

# Exploring alternatives to the late payment penalty scheme

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**National Research & Evaluation Unit**

Te Wāhanga ā-motu mo te Rangahau me Aromātai

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Aromātai

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## Section 1. Recommendations

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This study contributes to the development of the future state of the tax system. It identifies the more viable options to decrease the influence of late payment penalty (LPP) on the impairment of the debt book. To support the effectiveness of these options, new sanctions are also presented as complementary tools to support increased tax compliance.

### Potential alternatives worth considering further to the current LPP regime

#### **Cap the LPP**

The LPP will only be applied up to a maximum cap. Capping would prevent the value of the debt book increasing because of the LPP.

#### **Remove LPP and apply cost of money only**

Previous research findings indicate that it is not specifically the LPP that is driving payment of tax obligations on time. Having a sanction of cost of money has significant merit, because the consequence of non-compliance is still present as interest is charged on the debt. This approach to non-compliance is more consistent with a commercial operating model.

### New collection tools worth considering

#### **Credit reporting**

Reporting people with outstanding tax obligations to credit agencies could be used as an effective tool for increasing compliance.

#### **Travel Restrictions**

Restricting overseas travel by debtors is an option that has been applied for other debt, and could be used as an effective tool to encourage compliance.

#### **Require tax clearance for government contracts**

Requiring contractors to gain tax clearance before being awarded government contracts is relatively common in other tax jurisdictions.

#### **Withhold government payments to debtors**

This could be a useful tool to get debtors to contact Inland Revenue about their debt.

#### **Director penalty notices**

A notice is issued in regard to a company's PAYE obligations not being met. The effect of the notice is that if the debt is not resolved, the company director will become personally liable for the payment of the PAYE deduction.

#### **Compulsory electronic charge**

This would involve collecting tax debt by adding a charge to electronic transactions.

## Section 2. Purpose of the study

Is the Tax Administration Act (TAA) fit for the 21st century? The IR leadership team has been discussing some big ideas about the future of our tax system, in particular the legislation and the overall tax system we work with. Part of this discussion includes the potential to revisit the interest and penalties regime.

IR is increasing its focus on both the collection of debt and management of its debt book. In its current state the debt book is heavily impaired. High impairment means the value expected to be recovered is significantly lower than the face value.

The intent of penalties is to provide customers with incentives to comply. However, the current penalty and interest (P&I) regime contributes significantly to the makeup of the overdue debt book. P&I regimes vary across tax types and social policies.

LPP has been identified as being a major contribution for increases in tax debt, in June 2013 nearly 50% of the debt book was composed of interest and penalties charges. The purpose of this study is to gain insight into how the LPP is functioning and explore alternative options to the existing LPP regime, and is an input into the Encouraging Compliance Project, which is investigating policy and legislative settings applying to debt and penalties.

### Integration with IR debt work

This work is consistent with requirements of the long term programme of the IR debt work, to improve the characteristics of the debt book. A key expectation of the IR debt work once implemented is that “penalty and interest regimes do not artificially inflate revenue on bad debt”. This programme builds on existing initiatives across IR and introduces new priorities, capabilities and technology to enable the organisation to achieve an improved future state for debt.

It is expected that this study of the LPP regime will underpin IR’s ability to:

- improve the understanding of and influence over customer behaviour
- provide a wider range of more flexible policy options
- treat customers differently, recognising that risk profiles and behaviours differ.

### Key research questions

1. What are the tools IR has currently available to encourage voluntary compliance?
2. How effective are these tools?
3. If the tools are not being used or under used, why?
4. What are the different tools other tax jurisdictions use to encourage voluntary compliance, and how effective are they at encouraging voluntary compliance?
5. Does Australian Tax Office (ATO) consider that removing the LPP has been effective?

## Approach to this study

1. Review of the previous IR research involving the Identifying Sanction Thresholds<sup>1</sup>, and consider international practice relating to tax compliance<sup>2</sup>.
2. Focus group discussions were held with 21 staff from IR's Collections business group based in Napier, Manakau and Takapuna (as suggested by the sponsor), three staff from Policy & Strategy, and the IR liaison with Business NZ, about the current LPP operating model. The participants identified suggestions for improvements, and feedback on alternative compliance tools.
3. Information was obtained from three staff from the ATO on removal of the LPP, and introduction of a cost of money penalty regime.

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<sup>1</sup> Intervening to reduce risk: identifying sanction thresholds among SME tax debtors; Poppelwell; eJournal of Tax research vol.10 no.2 2012.

