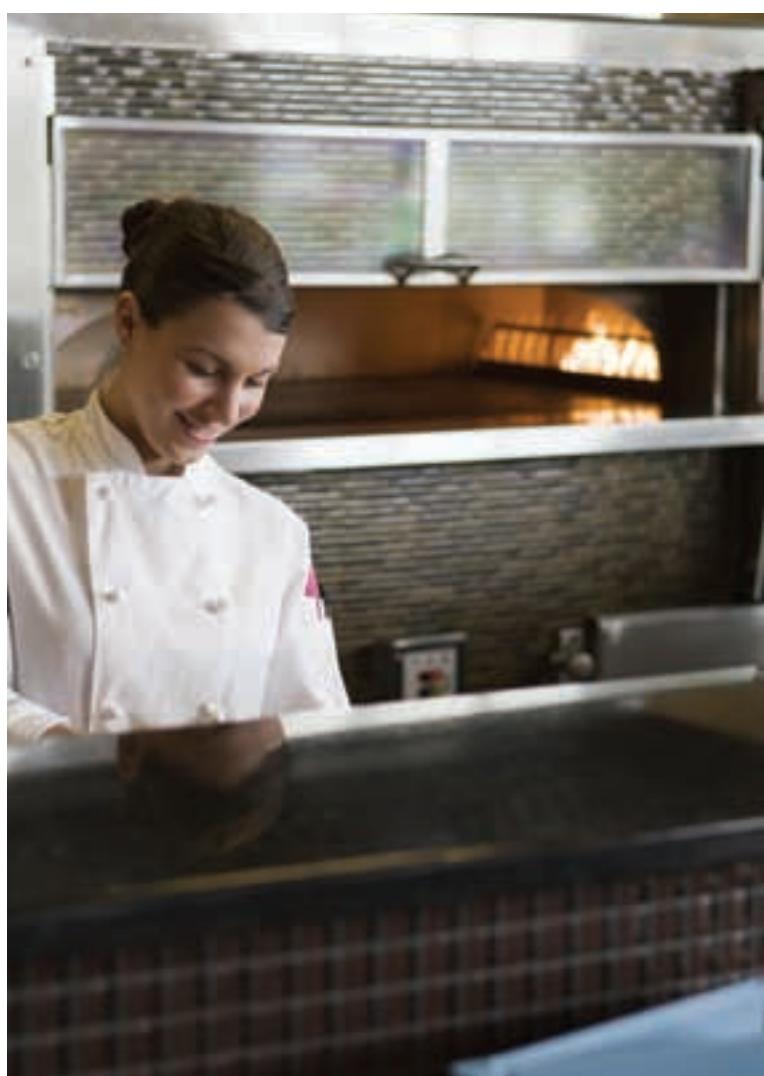
In a New Zealand context, many small businesses are not required to complete GAAP compliant financial reports. However even companies that are exempt from preparing financial statements that are GAAP compliant must still prepare accounts on an accruals basis¹⁷.

The reality is that many small businesses do have financial statements completed for commercial and tax reasons. While annual accounts would no longer be necessary as a precursor for tax return filing under the proposals in this paper, limited financial statements could easily be extracted from the data stored in the return filing software if an annual picture was required for any other purpose.

Thus banks monitoring compliance with lending criteria could have accounts extracted for any period (ending with a GST return period) desired. The obvious draw back is that the accounts would be prepared on the same basis as the tax return, which will be a cash basis. Therefore there would be a cost to convert the accounts to an accrual basis if desired.

We note that the Ministry of Economic Development (MED) has just released a discussion document, "The Statutory Framework for Financial Reporting" (see www.med.govt.nz), which among other things, discusses the need for small companies to prepare general purpose financial reports, see paragraphs 90 to 98 of the document.

The model proposed in this paper would compliment the MED's proposal to do away with the need for general purpose financial statements for small companies. That is, companies relieved from preparing financial statements for statutory reporting purposes will not then be required to prepare financial statements by default for tax purposes as may well be the case under current income tax settings.



