



# Identifying Sanction Thresholds Among SME Tax Debtors: An Overview

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## Executive summary

The aim of the report is to inform Inland Revenue (IR) on how financial sanctions and non-monetary sanctions can best be used effectively to encourage the payment of tax by small and medium enterprises (SMEs).

Fifteen percent of active SMEs owe one third of the total IR tax debt and a third of the debt owed is made up of penalties and interest. This report provides policy makers and administrators with advice about the interventions that are most likely to be effective in addressing the SME tax debt burden.

It stresses the importance of early intervention actions in conjunction with education, the increased discretionary use of waiving penalties as an incentive, along with the threat of non-monetary sanctions, such as credit reporting. On their own they are unlikely to produce effective outcomes, however they increase our knowledge of factors underlying SME tax debt.

### Key points include:

#### ***Penalties influence payment in many cases, and discourage it in some cases***

- It is the mere existence of penalties that influences payment for SMEs that have never been in debt (rather than the specific details).

#### ***Most SMEs are aware of financial penalties for late payment of business tax***

- There is a complex relationship between awareness of sanctions (penalties and interest) and compliance.
- Awareness and imposition of penalties and interest can increase compliance in the early stages of the tax debt being incurred.

#### ***There is a lack of detailed knowledge and understanding of the current late payment penalty***

- Most SMEs see penalties as influential but many lack specific knowledge of how they are applied.

#### ***Increased knowledge of the penalty system can increase compliance in the early stages of the tax debt being incurred***

- Increased knowledge of penalties and interest will help increase payment for some SMEs, in particular SMEs with current debt or SMEs who have a history of debt.
- Providing information in the early stages and early dialogue about payment options and the possibility of avoiding penalties is likely to encourage more SMEs to contact IR before payment is due.
- However, there is a debt tipping point at which penalties and interest are ineffective, if not obstructive.
- Most SMEs that were not aware of payment options and the possibility of avoiding penalties (and who have made a late payment in the last three years) would have contacted IR had they known they could avoid some penalties.

#### ***Debt experiences can impact on SMEs business practices***

- The main reasons for incurring late payment penalties are administrative error, short-term and long-term cashflow problems.
- Debt experiences can prompt SMEs to change their business processes or practices but it depends on the cause and simplicity of the tax debt. For example, the more simple the cause of the debt, the more likelihood of changes (and vice versa).
- Most SMEs with tax debt assume that their debts will only be written off through bankruptcy.

SMEs are evenly divided about the fairness of IR financial penalties for late payment

- This varies by debt status. For example, SMEs in debt consider the financial penalties as more unfair than SMEs that have never been in debt.
- SMEs that are not in debt perceive bankruptcy as an 'easy option'. They consider that IR should recover some tax debt rather than none, and support the waiver of penalties but not interest so that SMEs can make inroads into the tax amount.

***There are penalty thresholds and debt tipping points***

**Threshold**

- Penalties and interest build up at 8 days is 5.2%. At this point most SMEs would be encouraged to pay by the due date.
- For many SMEs penalties and interest amounting to 3.3% would encourage them to pay by the due date.
- There is an inverse relationship between penalty threshold and annual turnover.

**Debt tipping point**

- The median debt tipping point where debt becomes unmanageable across all SMEs is \$10,000. This does not vary by debt status.
- In addition to the above dollar amount, other factors in the debt tipping point are when income is not sufficient to service the debt, penalties and interest are approaching 50% of the original tax amount, or when payment arrangements are only paying penalties and interest without making inroads into the original amount.

***Non-monetary sanctions and incentives could be somewhat effective***

- Improved notification in itself would only be partly effective. The full leverage comes from early dialogue and IRs ability to waive penalties in return for a payment arrangement.
- Credit reporting in combination with dialogue and payment arrangements could encourage compliance.
- Smaller sized businesses are more sensitive to sanctions than larger SMEs so a combination of financial and non-financial sanctions would be effective for this group.

***IR can play an instrumental role in preventing future tax debt***

- SMEs accept that it is their responsibility to financially manage their business and comply with their tax obligations.
- But a more proactive role by IR in the management of tax debt would be effective, targeting those in early debt and those that have a history of debt.



## Introduction

Inland Revenue (IR) plays a central role in securing and delivering most of the financial resources required by the Government to provide services and facilities that improve New Zealanders' quality of life. Delays in collection affect the level and timeliness of financial resources available to the Government. Delay helps secure an unfair competitive advantage for those who withhold tax payments to improve their cashflow. At a macro-economic level, delaying tax payments also adds to the level of government borrowing and public debt interest.

The small and medium enterprise (SME) sector makes a significant contribution to New Zealand's economy, but a large proportion of the \$5.15 billion of total tax debt is owed by SMEs. SMEs make up about a third of tax debtors within New Zealand, with this debt primarily incurred through financial penalties that result from income tax, GST and PAYE. IR wants to understand the drivers behind SME debt in order to develop effective interventions to reduce it.

Past experience shows how difficult it is to design an effective penalty system. Other factors also contribute to tax compliance behaviour, such as social norms<sup>1</sup>, prioritisation of debts, and whether the tax system is considered fair and equitable.

A better understanding of SME attitudes and behaviour towards tax debt and IRs late payment penalties and interest assists IR to determine use of financial sanctions and other non-monetary sanctions and incentives. Specifically, the report looks at:

- views on current sanctions
- the effectiveness of current sanctions on compliance behaviour
- thresholds and tipping points of sanctions
- other types of sanctions

This will assist policy and operations to better target current penalties and help IR look at new ways or different approaches to its current and other non-monetary sanctions (see Future considerations).

The report explores whether there is a tipping point with financial sanctions, in particular, whether there is a threshold with late payment penalties and interest for some SME tax customers.

International research (OECD 2010) argues that sanctions are only partially effective as a compliance mechanism. This report looks at how sanctions and initiatives can more effectively be used by IR to help SMEs better manage their tax obligations, to reduce the time SMEs are in debt, and the level of debt incurred. It also explores hypothetical non-monetary sanctions to supplement the current sanction regime to encourage compliance for some SMEs.

We focus specifically on tax debt incurred by SMEs through late payment of income tax, GST and PAYE, and with late payment penalties (penalties) and interest charges.

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<sup>1</sup> *Social norms* are the accepted behaviours within a society or group. The term 'social norm' is used here as it encompasses wider behaviours than that of 'compliance norms', which refers to behaviour motivated by rewards and the avoidance of sanctions.

## Background

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SMEs play a crucial role in New Zealand's economic wellbeing. Ninety-seven percent of firms employ fewer than 19 employees (Ministry of Economic Development, 2010). Business revenue collection is also significant for IR. Therefore, it is important for IR to understand this sector, especially as small businesses are more susceptible to incurring tax debt than other IR customers.

Ten percent of SMEs owe almost half of IR tax debt and 15% of active SMEs owe one third. About one third of the debt owed by SMEs is made up of penalties and interest.

The OECD (2010) *Understanding and Influencing Taxpayers' Compliance Behaviour* report confirms that, although the success of deterrence strategies can be linked to fear of detection or severity of punishment, it is also linked to norms. Deterrence is more effective where strong social norms exist (see **The role of non-financial sanctions and incentives** for discussion). It proposes that revenue bodies consider the use of non-monetary penalties.

The report also stresses that it is important to understand the compliance behaviour of corporations and the role of tax intermediaries and other third parties in this. The report assists with understanding how penalties and interest (within IRs debt collection practices) impact SME debt behaviour<sup>2</sup>.

Previous research on compliance behaviour confirms that for some tax customers, sanctions are effective motivators to compliance. These tend to be the 'rational economic actors', who are motivated by a financial advantage to complying and see sanctions as an 'incentive' to comply. There are also tax customers who have high tax morale and are motivated to comply because it is the 'right thing to do'.

Despite this, tax debt is growing rapidly and current sanctions appear to be only partially effective as a compliance mechanism. The call by the Government to reduce or slow its growth, and reduce the time customers are in debt is the key driver behind this analysis.

