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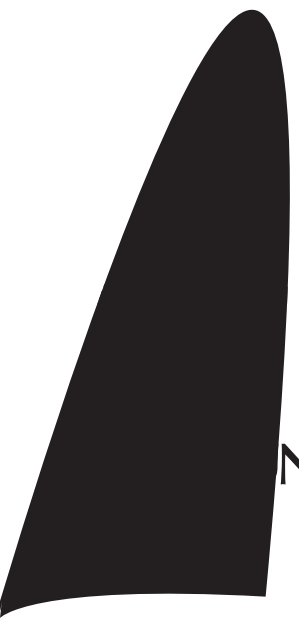
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# Intervening to reduce risk: identifying sanction thresholds among SME tax debtors

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## Abstract

Debt growth is outpacing the New Zealand Inland Revenue's capacity to manage it. This has triggered investment by the Government for Inland Revenue to look at new systems, approaches and tools to reduce debt, while maintaining integrity of the tax system. In New Zealand the small business sector makes a significant contribution to the economy, but it tends to be more susceptible to incurring debt. A large proportion of the total tax debt is owed by this sector with it making up about a third of tax debtors within New Zealand.

This research was designed to better understand intervention to reduce the risk of higher levels of debt for this business group. The research used a mixed method approach and included both debtor and non-debtor small and medium business participants to better understand what determines compliance behaviour. It explored the effectiveness of current sanctions and sought views on non-financial sanctions. It also attempted to identify tipping points and thresholds when penalties and interest become so large the SME debtor is likely to continue to make repayments.

The findings indicate that penalties and interest are influential. Improving awareness and knowledge of penalties would be







increasing the risk of non-compliance from tax payers who have previously complied. The balance is restored when tax debtors are perceived to receive their deserved 'penalty' by the tax authority, tax compliers and the debtor.

Lack of confidence in the system or perception that there is a lack of fairness or trust can occur when there is a disjoint between tax administration policy and operations. For example, participant perceptions, in the (2009) CRA study, was that written communication did not give an indication that the revenue body was willing to work with people unable to pay the full amount right away or offer payment options. Some instalment payers said it took too long to hear about their late payment and most said they preferred written communication to a phone call about their late payment.

### 2.3 Lack of understanding of tax sanctions

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; CRA, 2009). A meta-analysis conducted by the National Research Unit within Inland Revenue (2010) noted that the number of customers filing GST but not filing incometax was approximately 20,000 per annum and warranted further investigation.

Although the majority of participants in the (2009) CRA study assumed there would be some sort of adverse financial consequence, such as interest, awareness was low about late filing penalty and how charges are calculated and participants felt that

update records more regularly will minimise business activity statement (BAS) (related debt,<sup>8</sup> and the extent payment methods contribute to the likelihood of incurring debt





#### 4.4 Tax Experiment

An online behavioural experiment was designed by Victoria University of Wellington (VUW) <sup>12</sup> The tax experiment was an environmental economics exercise and was the first time Inland Revenue has used this type of method to research taxpayer behaviour. It provided an environment where (unlike a survey) actual debt prioritisation

Table 1: Profile of participants by debt status for the qualitative phase (indepth face-to-face interviews) N=60

Table 2: Phone survey SME participants by debt status, age of debt and business size group (N=450)

Debt status	Age of current debt	Sole trader	1 to 5 employees	6 or more employees
Never had debt	Not applicable	50	30	20
Has a debt history	Not applicable	73	47	31



using the statistical software SAS. The data was analysed by participant region, industry areas, business size and GST turnover.

#### 4.7 Limitations

Telephone surveys achieved a higher response rate among SMEs because interviewers

## 5.1 Awareness of late payment penalties

In the majority<sup>18</sup> of cases, penalties influence payment, and discourage it in a minority of cases. For SMEs who have never been in debt, it is the mere existence of penalties that influences payment (rather than the specific details of the penalties). The majority of SMEs said the penalties are influential in making sure they pay their business tax by the due dates. This is because they want to avoid any additional or



administrative errors said they made straightforward changes to business practices and processes to ensure it doesn't happen again, for example, reminders of due dates and improved administrative practices.

Findings from the tax experiment provided insight into how SMEs make the payment of debt. As part of the experiment decision makers were required to trade-off various competing payment priorities under different penalty regimes. Paying employee wages consistently received the highest average priority rating, as did the threat of implications. Payments to Inland Revenue rated second (with PAYE rating higher than GST). The behavioural differences observed between small and larger sized SMEs are quite notable, suggesting that different compliance strategies may be required for different sized businesses.

Perception of fairness of the penalties was explored with participants. SMEs were evenly divided on this issue, with about half of the participants perceiving Inland Revenue financial penalties as fair when it comes to financial penalties for late payment. As would be expected however, perceived fairness varies by debt status. For example, SMEs with a debt history and SMEs that are currently in debt were more likely to perceive the financial penalties as being fair for businesses.

The most common reasons for perceiving penalties and interest as unfair included that they are high, or concern that they can compound and get out of control. Reasons for perceiving penalties and interest as fair included that they are a lever to obligate SMEs to pay on time, and that they are needed to encourage compliance. There is a strong sentiment that ongoing penalties are 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 (more than the banks' loan rates) for unpaid amounts.

Analysis of the tax agent data showed that their views were also divided about whether the system is fair or unfair; half of tax agents believed the penalties are fair.



Results show that attitudes and behaviours vary across the SME customer groups. Importantly financial (and business) aptitude marks the difference between those SMEs that have never been in tax debt and SMEs that have experienced tax debt.





Table 4: 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
50 <sup>th</sup> percentile (median)	\$10,000	\$10,000	\$10,000	\$12,000	\$28,965
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

Base: All SMEs, excluding those that said 'no amount would be too high' or 'don't know'.