¹⁷ As per clause 4 of the Financial Reporting Order 1994

Our questions to you

We have a number of questions that we seek your feedback to. They fall into three categories: general, micro, and small business taxation proposals.

General

As we said at the outset, the proposals outlined in this report will only work if they make tax compliance easier.

- Do you consider that either or both of the proposals will provide material compliance cost savings?
- Do we have our definitions right? That is, have we correctly defined micro business as businesses with no employees and turnover below \$60,000 or \$5,000 per month and small business as businesses with turnover below \$1.2m or \$200,000 every two months?
- A turnover test does not deal well with high turnover / low profit margin business such as petrol stations for example. Are there ways to deal with this, for example businesses that have net profits or residual income tax below a set threshold?
- If enacted, should the proposals be optional or compulsory?
- If optional, should people be bound by their election one way or the other as long as the business continues to meet the criteria?
- Given the radically different basis of taxation, how would an existing business migrate across to the proposal if enacted, that is how would such things as capital assets, trading stock and retained earnings be dealt with?

Micro Business Taxation Proposal

- Should the focus on turnover be a monthly test instead or a yearly one?
- Is the 15% flat rate the appropriate rate? The object is to strike the right balance between ensuring taxpayers pay a broadly equivalent amount to what they would have had had they gone through all of the calculations, but without the compliance costs.
- Should a GST registered person be allowed to enter the micro regime?
- Should one option for GST registered people in the micro rules while keeping their tax system as simple as possible, be to adjust the rate from 15% to a higher tax rate of 21% ($15\% + 0.5 \times 12.5\%$ and rounded down) to compensate for GST output tax? We concede that could prejudice people who have one off large GST input tax credits, but they may be better in the small business taxation proposals.
- Should there be any restriction on the types of entities that can use the micro rules? For example, allowing a company or trust to pay tax on this basis could facilitate social assistance advantages.
- Should people with rental income or other passive income be eligible for the micro regime?
- It is proposed that a proportion of the tax paid be transferred to ACC to ensure micro business owners have ACC cover. Is this supported or unnecessary?

- Is the 50% reduction of income for social policy taxes appropriate?
- Would the amnesty under the transitional rules proposal create an incentive for people to enter the micro regime, or is this too generous?

Small Business Regime

- As proposed, the small business regime is only available to people prepared to account on a cash basis. This is achieved by using the GST payments basis timing rules for both income tax and GST. Should the GST invoice and hybrid bases be available for income tax purposes also?
- For companies and partnerships, should a merger of the shareholders and the company, and partners and the partnership, be required when income tax is paid every two months with GST? As the proposal is set out in this paper, the two measures are linked.
- By removing the barrier between a small company and its shareholders, dividends and the need for shareholder salaries are removed from the tax equation. However an issue can arise if excessive drawings were funded by borrowings. We consider that this is not an issue as effectively shareholder equity is being replaced by debt. Should we switch off the automatic deduction for interest for companies?
- Should a company that has trustees as its shareholders, be taxed at the trustee rate of 33% or individual marginal tax rates?
- Is the two month cash net profit an appropriate base for child support, working for families' tax credit and student loans?
- Should each two month return period be a final period for social policy receipts and payments?
- Is the proposal for livestock as outlined in "Some questions and answers" section below workable in practice?

What questions have you got for us?

- Email: carla.feakin@nzica.com, Tax Team Executive Assistant
- Post: PO Box 11 342, Wellington 6142 by February 2010
- Phone: Stephen Rutherford, Senior Tax Manager at NZICA on (09) 917 5918
- Phone: Craig Macalister, Tax Director at NZICA on (04) 474 7860
- Website: www.smetax.co.nz

Conclusion

These approaches are designed to assist micro and small businesses by making their tax filing requirements more consistent with the size of their businesses.

One objective has been to minimise tax compliance obligations of small business people, thereby allowing them to focus on running and building their businesses. We have attempted to do this by designing our small business tax models to require no more than one hour per month on income tax and GST compliance. Whether the micro or small business owner then completes their own compliance obligations or engages a tax agent to do this, the time and costs will reduce significantly compared to the standard model that is currently required by everyone regardless of size.