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<sup>2</sup> Tyler (1990) argues that retributive justice refers to the perceptions of fairness of sanctions when rules are broken. Perceptions of retributive unfairness may occur when sanctions are too harsh or too weak. Retributive fairness/justice also relates to the legitimacy of revenue authorities and is an area identified by OECD (2010) requiring further consideration.

## Analysis of IRs Administrative data

In April 2010 there were 1.1 million SME customers and over half (586,000) of them were active in business. The following analysis is based on IRs administrative data for 2010, and looks at two SME groups (all SMEs and Active SMEs) and their tax debt activity by different areas. 'Active SMEs' refer to businesses that have transactions with IR (i.e. Filing, GST, PAYE, Income Tax), which is a subset of all SMEs as not all of them have an obligation to File returns with IR (see the Appendix for definitions).

### Overall debt situation

- In 2010 10% (110,000) of SMEs accounted for nearly one-third of all IR debtors and owed almost half (\$2,430 million) of IR tax debt, with an average debt value of \$22,000 per customer. Fifteen percent (86,000) of active SMEs owed one third (32%) of the total IR tax debt, with average debt value of \$19,000.
- Around one-third of the debt owed by SMEs and active SMEs was made up of penalties and interest.

### Age of debt

- Figure 1 shows that when looking at the oldest unpaid debt element each SME debtor had, 41% was less than 6 months and this was the same percentage for those debt elements aged over one year. Compared with SMEs, the oldest debt element owed by active SMEs was younger; 47% younger than 6 months old and 34% over one year.

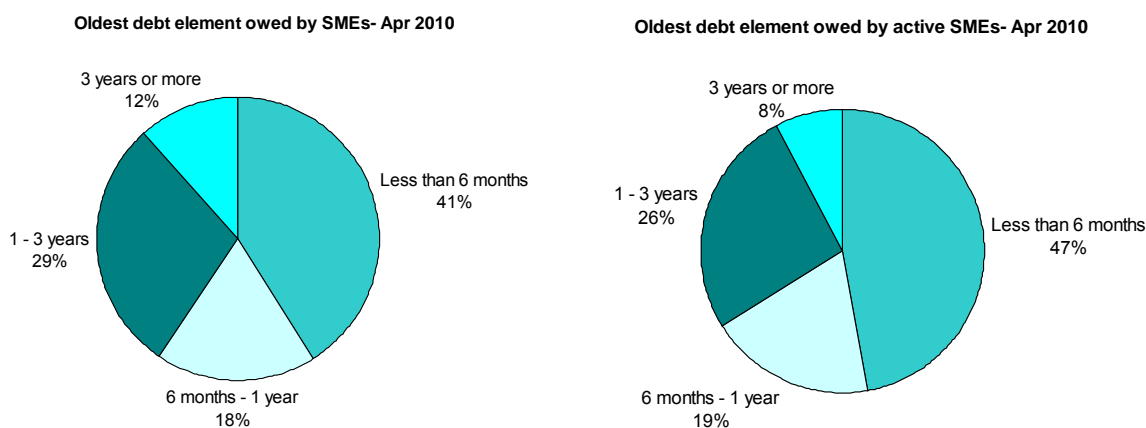


Figure 1. Oldest debt element owed by SMEs



## Tax type

- GST debt (including the penalty and interest applied) makes up almost half of total SME debt, followed by income tax debt. PAYE accounts for a smaller proportion of debt.
- 72%, 32% and 21% of the SME debtors had debt in GST, income tax and in PAYE respectively. Overall, 96% of the SME debtors had debt in one or more of GST, PAYE and income tax. The components of the active SME debtors were similar to that of SMEs, except that proportionally more active SMEs have debt in PAYE and less in income tax.

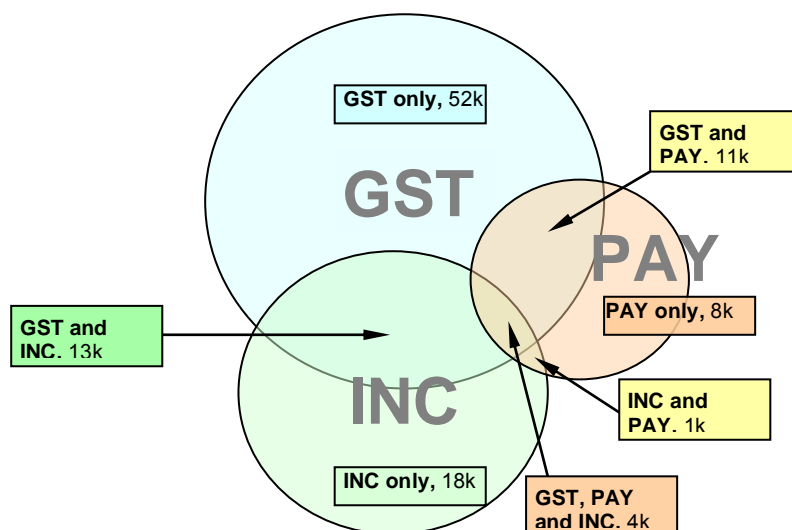


Figure 2. SME customers owing debt in GST, PAYE or income tax (k=,000)

## Debt by entity type

- Individual (or sole trader) and company groups had the higher proportion of debtors, with 19% and 13% respectively in SMEs and 16% and 18% among active SMEs.
- Two-thirds of tax debt was owed by companies. Sole traders (individuals in business) owed 20% and trusts owed less than 10%. See Figure 3 below.

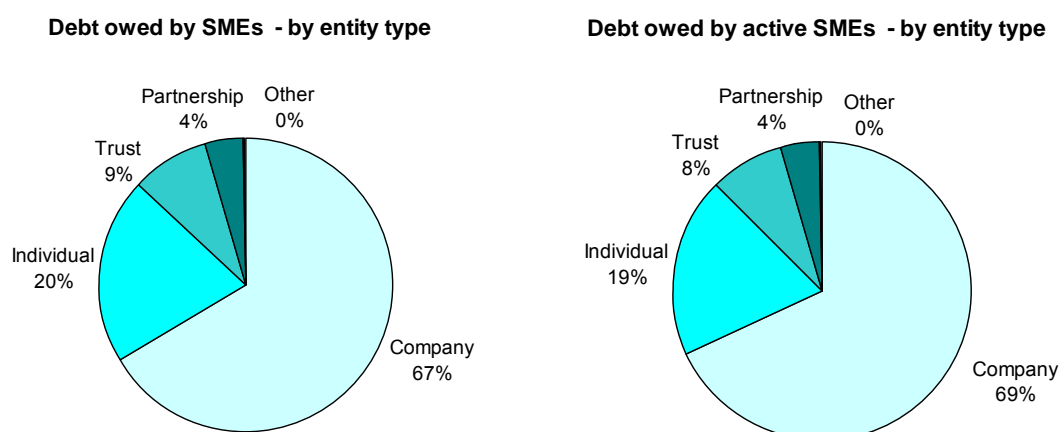


Figure 3. SME debt by entity type

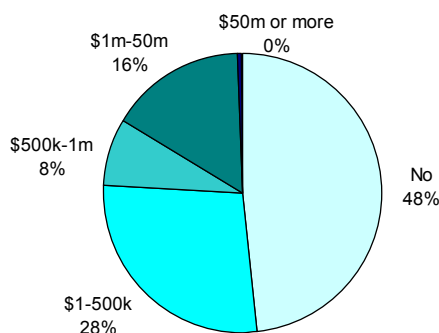
### Debt by industry area<sup>3</sup>

- The Primary Production sector has the best debt profile among the five industry groups<sup>4</sup>. The Services sector was the largest debt contributor (excluding SME customers who did not have an industry classification for their business) accounting for 25% of the total debt.

### Debt by business size

- Customers with a large GST turnover or more employees were more likely to be in debt. However, a very high proportion of the total debt was owed by small businesses with GST turnover below \$500,000 annually or with nil GST turnover. See Figure 4 below.