<sup>2</sup> Tax and Compliance, Lisa Marriott, Victoria University of Wellington, June 2013

## Section 3. Current state of the LPP

Advocates of the existing LPP believe this penalty delivers compliant behaviour. The general view of Collections staff was that taxpayers are aware there are consequences to non-payment of their tax liabilities, but they are generally unaware or confused as to what these consequences are.

This observation by Collections officers is supported by research with SMEs and tax agents (Poppelwell 2011) which found:

*The assumption that penalties and interest influence payment in the majority of cases is correct; the majority of SMEs say the penalties are at least quite influential for making sure they pay their business tax by the due dates. Interestingly, the fact that penalties merely exist appears to be the key motivation for paying tax on time for the majority of SMEs, rather than the structure, size of the penalties, or the interest charges. This is a consistent finding across SMEs that are currently in debt, SMEs with a debt history, and SMEs that have never had a tax debt.*

This research indicates that it is the avoidance of consequences for late payment that is driving compliant behaviour by taxpayers<sup>3</sup> as most SMEs are aware there are financial penalties for late payment of business tax, but lack specific knowledge of how they are applied. These findings are similar to that identified in the Canada Revenue Agency research which found that the majority of participants assumed there would be some sort of adverse financial consequence, such as interest, but awareness was low about how charges are calculated<sup>4</sup>.

*SMEs most commonly said that they simply want to avoid penalties altogether and that they always pay on time regardless.*

The research suggests that taxpayers are generally unaware of the mechanism of the LPP, so it does not support the notion that it is specifically the LPP that drives compliant behaviour.

### Impact on the debt book

The late payment penalty has increased tax debt, contributing to nearly 50% of tax debt at June 2013.

Although in the current system it is difficult to attribute tax payments to specific components of the debt (core, interest, penalties), modelling of the administrative data has provided an indication that around 50% of penalties may have been written off over 2009-12.

<sup>3</sup> Awareness and imposition of penalties and interest for late payment can increase compliance in the early stages of the tax debt being incurred but counterproductive with aged debt.

<sup>4</sup> Canada Revenue Agency. (December 2009). Attitudes towards payment of debt and compliance. Final Report. Prepared by Sage Research for Canada Revenue Agency.

## Operational experience of the LPP

Escalation of the debt due to LPP<sup>5</sup> can cause people to ignore their obligations as they pass the debt tipping point<sup>6</sup>.

Collections staff report that a large majority of tax agents negotiating the payment of debt have a starting position that does not include the LPP and will begin by negotiating the Core and Interest. This has a significant impact on the negotiation of the final settlement. Collections staff are constrained by maximising recovery where the amount can include core tax, and/or interest and/or civil penalties. The outcome of this can be that settlement on a long term debt, which is composed of a significant proportion of LPPs, may not include the LPP component.

New Zealand's LPP regime is "complex and relatively severe" (Marriott, 2013), compared to LPP used by other tax jurisdictions. Collections staff commented that the LPP is bitterly resented, especially by those that have the means to pay.

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<sup>5</sup> As at 30 June 2013 P&I made up 48% of the total debt overdue. 79% of P&I was linked to cases 2 years and older, and for cases > 5 years the P&I component is as high as 81% of the total debt.

<sup>6</sup> Intervening to reduce risk: identifying sanction thresholds among SME tax debtors; Poppelwell; ejournal of Tax research vol.10 no.2 2012.

## Section 4. Alternative options to the current LPP regime

### Remove the LPP and apply cost of money only

There was general support for the removal of the LPP by Collections participants interviewed for this study. They considered that taxpayers found LPP difficult to understand. They supported retaining the cost for the use of money on the outstanding debt, which is a generally accepted charge for people in debt. It was acknowledged the interest rate would need to be at a level that would deter the use of IR as a viable finance option.

#### Consistency with other collections regimes

To facilitate the move to a dedicated loan management system and reduce the extent to which overdue amounts grow due to penalties, the LPP associated with student loan overseas based borrowers (OBB) was removed on 1 April 2012 and replaced with a late payment interest charge of 4% above the base interest rate. As well as creating simpler consequences for non-payment, the rationale for this was to reduce the rate at which OBB debt grows. This is seen by some as a barrier to keeping up-to-date with current repayment obligations.

#### Australian Tax Office experience in removing the LPP

The Time for Business report<sup>7</sup> was a catalyst for the changes in the approach that ATO took with taxpayers. This included a move away from culpability to a pecuniary focus, which was more consistent with a commercial operating model. This resulted in the removal of their LPP and introduction of a cost of money regime called the General Interest Charge (GIC).