The flow-on effect to record keeping and certainty will lead to further savings.

Because the proposals are aimed at small businesses, people with predominantly passive investments will be required to return their income under the present system.

Finally it may well be that taxpayers decide to incur the compliance costs associated with the current tax rules because they get a lower tax cost. This is the correct outcome as taxpayers will choose to take on those extra costs.

Some questions and answers

Will the rules be mandatory or optional?

Presently we favour an “opt in” model. This is because the simpler system is inherently more arbitrary. An opt in model allows taxpayers to trade off accuracy for compliance costs. That is, if a taxpayer believes the present (standard) system gives a better tax outcome, and they want to incur the compliance costs of using the standard tax rules, then they should be able to do this.

Do you need to apply the rules consistently?

Once you have elected into either the micro or small taxpayer rules, it is not anticipated that there be an ability to opt out. That defeats the compliance simplicity.

Why not include micro businesses that are registered for GST?

We have explored this idea. The target of our proposals is those businesses that are relatively unsophisticated in terms of their accounting and record keeping methods. It was thought that businesses below the GST registration threshold that wanted to register for GST would be better in the small business tax model.

However, one option to include GST registered people in the micro rules while keeping their tax system as simple as possible would be to adjust the rate from 15% to, say, 21%¹⁸.

How do you transition from the existing standard rules into the new micro or small rules?

We want to make it as simple as possibly for a business to migrate from the existing standard rules. However the issues can be a little tricky as this needs to be balanced against the need to not create opportunities for people to avoid tax. We set out our initial thinking below but welcome thoughts on this.

Micro

Given the completely different basis of taxation proposed for a micro business it would probably be necessary to have a notional business windup, and thus square up the tax liability under the previous rules. As with small businesses, retained earnings will be an issue.

Small

This issue can be a little tricky. For existing business, the change would occur for the period after the end of an income year. That is, the results of the previous year's trading under the standard rules would be squared off prior to entry. Capital account (depreciating) assets would move across at their written down value and be amalgamated and depreciated at the new single asset rate (recall though that buildings will use the building rate). Trading stock on hand at year end will be allowed as a deduction in the new entity if it has been paid for. If it has only been invoiced no deduction will be allowed until the invoice is paid.

If businesses have been accounting for income tax on an accrual basis then there will need to be an adjustment back to a cash basis for sales and expenses.

If the business has retained earnings, it may be necessary to pay a tax like the qualifying company election tax to move across or possibly the retained earnings could be carried forward.

Will company losses incurred when using the small taxpayer model survive a change in shareholding?

The small taxpayer model is analogous to the taxation of a sole trader. Consistently with this, the losses should stay with the shareholders. Thus, if there is a sale of the shares losses incurred will remain with the exiting shareholder(s).

Will the model work for farmers with livestock?

Livestock poses some particularly difficult problems given the significant value of livestock. Allowing all livestock to be deductible on the same basis as our trading stock proposal (which allows deductibility on a cash basis) would pose understandable revenue concerns.

An option we are considering is based on treating the herd as a capital asset that retains its value through animals bred to replace the herd as it ages.

Under this proposal no deductions are allowed for the original herd. On entry to the simplification system the farmer will nominate the number in the herd that is the capital asset. Any purchases / disposals (including deaths) to the herd are capital and adjust the herd number. Any natural increases have no tax implications until disposal, although the cost of breeding and rearing is deductible on a cash basis.

On disposal of the herd, the herd numbers recorded (initial herd plus purchases less sales) will be capital and non taxable. The natural increases will be taxable on sale (as costs of breeding were deductible).

Any additions/disposals of non herd animals are taxable/ deductible on a cash basis.

Any progeny / produce will be taxable on a cash arising basis (milk, wool, bred for sale lambs, calves, kids, fawns and the like).

¹⁸ That is, \$100 - \$50 notional expenses = \$50, which at 12.5% is 6.25%. If we round this down to 6%, the combined tax and GST rate would be 21%.