Debt owed by SMEs - by GST turnover



Debt owed by active SMEs - by GST turnover

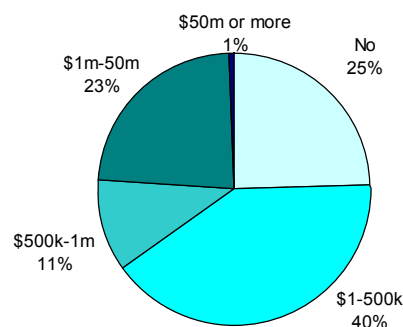
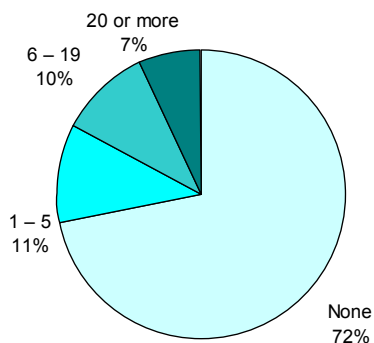


Figure 4. SME debt by entity's turnover

- 72% and 59% of the debt owed by SMEs and active SMEs respectively were from the entities that did not employ any people. See Figure 5 below.

Debt owed by SMEs - by number of employees



Debt owed by active SMEs - by number of employees

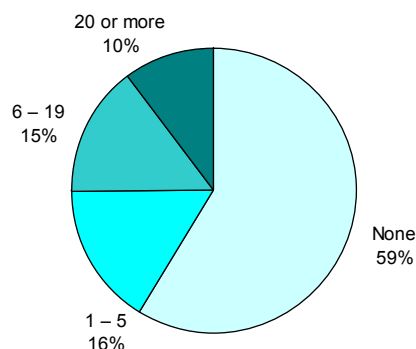


Figure 5. SME debt by entity's employee number

<sup>3</sup> NB. Almost 50% of SMEs and 25% active SMEs did not have an industry code

<sup>4</sup> The industrial group is based on ANZSIC06 and grouped into five categories: Primary Production, Industrial, Distribution, Business and Finance, and Services.

## Debt by business age

- Younger SMEs (with a shorter time in business) were more likely to be in debt. But the average debt value and proportion of penalty and interest was significantly lower than older businesses.
- Figure 6 below shows that about two-thirds of SMEs owing tax debt were from businesses aged over five years. The penalties and interest for these customers made up about 40% of their debt.

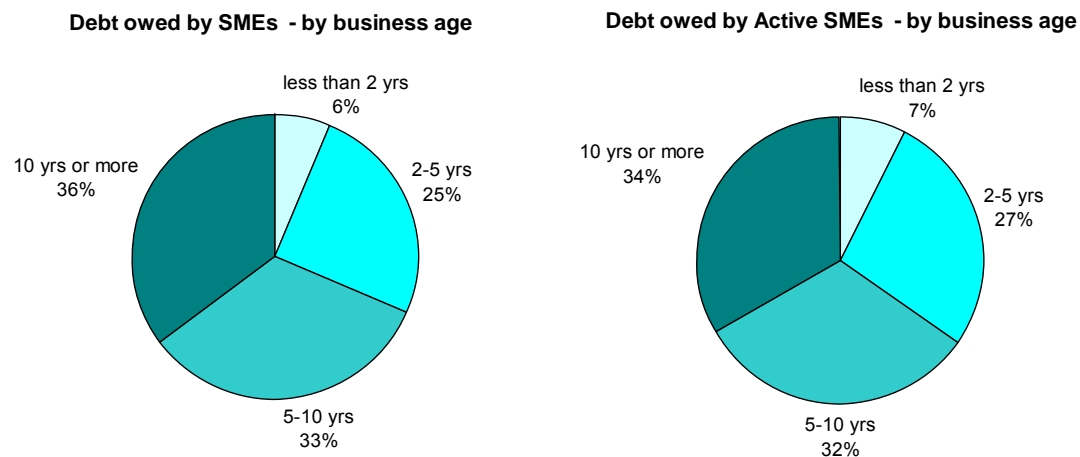


Figure 6. SME debt owed by business age

## Use of tax agents

- Many SMEs use a tax agent. SMEs that did not were more likely to owe tax debt. Their average debt amount, as well as the proportion of penalty and interest, was higher than those who use a tax agent.

## Debt by location

- About half of the debt was owed by SMEs from the Auckland region.
- Figure 7 below shows that the Auckland region (including Takapuna and Manukau service centre areas) has a higher proportion of debtors. Also the average debt value of those from Auckland region was higher than other regions.

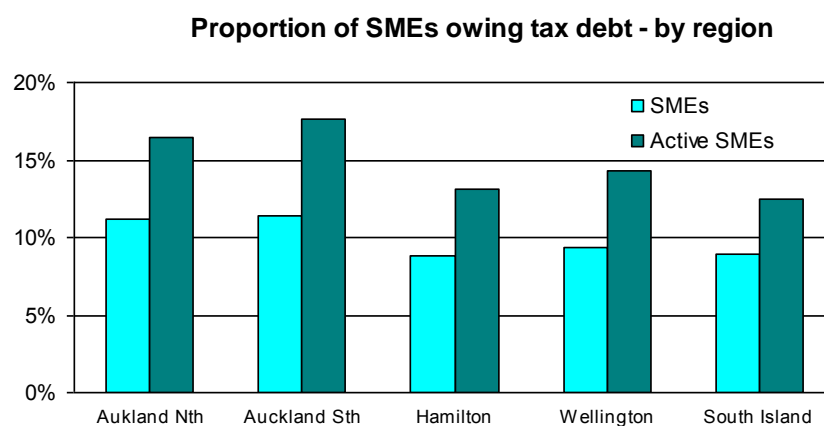


Figure 7. Proportion of SMEs owing tax debt by region

## Key findings

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Inland Revenue's experience with penalties and compliance.

### Awareness of late payment penalties

#### ***Penalties influence payment in the majority of cases, and discourage it in a minority of cases***

- It is the mere existence of penalties that influences payment for SMEs that have never been in debt rather than the specific details (see the **Discussion** section).
- For the majority of SMEs penalties are influential in making sure they pay their business tax by the due dates to avoid any additional or unnecessary cost to their business.
- Few SMEs are aware of the size of the penalties or the interest rate, that the penalties can build up quickly, or that the penalties could impact their business.
- The views of tax agents are similar.

#### ***Most SMEs are aware of financial penalties for late payment of business tax***

- Most SMEs are aware that interest accrues on any unpaid amount and that penalties and interest are calculated on the total unpaid amount, including any unpaid penalties.
- However, there is a complex relationship between awareness of sanctions (penalties and interest) and compliance.
- Awareness and imposition of penalties and interest can increase compliance in the early stages of the tax debt being incurred.

#### ***There is a lack of detailed knowledge and understanding of late payment penalties***

- Most SMEs are aware there are financial penalties for late payment of business tax and see them as influential but they lack knowledge of how they are applied.
- Relatively few SMEs are aware that on the day following the due date a penalty of 1% is applied, that after the seventh day following the due date a penalty of 4% is applied, and that a 1% penalty is applied per month on any unpaid amount.

#### ***Increased knowledge of the penalty system can increase compliance in the early stages of the tax debt being incurred***

- Increased knowledge of penalties and interest will help increase payment for some SMEs, in particular SMEs with current debt or SMEs who have a history of debt.
- Most SMEs that were not aware of payment options and the possibility of avoiding penalties (and who have made a late payment in the last three years) would have contacted IR had they known they could avoid some penalties.
- Providing information in the early stages and early dialogue about payment options and the possibility of avoiding penalties is likely to encourage more SMEs (especially those at risk of being late with their tax payments) to contact IR before payment is due.
- However, there is a debt tipping point which penalties and interest are ineffective, if not obstructive.

## Reasons for late payments

### ***The main causes of tax debt include administrative or cashflow problems***

- For SMEs that have never been in debt, the reasons tend to relate to an error on the part of the business, such as not being aware of or forgetting the date, or some other error. SMEs with a debt history tend to attribute their most recent late payment to not being aware of or forgetting the due date, or external circumstances beyond their control.
- SMEs currently in debt, on the other hand, tend to attribute their late payment to poor cashflow. These SMEs are also more likely than average to say they used the money for other expenses.
- Many SMEs late with a payment have no contact with IR prior to the due date.
- Most SMEs are aware they can contact IR in advance to avoid some penalties although SMEs currently in debt are less likely to be aware of this.
- Tax agents generally believe SMEs miss the due dates for tax payment primarily due to a lack of cashflow.