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 they have a higher threshold to incurring debt.

Table 5: Debt tipping point by number of employees

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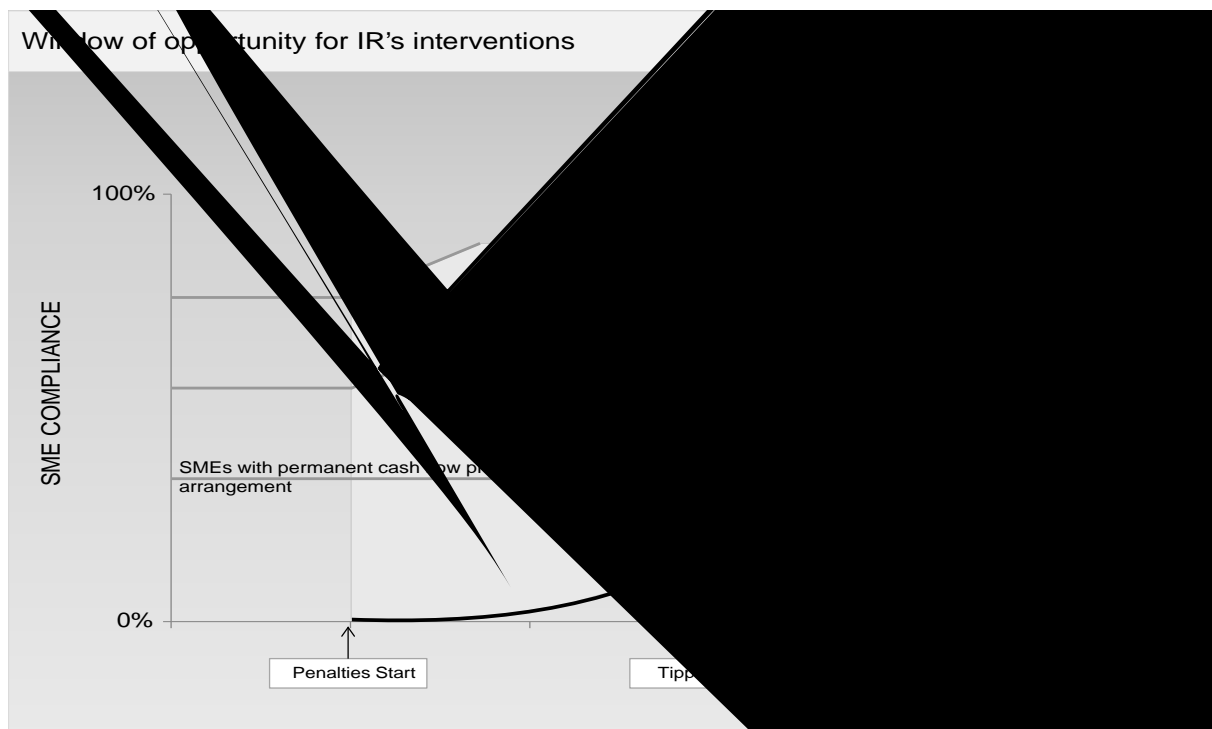
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Table 6 Debt tipping point by debt status

	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
50 <sup>th</sup> percentile (median)	\$10,000	\$10,000	\$10,332	\$10,000
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

Base: All SMEs, excluding those that said 'no amount would be too high' or 'don't know'.

When the thresholds and other additional factors are taken into account, there is a small window of opportunity where the tax administration can intervene for impact before the debt tipping point is reached. This is the best time to intervene to reduce the risk of debt. This is illustrated in figure 2 below.







risk. For example, more than two thirds of all SMEs surveyed said they were aware they can contact Inland Revenue in advance to avoid some penalties. SMEs currently



## 6.1 Intervening to reduce risks with current sanctions

The majority of SMEs thought that penalties are influential in making sure they pay their business tax by the due dates. However, depth knowledge of the penalty rules does not necessarily equate to good compliance behaviour. Most SMEs were aware of financial penalties for the late payment of business tax, but the research highlighted a lack of detailed knowledge of how the sanctions were applied. For example, only a quarter of SMEs were aware of the current interest rate.

SMEs with debt or who have a history of debt were 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, but less so for SMEs who have never been in debt. Knowing that penalties exist is enough for this group to ensure they comply.

These findings are similar to that identified in [CBA \(2009\)](#) u

application of penalties and interest without proactive (and effective) intervention from the tax administration 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 targeting the existing sanctions more effectively to different SME groups. Inland Revenue is undertaking segmentation analysis using its administrative data to help identify SMEs at risk of incurring tax debt.

## 6.2 The role of other types of sanctions and incentives to help Inland Revenue intervene to reduce risk

Social or personal norms are important drivers of compliance. 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 linm1(t)-3ndingnders6a(ett de r)-4(a)9(t)(nde)1(a)-2(r)-nto



(provisional and terminal) to smooth out payments, and aligning the due dates for each tax type<sup>29</sup>

Inland Revenue's role is primarily a tax collection agency and is not supposed to be an organisation whose aim is to coach business people to gain better business skills. Although some participants may see Inland Revenue not acting in line with government's policy to encourage economic growth some participants understood that the Department is not in a position to make specific recommendations to an individual business.

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

## 6.6 Issues of fairness

Issues of unfairness and inflexibility were identified for Inland Revenue and

As discussed previously, Inland Revenue's Finance and Planning (July 2011) report acknowledged that the attached [B28.804 0kB (g)1Tm [(A)5Ao /7 Tc eachAlledotta







growing levels of outstanding returns and debt and developing high level solutions that encourage taxpayers to comply.

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