The ATO has also implemented the Business Activity Statement (BAS)<sup>8</sup> to increase the visibility of and have a better understanding of its clients. This mitigates the situation where people are not communicating with the ATO, as they have an obligation to submit their BAS. This is especially true of entities that have a small turnover. They have also established a business viability tool, to mitigate the risk of businesses incurring tax obligations that they are unlikely to pay.

To support this regime there has been a change of emphasis to “on time lodgement” (Filing) for the taxpayers, with an increase in the culpability for non-lodgement.

The ATO introduction of the GIC is covered in greater detail in Appendix 1.

#### Pros:

- Removal of the LPP would reduce the inflation of the IR debt book and also increase the proportion of recoverable debt.
- Creates a more readily understood consequence for non-payment, which is consistent with standard business practice.

#### Cons:

- Owing debt to IR could be seen by businesses, as a cheaper alternative to other sources of finance.

<sup>7</sup> Although the ATO tax environment was different to the NZ situation it is informative to review the changes that they instigated. See Appendix 1

<sup>8</sup> BAS is a form submitted to the ATO by all businesses to report their taxation obligations

## Cap the LLP

Collections staff interviewed for this study suggested that capping the proportion of the LPP relative to the original core debt, or putting a cap on the age of the debt where LPP can be applied, could mitigate LPPs adding to the value of the debt book.

The rationale for the LPP is to influence on time payment. If non-payment continues then the LPP is not effective in this situation and so applying a cap and imposing other compliance measures makes sense.

The cap to the LPP could be imposed in a variety of ways e.g. as a fixed dollar amount, as a percentage of the core tax debt, or the age of the debt.

### Pros:

- A cap will reduce the inflation of the IR debt book and also increase the proportion of recoverable debt.
- This would ensure the LPP is applied only to the extent that it is effective in influencing payment.
- A cap is used by other jurisdictions. The US Internal Revenue Service has a LPP that is subject to a cap.

### Cons:

- If the cap is a percentage of a small debt, this may decrease the incentive to pay back the debt.

## Discretion to apply the LPP

Under this option, it is envisaged that IR will have discretion as to whether LPP is applied to debt. The criteria for discretion in applying the LPP were not defined by participants, but the concept was debated. Collections staff were concerned about maintain consistency between taxpayers with the application of existing tools to encourage compliance. For example it was noted there can be regional variations and reliance on the knowledge and experience of Collections staff. It was considered that introducing flexibility in the ability to apply a penalty would add a significant degree of complexity to these decisions.

### Pros:

- Could take into account the previous compliance behaviour of the tax payer.
- Reduces the inflation of the IR debt book and also increase the proportion of recoverable debt.

### Cons:

- Could increase inconsistent treatment of taxpayers.

## Section 5. Compliance tools for consideration

This section outlines the sanctions identified as feasible compliance tool options that could be considered for implementation by IR.

### Credit reporting

Reporting of individuals with outstanding tax obligations to credit agencies had a substantial level of support from Collections staff who participated in this study, with some of the opinion that this would be “the best tool”. They believe this has a real consequence for many debtors which will lead them to resolve outstanding debt with IR.

The Business NZ liaison saw a potential advantage of credit reporting as being increased transparency for business interactions. Businesses providing goods and services could have better visibility of the viability of entities they are trading with.

From the research ‘Identifying Sanction Thresholds Among SME Tax Debtors’<sup>9</sup> this sanction was considered to be effective by 62% of tax agent respondents.

### Travel restrictions

Restricting overseas travel by debtors is an option that has been applied in Child Support debt, and is currently being considered in the case of student loans debt. Collections staff who participated in this study considered that this could have significant impact on directors of companies, although the thresholds would need to be worked out. A number of other tax jurisdictions also use this penalty, e.g. Australia, Denmark, Germany and Ireland.

From the research ‘Identifying Sanction Thresholds Among SME Tax Debtors’ this sanction was considered to be effective by 64% of tax agent respondents.

### Require tax clearance for government contracts

Contractors could be required to gain tax clearance before being awarded government contracts. This is relatively common in other tax jurisdictions e.g. Sweden, Spain, Norway and Germany. There may be an opportunity to pursue this option within the new government procurement system.

### Withhold government payments to debtors

Collections participants considered that withholding government payments to debtors would be a useful tool to get debtors to contact IR about their debt. They would not get any potential refunds if they have debt, until they contact IR. This enforcement power is used by a number of other tax jurisdictions e.g. Australia, Canada, France and USA.