### ***The majority of SMEs make changes to practices and processes as a result of making a late payment***

- The cause and simplicity of the tax debt has a direct correlation with changes to business practices. The more simple the cause of the debt, the more likelihood of change (and vice versa). Many SMEs that have missed a recent payment have made a change to their practices or processes as a direct result of having missed a payment.
- SMEs currently in debt (for whom short-term cashflow was the primary reason for late payment) are most likely to set funds aside to ensure they make payments or keep a closer eye on their obligations and finances.
- SMEs with tax debt caused by long-term cashflow difficulties and more complex financial issues in their business are likely to be more restricted in the immediate, simple, straightforward changes they can make. They will need to make more substantial changes to avoid this situation in the future, e.g., generating more revenue, improving debtors' management and better management of finances. The potential for changes depends on the economy, overall debt level of the business, the ability to generate income and whether they can realistically trade out of difficulties.
- SMEs with a debt history (who are not aware of or have forgotten the due date) are more likely than SMEs currently in debt to have set up a reminder to ensure they do not miss due dates in future.
- SMEs with tax debt caused by administrative errors make straightforward changes to business practices and processes to ensure it does not happen again, e.g., reminders of due dates and improved administrative practices.

### ***Payment prioritisation of debt***

- Decision-makers trade-off various competing payment priorities under different penalty regimes. Paying employee wages is the highest priority, regardless of the threat of implications. Payments to IR rate second (with PAYE rating higher than GST).
- Differences between small and larger sized SMEs suggest that different compliance strategies are required for different sized businesses.

### ***SMEs are evenly divided about the fairness of IR financial penalties***

- This varies by debt status. For example, SMEs with a debt history and SMEs currently in debt are more likely to consider the financial penalties as being unfair for businesses.
- Most commonly this is because they think financial penalties are high, or they can compound and get out of control.
- However there is recognition that they are a lever to obligate SMEs to pay on time and are needed to encourage compliance.
- Ongoing penalties are considered to be unfairly harsh for those who are making an attempt to pay, and in this situation the penalties undermine the ability to comply. There is, however, support for the continued application of interest rates (higher than the banks' loan rates) for unpaid amounts.

**Tax agents**

- Tax agents are divided about whether the system is fair or unfair.
- Some consider it is a business' obligation to pay on time, that the interest rate is fair, and that the penalties are an incentive for businesses to pay on time.
- Others consider the financial penalties are unfair because the penalties or interest rate is too high, or because penalties can build up and become out of control.

**Attitudes and behaviours vary over SME customer groups**

- Financial (and business) aptitude marks the difference between those SMEs that have never been in tax debt and SMEs that have experience of tax debt.
- IRs appropriate and effective management of tax debt needs to be aware of the difference between SMEs that have tax debt caused by administrative error (but ability to pay), tax debt caused by short-term cashflow, and ongoing cashflow difficulties associated with reduced ability to pay.

**SMEs are not gambling that tax debts will be written off**

- Most SMEs with tax debt assume that their tax debts will only be written off through bankruptcy and that IR will use bankruptcy as a tool of last resort. They want to avoid bankruptcy believing they may be able to trade their way out of their financial difficulties.
- SMEs that are not in debt perceive bankruptcy and tax debt written off as an 'easy option' taken by SMEs in debt. They consider that IR should recover some tax debt rather than none. To this extent, they support the waiver of penalties but not interest so that SMEs can make inroads into the tax amount.

**Penalty thresholds and debt tipping points****There are penalty thresholds and debt tipping points**

- It is important to determine the point at which penalties encourage SMEs to make their payments by the due dates (the penalty threshold).

**Penalty and interest build up at 8 days is 5.2%.**

- At this point most SMEs would be encouraged to pay by the due date.
- For 75% of SMEs penalties and interest amounting to 3.3% would encourage them to pay by the due date.

**Penalty threshold and annual turnover**

- There is an inverse relationship between penalty threshold and annual turnover.
- The threshold at which 75% of SMEs would be encouraged to pay at 8 days is outlined in Table 1.

**Table 1 Percentage of tax bill by SME annual turnover**

% of SMEs tax bill	Annual turnover
6.5%	up to \$50 thousand
3.8%	\$50,001-\$100 thousand
2.0%	\$100,001-\$500 thousand
1.7%	\$500,001-\$100 million



### **Debt tipping point**

When does the amount of debt become unmanageable?

- Across all SMEs the median debt tipping point is \$10,000.
- For SMEs with \$500,001-\$100 million turnover this is closer to \$30,000.
- For SMEs with 6+ employees it is \$40,000.
- The median tipping points do not vary by debt status.

In addition to the dollar amount, other factors influence the debt tipping point:

- When penalties and interest compound to the extent that they are 50% or more of the original tax amount owing.
- The repayment amount that businesses can afford out of current revenue is so little that it is only addressing penalties and interest and not the tax amount itself.
- Other business and personal debt, e.g., employee wage costs, suppliers, bank interest and other costs, contribute to SMEs inability to pay tax debt.
- There is a cumulative tax debt across several tax types.
- The total amount owing is out of proportion with yearly income.

### **The role of non-financial sanctions and incentives**

#### ***Non-monetary sanctions and incentives could be somewhat effective***

- Five non-monetary sanctions and incentives have been identified as potentially encouraging SMEs to pay their outstanding tax.
- These include improved notification, credit reporting, an annual practising certificate, travel restrictions, and information on statements to show how penalties and interest build up.
- Travel restrictions, improved notification, and credit reporting were considered the most effective, although all five sanctions and incentives would be somewhat effective in encouraging on-time payment.

The effectiveness of each non-monetary incentive and sanction differs considerably by sub-group

- SMEs that have never been in debt and tax agents favour more punitive options, such as travel restrictions and credit reporting.
- SMEs with a debt history preferred improved notification, followed by travel restrictions and credit reporting.

#### ***Improved notification and information on statements***

- Improved notification in itself would be only partly effective. The full leverage comes from the dialogue and IRs ability to waive penalties in return for a payment arrangement.
- Improved notification and showing how penalties and interest build up over time are not effective for people who have long-term/large debt with insufficient revenue to enter into a payment arrangement. In this situation, the notification contributes to the tipping point and inaction.

#### ***Travel restrictions and certificate of compliance***

- Travel restrictions are considered difficult to enforce, and a certificate of compliance is an ineffective incentive.
- SMEs that are not in debt support travel restrictions for SMEs in debt who 'just want to holiday', but they do not support travel restrictions for those who need to travel for their business.
- It would be ineffective for SMEs that have debt – they cannot afford to travel and see it as a punitive measure.

### ***Credit reporting***

- Credit reporting is perceived to be an effective tool working in much the same way as penalties.
- The threat of credit reporting would need to be used early (while the debt can still be managed) to warn SMEs of the consequences of not making arrangements with IR for the repayment of outstanding tax.
- However, just like accumulated penalties and interest, credit reporting will contribute to the tipping point and to the business' inability to trade out of difficulty.
- It is likely to be a short step from credit reporting to bankruptcy for some SMEs.
- SMEs that are not in debt would welcome the protection offered by the credit reporting of insolvent businesses.

Improved notification and information to show how penalties build up would be most effective when combined with the current financial penalties and interest. Smaller sized businesses are more sensitive to sanctions than larger SMEs and a combination of financial and non-financial sanctions would be effective for this group.

## **The role of Inland Revenue**

### ***Inland Revenue can play an instrumental role in preventing future tax debt***

- SMEs accept that it is their responsibility to financially manage their business and comply with their tax obligations.
- However, they think that IR taking a more proactive role in the management of tax debt would be effective; targeting those in early debt and those that have a history of debt.

