

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.

