



## Simplifying small business taxation

Following consultation, proposals to simplify the taxation of small businesses in New Zealand have been modified.

**AT THE** outset, we wish to acknowledge services supplied by accountants during the preparation of the annual accounts and return filing, such as the annual GST reconciliation and related business advisory, add significant value. This has never been in doubt.

However, what is in doubt is whether, if these services are engaged solely for tax compliance purposes, the cost is proportionate for micro and small businesses? Should they require this level of professional engagement to complete their filing and payment obligations?

A common view was that micro and small businesses will falter or run into financial distress if the need to prepare annual tax returns and the associated financial

statements was replaced with a cash-based system.

There may be some validity to that view in individual cases, but we were not persuaded that this would be a universal occurrence.

Annual financial statements are often prepared well after the balance date, which limits their usefulness if a business is failing. If a lending institution wants knowledge of the financial position of a business, a more up to date position than the last available financial accounts may be required.

Further, under the proposals, small business taxpayers would have financial performance measured every two months: albeit a cash-based assessment. This is more likely to signal when the business is starting to run into financial difficulty.

Many small businesses understand cash accounting and operate on that basis between annual financial statement preparations.

In saying that, we acknowledge that if micro taxpayers adopted the proposals they would have to reconcile earnings to their bank statements to get a picture of their financial performance.

### MICRO BUSINESSES

Many members prepare financial statements and returns for businesses with less than \$60,000 turnover. Some of these members felt the change to the turnover model means existing clients will no longer seek accounting advice.

In removing the obligation to file tax returns to meet tax obligations, there will be some people that will stop employing an accountant. However, we were not persuaded that this would mean the end of accounting services for this category of taxpayer.

The flat rate no deduction model does not suit everyone, and for some people the existing arrangements may be preferred. Also, many accountants produce financial statements and tax returns for this category of business at very reasonable prices: in some cases for as little as \$350. At that fee level, there may be little if any benefit in moving to the more arbitrary micro model.

The micro model had support if a suitable tax rate could be set for retailers, and the turnover threshold was set at a lower level. We reconsidered the \$60,000 turnover figure, but felt that, as it is the current GST registration threshold is \$60,000 in a 12-month period, it is the appropriate top end for micro businesses.

To better tax traders, a rate that recognises their cost structure is required. Also, following Budget 2010, we reconsidered the rate generally. At the end of the day, any rate is going to be arbitrary. Consistent with our principal that the rate reflects a 50% expense allowance, we believe the rate should be 14% of turnover for people principally deriving income from personal services and

7% for people principally in the business of retailing or trading.

We consider that it should be optional for business to report tax on this basis. While the rates are arbitrary and may over tax people, this is the trade off for simplicity and certainty.

Obviously, it is designed primarily for taxpayers in business. Thus, those people currently in receipt of scheduler (withholding) payments would qualify if they wished, but would not be entitled to expenses as they are now.

Those taxpayers in receipt of salary and wages would not qualify.

There was comment that people would rearrange their employment status. However, unlike the period in the 1980s, there is now more commercial awareness among taxpayers of the implications of doing this. That is, taxpayers are aware that if they hold themselves out as self-employed for tax purposes, they are unlikely to be regarded as an employee for employment purposes.

However, to further clarify the matter we would recommend that statutory criteria be developed for this purpose and that the legislative presumption be that a person who works for the one employer is an employee.

People who operate a part-time business that is distinct from their employment should be able to elect to have their business income taxed as a micro business, and not combined with employment or other income. That is, the income from the micro business would be ring-fenced within the micro tax rules. This is because, regardless of the person's other earnings, the micro rules are designed to reduce compliance costs. It would undermine the

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model and its objectives if the business proprietor who is also an employee had to incur higher costs for that reason.

Some criticisms were levelled at the suggestion that this model would assist in encouraging compliance by those that did cash work. We agree that more than this proposal on its own would be needed. What we were aiming to achieve in this context was reducing as many barriers as possible between the receipt of cash income and the payment of tax, such that the remaining hurdle was then a moral one.

We believe that there are too many hurdles involved for people in receipt of income from cash jobs: such that

it is just too hard, or they cannot be bothered to take the time to find out how to, pay tax. The proposals go somewhat toward alleviating these issues.

#### SMALL BUSINESS

In addition to the principal concerns raised by members, as discussed above, a criticism of the paper's proposals was that the turnover threshold of \$1.2m before you could no longer enter the rules and \$1.6m before you were forced out, was too high.