Currently IR notifies SMEs in debt that penalties and interest are applying, that they can enter into a payment arrangement and that they can phone IR. However, this current communication is not maximising the leverage that IR has for effective intervention to prevent, manage or limit tax debt. SMEs believe that IR currently prevents or limits tax debt almost solely through information and sanctions (with some payment arrangements). While, on the one hand, the debt is serious enough to impose penalties and interest, SMEs are also getting the message that it is not urgent or of sufficiently high priority for IR to actively contact SMEs and instigate standard debt collection practices.

Those with a high level of financial management skill (and meet their tax obligations) perceive IR's role as tax collection only. More contact may be generated if more SMEs are made aware earlier of payment arrangements and the waiver of penalties. At this point they are likely to have small or short-term debt and the cashflow reserves to enter into payment arrangements.

Those with a poor level of skill and/or extenuating circumstances (e.g., affected by a downturn in the economy) favour a greater role by IR to prevent and/or manage tax debt. These SMEs are likely to need proactive management from IR. They are likely to have large or long-term debt, have already incurred substantial penalties and interest, business financial difficulties and/or a mindset of not dealing with issues.

### ***Awareness and use of instalment options***

- Increased awareness of payment options and the waiver of penalties are likely to increase contact with IR by SMEs at risk.
- Most SMEs are aware they can contact IR in advance to avoid some penalties, although SMEs currently in debt are less aware of this.
- Most SMEs who have been late with a payment had no contact with IR prior to the due date. Many would have contacted IR had they known they could avoid some penalties.
- There is a strong argument from SMEs and tax agents for IR to manage tax debt through a more urgent, standardised business debt collection practice which would consist of early, personalised contact (by telephone from a dedicated debt collection team), dialogue, negotiation of the payment terms in return for avoiding negative consequences and then the consequences introduced if the business makes no attempt to pay (penalties, credit reporting and bankruptcy).

## Future considerations

The 2011 IR annual report shows \$1.15 billion of debt, (overdue tax, penalties and interest) at 30 June 2011, being paid back under instalment arrangement compared to \$938 million at the same time the previous year. Much of this is SME debt. The increase of 23 percent is part of a strategy by IR to deal with tax debt, which rose from \$3.66 billion at the end of June 2007 to just over \$5.5 billion at the end of June 2011.

Analysis of IR administrative data has shown that the older tax debt becomes, the more uncollectable it is, which has led to a focus on tackling it early. Uncollectable tax debt has increased from \$1.17 billion in 2007 to \$1.71 billion.

Inland Revenue has identified the following issues for future consideration.

### **Better targeted communications to SME customers (in particular to those currently in early stages of tax debt and those who have a history of tax debt) focusing on late payment penalties**

#### ***Undertake a review of current communication messaging aimed at late payment penalties***

- There is a lack of specific knowledge of penalties by SMEs.
- The review would include the content of outgoing letters that relate to penalties, including the type of language used, and that interest rates can and do change over time.

#### ***Undertake a targeted campaign aimed at SMEs with a history of late payment tax debt (in particular, SMEs with young tax debt)***

- This would include directing SMEs to an online calculator that would help them estimate the consequences and impact if they do not enter into a payment arrangement.
- Messaging would focus on SMEs that have a first debt case, providing them with additional information about penalties and interest.
- Evaluate the impact of the campaign and explore the feasibility of applying it to other types of penalty, such as employer monthly schedules (EMS) penalty.

#### ***Leverage off intermediaries to disseminate information more effectively***

- For example, host a 'tax game' or a SME tax calculator on IRs website or other industry websites.

### **Improved processes and systems to enable easier repayment**

#### ***Consider the use of standard debt collection practices<sup>5</sup>***

- Trial early contact using the campaign management teams to contact debtors 3 - 4 days after the due date.

#### ***Review the timing of notifications***

- Design and trial changes to the frequency and type of notifications.

<sup>5</sup> For example, personalised contact (by telephone from a dedicated debt collection team), dialogue, negotiation of the payment terms in return for avoiding negative consequences and then the consequences introduced if the business makes no attempt to pay (penalties, credit reporting and bankruptcy).

***Support better SME self-management***

- IR can promote the types of changes businesses make to their processes (such as reminders of due dates and better administrative practices), or practices used by SMEs that have never been in debt. For example, keeping a tight rein on all financial aspects and accounting for the business, i.e. invoice debtors on the 20th of the month and pay all creditors on the due date.
- For cashflow problems, these include: setting aside funds to ensure payments can be made; generating more revenue; improving debtors' management and better management of finances to help improve tools currently being used.
- Inform new businesses or businesses with 'young' debt.

**Investigate policy options on the use of incentives and non-monetary sanctions**

***Undertake an in-depth evaluation of IRs early intervention processes***

- Investigate the feasibility of credit reporting and travel restrictions as levers to encourage repayment of tax debt.
- Increasing the visibility of non-monetary sanctions would support SMEs and encourage non-viable businesses to cease trading before they are forced into receivership.
- This would require closer consultation with the Ministry of Justice, which is already exploring the use of non-monetary sanctions for non-payment of fines.

## Discussion

There may be opportunities for changes to policy and practices to assist with reducing the growth of SME tax debt and ensure optimal solutions are in place to reduce the level of default and increase revenue for the Government.

The issues regarding SME tax debt are complex and it would be naive to imagine that a magic bullet can fully address the growing level of IR debt. Any changes would require a sustained and consistent approach.

Although most SMEs pay their tax on time, some SMEs are at particular risk of incurring debt. HM Revenue & Customs (2010) noted that countries which act early to ensure taxpayers pay on time and prevent payments from becoming overdue end up holding less debt and have less debt to recover. This means that older existing debt is harder to clear.

This report considers both debtors and non-debtors as we learn what determines compliance behaviour. It also identifies tipping points and thresholds when penalties and interest become so large that the SME debtor is unable to continue to make repayments. These indicate the importance of early intervention.

Key conclusions indicate that a 'wrap around approach' to early intervention would be more effective than one that is more 'linear'. For example, notifying and educating SMEs who are late with their payments will not help those SMEs who do not have the capacity to make payments.

A coordinated approach is likely to produce more effective outcomes. This approach would need to include early identification, notification, and education, along with a long-term sustainable payment schedule. It would also require close monitoring of that schedule. The use of IRs discretionary power to waive penalty charges also emerges as an effective lever. This, along with the threat of non-financial sanctions, will provide a more effective approach to managing SME tax debt.

The overall purpose is to explore current sanctions and their effectiveness on compliance behaviour, identify thresholds and tipping points of sanctions, and identify other types of sanctions.

### Current sanctions

For the majority of SMEs penalties are influential in ensuring they pay their business tax by the due dates. However, in-depth knowledge of the penalty rules does not necessarily equate to compliance. While most SMEs are aware of financial penalties for the late payment of business tax there is a lack of detailed knowledge of how the sanctions are applied.

SMEs with debt or who have a history of debt are no more knowledgeable than SMEs that have never been in debt. Increased knowledge of the penalty rules would more likely benefit SMEs currently in debt or with a history of debt in the early stages of the tax debt being incurred. For SMEs who have never been in debt, knowing that penalties exist is enough for this group to comply.

The Canada Revenue Agency wrote about similar findings in 2009 (*Attitudes towards payment of debt and compliance*). The majority of taxpayers assumed there would be some sort of adverse financial consequence, such as interest, but awareness was low about how charges are calculated.

The introduction of non-payment penalties appears to have had some success by encouraging customers into instalment arrangements. However, those who enter into instalment arrangements are those more vulnerable to being unable to make tax debt payments.

### **Issues of fairness**

SMEs are evenly divided on the fairness of sanctions. SMEs in debt (especially those in debt for a longer time) or with a history of tax debt consider the regime as more unfair than SMEs who have never been in debt. Financial penalties are considered to be high, and there is a concern that penalties and interest can compound and get out of control.

While it is accepted that incurring interest on outstanding tax owed is fair, where SMEs have entered into payment arrangements there should not be ongoing and compounding penalties. This contributes to the tipping points and makes it less likely that the tax debt will be paid.

In the UK in 2008, HM Revenue & Customs reported that taxpayers felt that a system of interest and penalties for non-payment of tax is necessary in order to ensure fair treatment. They also perceived that percentage interest payments, in line with those of other financial institutions (such as banks), to be the fairest sanction for non-payment.