<sup>9</sup> Intervening to reduce risk: identifying sanction thresholds among SME tax debtors; Poppelwell; eJournal of Tax research vol.10 no.2 2012.

## Director penalty notices

One of the tools available to the ATO is the issue of a director penalty notice. A notice is issued in regard to a company's PAYE obligations not being met. The effect of the notice is that if not resolved, the company director they will become personally liable for the payment of the PAYE deduction. The action required is for the director to ensure that the company makes the outstanding payments, or to place the company into voluntary administration or liquidation. The result is that the company director is forced at an early stage to address the company's solvency.

Some Collections participants considered this may involve a trade off with the IR having priority on PAYE, so IR could lose more than it gains. There may be a requirement to consider IR having priority on PAYE. It was considered the implementation of the director penalty notices could be done better than the ATO, which would mitigate some of the negative operational experiences that occurred in Australia.

## Compulsory electronic charge

This would be an extension of tools used for the collection of tax debt by incorporating modern payment methods. Transactional skimming would operate by IR having the ability to require financial institutions e.g. banks or other payment intermediaries to attach an additional charge on electronic transactions for taxpayers with outstanding tax debt. IR would take a portion of the funds due to the seller per electronic transaction, or the buyer would incur an additional Inland Revenue charge on top of the amount being spent.

This collection at source option could provide IR access to the business cash flow, and may also be useful for people who have difficulty in managing their financial affairs.

## Section 6. Learnings beyond the scope of this project

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### Non-filing

The current system may incentivise taxpayers to not file and drop outside the tax system altogether, so avoiding the visibility of their tax obligations. NZ has the lightest penalty for late filing of the countries examined in the 'Tax and Compliance' literature review (Marriott 2013), and also had the lowest level of on time lodgement.

Having visibility of taxpayer obligations is critical in understanding the overall debt book, and the potential income for government.

With the removal of the LPP and introduction of the GIC the ATO shifted its emphasis from paying on time to lodging (filing) on time.

### Business viability assessment tool

Understanding the ability of a business in tax default to meet its obligations is important to maintain a level playing field for compliant businesses.

The ATO maintains oversight of the viability of businesses with tax debt. This is a critical component of introducing a GIC, to prevent businesses developing unsustainable tax obligations. To assist, a model was developed with KPMG to determine the viability of businesses, and if they are determined to be unsustainable, proceedings can be issued to liquidate the business.

Collections are currently investigating the ATO business viability assessment tool, as this type of resource could potentially be useful for IR.

## Appendix 1: ATO introduction of the GIC

### Context for the ATO removal of the LPP

In 1996 the Australian Federal Government began a consultation process with business about reducing 'red tape' and reforming the taxation system. In November 1996, the Small Business Deregulation Task Force made recommendations designed to alleviate the paper work and compliance burden imposed on small business. The report 'Time for Business' specifically highlighted concerns that taxpayers had about the imposition and calculation of penalties under the various taxation laws, in particular late payment penalties.

In March 1997, the Prime Minister responded to the recommendations in his statement 'More Time for Business'. The Government accepted that the complexity of the existing penalty arrangements was a major factor contributing to confusion and misunderstanding among taxpayers. The Commissioner of Taxation was asked to review all penalty arrangements with a view to rationalising and simplifying the system.

The ATO, in consultation with professional bodies and taxpayer organisations, reviewed the penalty arrangements, in particular penalties under the various source deduction collection systems. The review found that the existing arrangements suffered from a number of drawbacks, including:

- penalty calculations were not easily understood by taxpayers
- inconsistent penalty rates and calculations existed across the different taxes and between classes of taxpayers
- the difficulties in having the ATO's systems automate the calculation of penalties and issue account statements
- the rate of penalty did not reflect market interest rates
- the lack of commercial reality in the penalty rules which prevented the ATO from assisting taxpayers to minimise any escalation of outstanding debt.

The Auditor General (Audit Report No 13 1996-1997 'Tax Debt Collection') had separately commented that the ATO should improve its business systems to automatically impose late payment penalties. This report also suggested that 'the ATO review the legislative framework for the ATLP [additional taxes for late payment] for all taxes...for the purpose of simplifying the relevant legislation and thus reduce the costs of compliance for both the community and the ATO'.