There was also criticism that there would be no effective means of undertaking a GST reconciliation (a function undertaken by many tax agents) if taxpayers attended to their own compliance work, and this was an area where tax agents identified a lot of errors in GST returns filed by the business.

We have considered these and the other concerns raised. We still believe that real tax compliance savings can only

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be made if a dramatic change is made to tax reporting for small business entities.

We propose that we stay with the framework of the October paper, modified to further integrate it with the GST system. That is, tax reporting a combined GST/income tax return prepared on a cash basis using the present GST reporting cycles. Quarterly reporting is a further option.

However, we agree that the turnover threshold of \$1.2m (which allowed up to \$1.6m before taxpayers were forced out) is too high given that the focus is “small” business. We propose that the regime will be limited to businesses with a turnover of up to \$600,000 per annum (retaining a number divided by 12 so two-monthly compliance with the cap can be easily monitored).

Under this modified proposal, for income tax and GST purposes, all transactions will be treated the same. That is, GST taxable supplies liable for output tax will be recognised as “income” for tax purposes. Thus, the GST time of supply rules will apply to determine derivation of income for tax purposes. Similarly, claimable deductions will align with taxable supplies received that are treated as input tax credits.

Essentially, all assets will be held on revenue account; deductible in full in the period of payment on a cash basis (with the exception of purchases of land and buildings) and assessable on sale. There will be an adjustment for non-business private use, a one-off adjustment at the time of purchase and an ongoing adjustment for operating expenditure at the same apportionment rate.

Interest and wages (and similar payments that have no GST component such as employer contributions to superannuation) will be adjustments to the income tax calculation.

In theory a further adjustment is required to put the income tax items on a GST-exclusive basis, but it may be that this is not necessary – we would have to give this more thought.

The adjustment for depreciation would not be necessary as all plant and equipment is deducted in full, apart from land and buildings, and in any event depreciation cannot now be claimed on buildings.

Accountants who use Banklink will be able to use the information supplied by Banklink to populate the GST/income tax return, and interface with front end suppliers such as Xero. This will further minimise time and cost.

In terms of merging the company with the individual controllers of the company for tax rate purposes, we believe this feature should remain – that is, paying tax on the progressive scale (with the thresholds doubled to allow for the standard two-shareholder trading company scenario) up to 33%. This allows each two-monthly period to essentially be a final period – in the way GST is now. Working for families, child support

and student loan repayments would all work off this figure. Thus, cash reserves will all be tax paid, and there will be no need for shareholder salaries or dividends to be paid at year end.


However, with full deductibility for most assets comes a risk that this could be abused. To minimise this risk and maintain the integrity of the tax system, if the government desired, an annual voluntary “health check” could be an elective feature of the regime.

We envisage that businesses that choose to have a health check would have this undertaken every 6th return filing period by a person who is a member of an Inland Revenue approved tax agent body. If a taxpayer has their approved tax agent perform a health check on their return, the business activities would then be regarded as a low risk to IR from an assurance perspective.

Other features of the proposal remain much as per the original think piece:

- All motor vehicle deductions for vehicles engaged full-time in the business will default to 80% for passenger vehicles. This recognises the reality that these vehicles all incur some private use and removes the need to keep log books. This meshes neatly with the changes to the GST rules to move to an apportionment basis.
- Because tax is paid at the personal marginal tax rates, there is no tax on any amounts distributed. Thus, no dividends (and related imputation issues) and no shareholder salaries are required.
- The tax returns would be treated as final in the same way as a GST return.
- No FBT for proprietor benefits, but an option to pay FBT on employee benefits or add back the tax deductible employee benefit cost (possibly based on agreed IR amounts).
- No entertainment adjustment – subject to private use adjustment if non business.

We have reconsidered the suggestions we made in respect of livestock businesses. We have had no feedback on these. Essentially the proposal treated the livestock as a capital asset – that is disposals and purchases of herd animals have no tax implications, but sales of natural increases (progeny) and produce such as wool and milk would be taxable. Under the changes to the model outlined above, all livestock would be deductible in full at the time of purchase and assessable when sold. The turnover threshold of \$600,000 would limit the number of farms that could use this basis of taxation.

Members’ and readers’ views are invited on the modified proposals. Email [taxquestions@nzica.com](mailto:taxquestions@nzica.com). 

*The original proposal Simplifying the Taxation of Small Business in New Zealand from NZICA and Tax Management NZ can be viewed at [www.smetax.co.nz](http://www.smetax.co.nz).*