In New Zealand, IR plays a central role in securing and delivering most of the financial resources required by the Government to provide services and facilities that improve New Zealanders' quality of life. Delays in collection affect the level and timeliness of financial resources available to the Government. Delay also helps secure an unfair competitive advantage for those who withhold tax payments to improve their cashflow. At a macro-economic level, delaying tax payments also adds to the level of government borrowing and public debt interest.

Various factors influence tax debt attitudes and behaviour. One of the factors is a perceived lack of fairness, equity and justice with the tax system.

Inadequate knowledge of tax law has been argued by small business taxpayers as a reason for their inability to meet their obligations (McKerchar, 1995; Coleman and Freeman, 1994, 1997; Canada Revenue Agency, 2009). Although some respondents in the Canada Revenue Agency study did understand the role of charges as a penalty (and for some it was a deterrent), they thought that more knowledge about how charges are calculated could have a stronger deterrent impact.

IR is increasingly aware that small businesses choose to use tax agents because of the complexity of the tax system and the fear of being penalised should they make mistakes in doing the tax themselves.

Early communication with at risk SME groups (SMEs with early debt or a past history of debt) to raise awareness of how penalties are calculated, and a sustainable repayment schedule should help increase the perception of fairness in this group.

### **The role of IR**

Most SMEs accept that it is their responsibility to meet their tax obligations on time and it is IRs responsibility to collect tax and impose consequences if tax is not paid by the due date. However, IR needs to achieve the appropriate balance of help versus consequences.

IR provides information to businesses on its website with a section focusing on the needs of new businesses. In addition, IR provides information to trade associations and other organisations dealing with businesses.

'Debt prevention education' for new businesses is regarded as important and for SMEs to be upskilled in good business and money management skills to ensure that tax obligations are met in full and on time.

Businesses would like to see IR being more proactive and would also like to see IR offer advisory services to all business and provide account managers. However, IRs role is primarily a tax collection agency and it is not supposed to be an organisation whose aim is to coach business people to gain better business skills.

The issue for IR will be how it can clarify its role as government's principal revenue collector to its SME customers and at the same time provide a tax system that encourages communication and compliance.



### **Instalment arrangements**

Those who enter into instalment arrangements are those more vulnerable to being unable to make tax debt payments. The Canada Revenue Agency (2009) research highlighted a lack of awareness that partial payments can be a viable option for final tax payments. Respondents believed that Canada Revenue Agency will not work with people to develop a payment schedule, but rather insist on receiving the full amount immediately. This belief resulted in participants saying that instead of filing on time and making partial payment at the deadline, they will delay filing and pay the entire amount late.

Providing specific information about penalties and payment options is likely to have some influence on SMEs, with a debt history or who are currently in the early stages of debt, to contact IR in advance.

### **The effectiveness of current sanctions on compliance**

As highlighted earlier, the fact that penalties merely exist (and not how they are applied) is a deterrent for most SMEs and in particular those that have never been in debt. The Irish Revenue (2009) *Survey of Small and Medium Sized Business Customers* found that knowing there were sanctions was one of the factors respondents gave that encouraged them to pay their taxes on time.

Overall, it is clear that in the majority of cases penalties and interest encourages compliance and in a minority of cases they discourage compliance. Current sanctions encourage payment of tax debt in the early stages but are not effective motivators the older the debt becomes.

SMEs who have never been in debt consider bankruptcy and tax debt written off as an 'easy option' taken by SMEs in debt. They support the waiver of penalties (but not interest) so that SMEs have the ability to make inroads into the tax amount.

Feedback suggests IR should act more quickly to intervene, but also impose sanctions if there is no change in behaviour. SMEs not in debt also support credit reporting, as it protects other businesses.

Current penalties and interest offer very effective leverage to prevent debt and to manage debt within the first few weeks after a late payment (before the debt escalates). Beyond that window of opportunity, continued application of penalties and interest without proactive (and effective) intervention from IR becomes less effective.

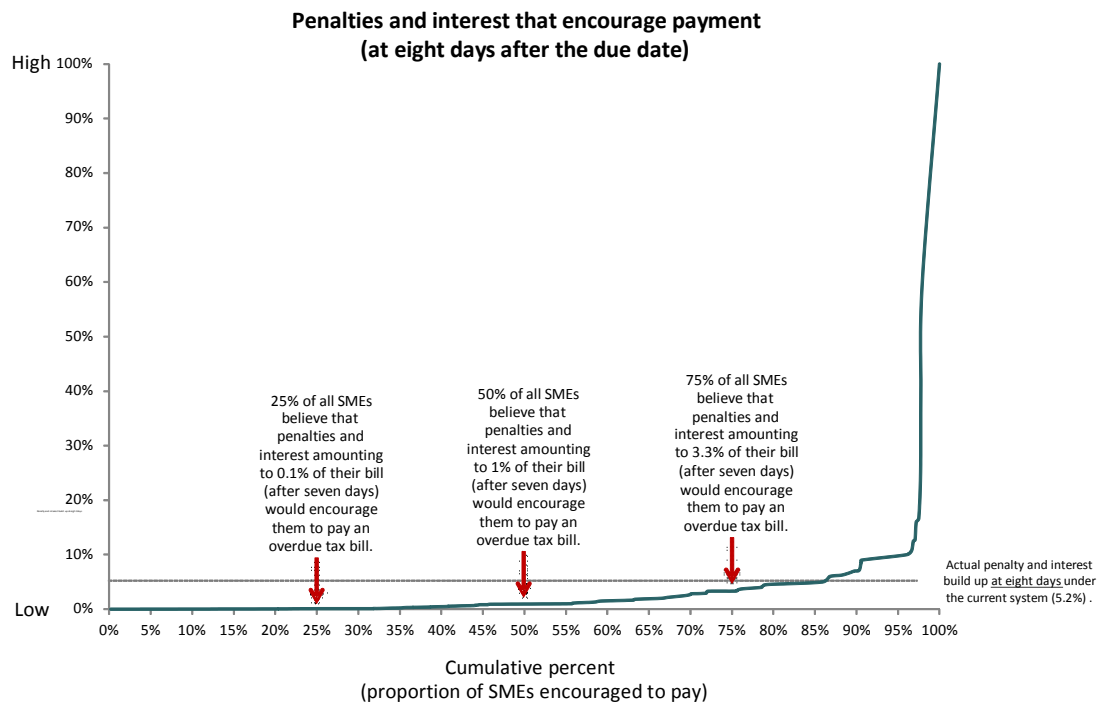
Proactive intervention, in combination with not imposing penalties when taxpayers comply with instalment arrangements, is likely to be effective. There would appear to be no need to change the penalty or interest rates, but rather use the existing sanctions more effectively – through operations and communications.

### **Thresholds and tipping points of sanctions**

#### **Penalty thresholds**

- Penalties and interest of just 1% at eight days would encourage half of SMEs to pay by the due dates.
- Three quarters (75%) of SMEs say that penalties and interest of 3.3% would encourage them to pay by the due dates.
- Penalties and interest of 5.2% (build-up at eight days under the existing system) would encourage most to pay by the due dates.

Figure 8 shows the proportion of all SMEs that would be encouraged to pay at each penalty and interest value. The horizontal line represents the penalty and interest build-up at eight days under the existing system (5.2% at eight days). At this point most SMEs would be encouraged to pay by the due dates. The results are consistent with knowledge of how penalties and interest are applied, that for many SMEs the mere existence of a penalty encourages them to pay their tax by the due dates.



**Figure 8. Proportion of SMEs encouraged to pay at each penalty and interest value**

### Debt tipping points

There is a tipping point at which penalties and interest decrease compliance, at around \$10,000 (total GST debt, including core debt, penalties and interest) beyond which people feel that they will not be able to pay off the amount.

As can be seen in the tables below, across all SMEs the median tipping point is a total debt of \$10,000. This tipping point remains relatively constant except for larger SMEs that have an annual turnover between \$500,001 and \$100 million, or six or more employees. The median tipping points for these SMEs are \$28,965 and \$40,000, respectively. As can be seen in the tables below, the median tipping point does not vary by debt status.