### The former ATO LPP regime

It is useful to understand the previous approach to late payment penalties. For revenue lines related to source deduction, the penalties comprised a 'culpability' component, being a flat percentage of the tax not paid on time (at a maximum of 20% but usually imposed at 4%) of the amount not remitted, plus a 'per annum' component (set at 16% per annum). For taxes such as sales tax or fringe benefits tax, taxpayers faced a penalty calculated on a per annum basis calculated from the due date for payment.

For income tax, the regime depended on the year of income involved. For years of income prior to 1993, late payment penalty applied at the rate of 20% per annum (reduced to 16% per annum from 1 October 1992). For income years from 1993, taxpayers were liable to two separate charges imposed under sections 207 and 207A of the Income Tax Assessment Act 1936 (ITAA 1936), on any unpaid amount of tax:

- late payment penalty (non-deductible) at the rate of 8% pa
- interest (deductible) (at a rate provided for at section 214A ITAA 1936) which varied every 6 months.

In short, taxpayers faced a variety of late payment regimes that were quite complex and punitive.

Taxation Laws Amendment Act (No.3) 1999, which introduced Running Balance accounts and the General Interest Charge, represented a key part of the Government's response to these concerns.

## Introduction of the General Interest Charge (GIC).

The GIC formed an integral part of a package of changes introduced in June 1999. This package of changes was aimed at improving the administration of the tax system by assisting taxpayers, especially small business taxpayers, to better understand and comply with their obligations, and removing punitive culpability provisions for late payment of some taxes. These changes included:

- the introduction of Running Balance Accounts (RBAs). The RBA enabled the production of regular automated statements of account, hence assisting taxpayers to better understand and manage their tax affairs. The GIC, which enables interest to be calculated on the daily balance of the RBA, is an essential element of the RBA. The RBA has been expanded since its introduction to enable many taxpayer's obligations and payments across revenue lines to be recorded on a single statement of account
- abolition of complex and punitive penalty regimes and their replacement with a uniform interest charge which is fully tax deductible for all taxpayers
- more time for business to remit certain withholding liabilities. This included the alignment of remittance dates in anticipation of a large number of businesses being required to make one payment each month or quarter to cover most tax debts
- removal of offence provisions for non-remittance of a variety of taxes.

The introduction of the GIC meant that the complex system of interest and punitive culpability penalties was replaced with a uniform regime for calculating and imposing a range of penalties including those for late payment. The GIC regime was intended to be transparent, consistent, commercially based and easy to administer.

The GIC applies to almost all taxes, levies and charges administered by the Commissioner. These include:

- an amount of tax, charge, levy or penalty that remains unpaid
- an underpayment of tax following an amendment of an assessment
- an underestimate of an instalment of tax
- administrative overpayments not repaid (where appropriate notice requiring repayment has been given to the taxpayer).

The GIC was set in accordance with the weighted average yield of the 13 week Treasury Note rate plus 8 percentage points, and was:

- varied to reflect quarterly movements in the 13 week Treasury Note rate
- calculated daily on a compounding basis
- tax deductible.

## Operational context for the removal of the LPP by the ATO

The tax environment in the early nineties was considered to be overly complex, a function of a number of contributing factors including:

- Each tax product was developed in isolation
- No consistency between products
- Very difficult to administer
- Different IT systems
- Fiduciary duty role on the taxpayer.

## ATO operational experience

There is no record of an evaluation of the changes that were implemented, but the general opinion of people who have been involved with the change is that it is consistent the expectations of the Small Business Deregulation Task Force recommendations.

It is considered that some taxpayers are at times making a commercial decision to incur the General Interest Charge, rather than pay their tax liability. To mitigate the potential of providing an unfair advantage to compliant taxpayers a business viability assessment is conducted, and firmer actions, such as court action, is enacted if they are determined to be viable.

The ATO has also implemented the Business Activity Statement (BAS) to increase the visibility and have a better understanding of the clients. This mitigates the situation when people are not communicating with the ATO, as they have an obligation to submit their BAS. This is especially true for entities that have a small turnover.

With the introduction of the GIC, retrospective actions were difficult, and there were issues with situations where assessments involved time periods predating the introduction of the GIC. This meant that some people were disadvantaged under the new regime, so to mitigate this ATO introduced a short fall interest rate.

To support this new regime there has been a change of emphasis from paying on time to on time lodgement (Filing) for the taxpayers, with an increase in the penalty associated with non-lodgement. To facilitate this, analytics are used to interrogate large data sets of non-lodgers, to determine who is seen in other parts of system as a having potential issues. Once likely candidates are identified they can be followed up.