**Table 2 Debt tipping point by annual turnover**

	All SMEs	Annual turnover			
		Up to \$50,000	\$50,001 to \$100,000	\$100,001 to \$500,000	\$500,001 to \$100 million
Base (n=)	251	41	57	88	62
10 <sup>th</sup> percentile	\$2,000	\$1,000	\$1,800	\$4,000	\$6,115
25 <sup>th</sup> percentile	\$5,000	\$2,000	\$5,000	\$5,948	\$10,000
<b>50<sup>th</sup> percentile (median)</b>	<b>\$10,000</b>	<b>\$10,000</b>	<b>\$10,000</b>	<b>\$12,000</b>	<b>\$28,965</b>
75 <sup>th</sup> percentile	\$30,000	\$20,000	\$20,000	\$38,680	\$180,000
90 <sup>th</sup> percentile	\$100,000	\$50,000	\$34,000	\$62,822	\$500,000

By annual turnover, findings indicate an interest scale could be an effective approach rather than a one size fits all. Smaller SMEs are more vulnerable to incurring debt and it appears have a higher threshold to incurring debt.

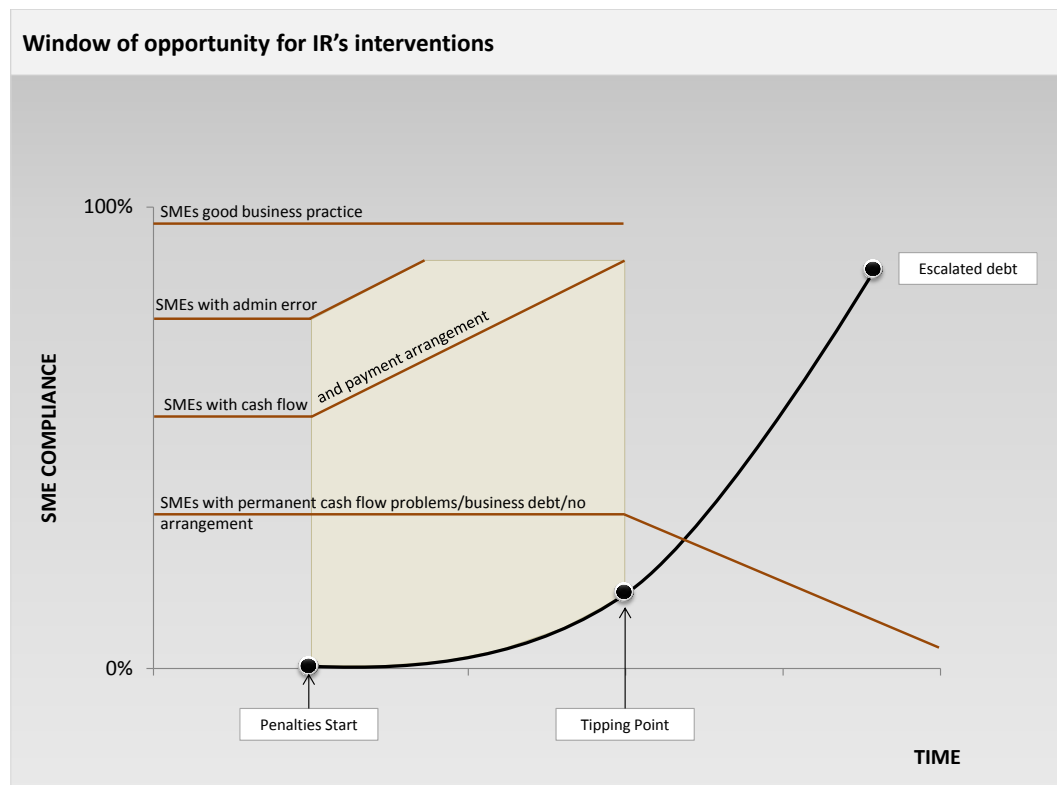
**Table 3 Debt tipping point by number of employees**

	All SMEs	Number of employees		
		Sole trader	1 to 5 employees	6 or more employees
Base (n=)	251	71	124	56
10 <sup>th</sup> percentile	\$2,000	\$2,000	\$2,453	\$7,036
25 <sup>th</sup> percentile	\$5,000	\$3,628	\$5,000	\$15,406
<b>50<sup>th</sup> percentile (median)</b>	<b>\$10,000</b>	<b>\$10,000</b>	<b>\$10,000</b>	<b>\$40,000</b>
75 <sup>th</sup> percentile	\$30,000	\$20,000	\$20,000	\$180,114
90 <sup>th</sup> percentile	\$100,000	\$100,000	\$50,000	\$500,000

**Table 4 Debt tipping point by debt status**

	All SMEs	Debt status		
		Never had a debt	Has a history of debt	Currently has debt
Base (n=)	251	56	79	116
10 <sup>th</sup> percentile	\$2,000	\$1,000	\$3,000	\$2,000
25 <sup>th</sup> percentile	\$5,000	\$4,485	\$7,027	\$4,418
<b>50<sup>th</sup> percentile (median)</b>	<b>\$10,000</b>	<b>\$10,000</b>	<b>\$10,332</b>	<b>\$10,000</b>
75 <sup>th</sup> percentile	\$30,000	\$20,000	\$50,000	\$28,569
90 <sup>th</sup> percentile	\$100,000	\$50,000	\$150,000	\$78,176

The diagram below illustrates the window of opportunity before the debt tipping point.



**Figure 9. Window of opportunity before tipping point**

### Triggers to debt

There are two main reasons for late payment of tax – administrative errors and cashflow (short-term and long-term). These causes of tax debt are also found in other tax jurisdictions research (Australian Tax Office, 2008; Canada Revenue Agency, 2009; HM Revenue & Customs, 2008).

With regard to decision-making and triggers to debt, the HM Revenue & Customs (2008) found that many debtors described how the misalignment between tax due dates and business invoicing dates caused short-term problems. Changes to income tax timeframes (provisional and terminal) to smooth out payments, and aligning the due dates for each tax type would be useful.

Paying tax owed is regarded as important, but when it comes to resource allocation decisions and prioritising outstanding debt, businesses rank meeting employee wage costs above other bills. Small business is assumed to be vital to the New Zealand economy, and that the Government needs small business earning revenue and employing people.

SMEs with long-term or high tax debt hope that back penalties (and possibly some interest), as well as future penalties can be wiped, so that the original tax debt repayment is achievable. Otherwise they 'bury their head in the sand' when they are unable to pay their tax debt or meet their instalment repayment obligations.

A group of motivational postures have been identified by Braithwaite (2002) as important in the context of taxation compliance, one of these is disengagement. This is where individuals and groups have moved past the point of challenging the tax authority. For these people the tax system and the tax office are off the radar. The objective is to be socially distant and blocked from view. Disengagement would be a 'by-product' of the tipping point with tax debt. IR would need to be cognisant of early warning signs and act before the SME reaches their threshold, and therefore the point of no return where tax becomes uncollectible.

IR can use its dialler technology (which is suited to large volume early contact) and its campaign management teams to contact debtors a few days after the due date. At this point it would enable IR to get more debt matters resolved when any penalties and interest would be minimal.

## Other types of sanctions and incentives

The OECD (2010) *Understanding and Influencing Taxpayers' Compliance Behaviour* report confirms that although the success of deterrence strategies can be linked to fear of detection or severity of punishment, it is also linked to norms, and deterrence is more effective where strong social norms exist. It proposes that revenue bodies consider the use of non-monetary penalties.

Five non-monetary sanctions and incentives have been identified as potentially encouraging SMEs to pay their tax by the due date. These are improved notification, credit reporting, an annual practising certificate, travel restrictions and information on statements to show how penalties and interest build up.

All five sanctions and incentives would be at least somewhat effective in encouraging on-time payment. Improved notification and information on statements to show how penalties build up would be more effective when combined with the current financial penalties and interest charges.

More punitive options, such as travel restrictions and credit reporting, appeal to SMEs that have never been in debt and tax agents. For SMEs in debt, improved notification is the most effective incentive.

Other non-financial sanctions are less appealing.

The optimal system needs to strike a balance between punitive elements (penalties and interest charges for late payment) and assistance from IR to help ensure payments are made by the due dates (such as improved notification and more information on statements).

The introduction of credit reporting is likely to work in similar ways to penalties and interest, in that it would give IR effective leverage within the first few weeks of debt. However, credit reporting will also work in the same way that accumulated penalties and interest do – making it less likely for the debt to be repaid once the SME has accumulated penalties and interest and a bad credit rating.

### **Incentives**

Businesses would like a penalties and interest system to take account of good past history. They want IR to be flexible, with more tolerant treatment in terms of penalties and interest for those with good records.

In particular, SMEs with a good track record should have some leniency (e.g., no penalty) if they have a one-off late payment. It provides that IR will notify a taxpayer the first time their payment is late, rather than imposing an immediate late payment penalty, and setting out a further date for payment. If payment is not made penalties are then imposed.

The most effective route to debt management and recovery is through IR more effectively managing the existing interventions and adopting standard debt collection practices which consist of proactive, early and personalised intervention from staff who are skilled in negotiating and agreeing outcomes.

## Conclusion

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This report has explored factors underlying SME debt attitudes and behaviour. The aim was to identify potential changes to policy and practices that help to lessen the growth of debt, or the time SMEs spend in debt.

Penalties and interest are influential, and improving awareness and knowledge of penalties would be effective in preventing or limiting tax debt in the early stages of tax debt. However, there are thresholds and tipping points and these suggest that, rather than changing the penalty rules, IR needs to use the existing sanctions more effectively. This would include better targeting of SMEs at risk, early dialogue, and ensuring staff are skilled in negotiating and agreeing viable repayment agreements.

The introduction of credit reporting is likely to work in similar ways to penalties and interest, and could be used in combination with more proactive actions. In particular, the threat of non-financial sanctions can be part of the early dialogue if SMEs do not adhere to payment arrangements.

The *SME Capability to Manage Regulation* (2011) research<sup>6</sup> argues that capability to manage any type of regulation is closely related to the capability to manage the business in general. The World Bank report, *Doing Business* (2010), states that New Zealand is one of the easiest countries to start a new business but IR tax data and Statistics NZ data show that SMEs are most vulnerable to fail in the first year. There could be a connection between the ease of set up, and the lack of knowledge of regulation obligations.

As raised at the beginning of the discussion, the complexities of the issues are such that it would require a collaborative, sustained and consistent approach by those in operations, policy and communications. No single intervention will in itself lead to a step change in outcomes; making a substantive difference over time will take an integrated and consistent approach involving new approaches and interventions.

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<sup>6</sup> Battisti, M. Deakins, D. & Perry, M. (2011). SME capability to manage regulation. New Zealand Centre for Small & Medium Enterprise Research, Massey University. Report prepared for Inland Revenue. The report argues that while compliance is a measure of demonstrated action, the concept of capability expresses the broader potential to act. It allows for a more nuanced understanding of how SME owners manage regulation.



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## Appendix A

### Key definitions

The Target group	Small and medium enterprises (SME)	<p>All entities with an active relationship for GST or PAYE that do not belong to large enterprises or non-profit organisations, and</p> <p>All non-individual entities without active registration for GST or PAYE not belonging to non-profit organisations.</p> <p>Enterprises with less than \$100 million GST turnover annually.</p>
Sanctions	Penalties and interest (related to new and old debt)	<p>This study focuses solely on late payment penalties and interest.</p> <p>Late payment penalties - If taxes and duties are not paid by the due dates, customers may have to pay a late payment penalty.</p> <p>Interest - If customers underpay, they will be charged interest from the day after the original due date for payment.</p> <p>These rules are designed to encourage customers to pay the right amount of tax at the right time and to compensate the Government if the customer pays too little tax by charging interest.</p> <p>Interest rates are set by government and are based on market rates and will vary over time. Interest on underpayments is linked to the market rate for short-term borrowing.</p> <p>Interest is calculated on a daily basis on the amount of overpaid or underpaid tax.</p> <p>Interest does not compound and is not included when calculating penalties.</p> <p>Interest on tax underpayments is charged on the tax owing, which includes accumulated penalties and shortfall penalties.</p>
Debt <sup>7</sup>	<p><b>Collectible debt</b> is debt that IR expects to collect and where active collection action is occurring or possible. This includes debt that is being progressively repaid under an instalment arrangement.</p> <p>The debt collection process starts with automated actions, such as reminder notices to customers with overdue debt. Next, on the basis of risk of continued non-compliance, cases are identified for debt staff to proactively contact customers to arrange payments, e.g., by phone.</p> <p>Customers who are unable to pay their debt at that time can arrange to repay by instalment. These have grown significantly, partly because of IRs voluntary compliance policy to encourage customers facing financial difficulty in the economic recession to contact IR and set up instalment arrangements to pay their debts.</p> <p><b>Non-collectible debt</b> includes deferred debt, insolvency debt, default assessments and debt to be written off. Deferred debt is debt that is suspended pending investigation or litigation action. There is potential for a proportion of deferred debt to become collectible once the legal process has finished. The amount of insolvency debt that will be collected depends on the outcome of the insolvency process.</p>	

<sup>7</sup> Definition of debt is taken from Inland Revenue (2010) Annual Report.

	A default assessment is made where a customer has not filed a return to encourage them to comply with their filing obligations. In some circumstances, default assessments are collectible and paid. A proportion of the non-collectible debt will never be collected, and may be written off under various legislative provisions (e.g., hardship provisions).
Tax types	Income tax, GST and PAYE (most common tax types that incur SME debt).
Tipping points	When penalties and interest have a positive influence to compliance behaviour and when they become barriers to tax debt repayment.

The **enterprises** in this report are entities that have active registration with Inland Revenue, including:

- all non-individual customers that are not non-profit organisations, and
- individuals if they registered for tax types of 'GST' and/or 'PAYE'.

**SMEs** are enterprises with less than \$100 million GST turnover annually.

**Active in business.** Not all enterprises have reported business activities; some of them register with IR but do not have obligations for filing returns or paying GST, PAYE or Income tax because they do not provide services or sell goods. To identify and separate these entities, those who are running a business and have obligations in filing return or paying for GST or PAYE, or paying Income tax are identified as 'active'<sup>8</sup>.

**Turnover or GST turnover**<sup>9</sup> of an enterprise or SME is the annual sales and income from goods sold and services provided where GST is charged. It includes GST and zero-rated supplies (zero-rated supplies are taxable supplies that are taxed at the rate of 0%) but excludes exempt supplies<sup>10</sup>.

This turnover information is from GST101 returns (for GST), which can be filed monthly, two-monthly or six-monthly. For a new entity that starts a business sometime during a tax year, the annual turnover is proportionally estimated based on the turnover it gives for a period of time in the GST101 returns. However, if an entity which has obligation for filing GST did not file any GST101 returns for a tax year, the annual turnover is unknown. For the entities that do not have the GST filing obligation, the GST turnover is regarded as zero.

**Expenses** of an enterprise or SME include the annual purchases and expenses, for which tax invoicing requirements have been met, including GST but excluding imported goods.

Expense data are from GST101 returns. Same as GST turnover, the expenses for the new entities that start business sometime after the start of a tax year are proportionally estimated based on the expenses claimed from their GST101 returns. Also the annual expenses are unknown if the entity has not filed at least one GST101 return for the tax year.

Because turnover and expenses come from GST101 returns, enterprises, even though they are running a business in a tax year, have unknown turnover and expenses if they:

- are a member of a GST filing group, where a representative of the group files GST returns for all members, or
- are totally non-compliant in all their GST filing obligations in the tax year.

Some enterprises do not have GST turnover if their business is purely about exempt supplies and does not charge GST.

<sup>8</sup> 'Active' here means active in business, rather than active status of the enterprise.

<sup>9</sup> In this report, 'turnover' means GST turnover.

<sup>10</sup> For details, see *GST Guide – IR375* at

<http://www.ird.govt.nz/resources/d/a/dab382004bbe58fa80efd0bc87554a30/ir375.pdf>