



2008/09 financial review of the Inland Revenue Department

Report of the Finance and Expenditure
Committee

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Inland Revenue Department

Recommendation

The Finance and Expenditure Committee has conducted the financial review of the 2008/09 performance and current operations of the Inland Revenue Department and recommends that the House take note of its report.

Introduction

The Inland Revenue Department's responsibilities include

- advising the Government on tax policy and certain social policy measures
- collecting tax payments, child support, and student loans
- distributing payments such as tax refunds and rebates, Working for Families tax credits, child support, and paid parental leave
- administering KiwiSaver.

In the year ended 30 June 2009, the department found savings of \$10.9 million for return to the Government, reviewed operating costs and increased productivity to find further savings, negotiated double tax and tax information exchange agreements, supported taxpayers experiencing hardship while maintaining compliance, improved access to on-line and telephone services, and worked on improvements to the disputes process.

The department's total revenue for the year ended 30 June 2009 was \$665,018 million (actual) and total expenditure was \$658,924 million (actual) with a net surplus of \$6.094 million.¹

Tax debt

The department's performance in managing tax debt has been a long-standing concern for us, and our predecessors. We note that the book value of the tax debt at the close of 2008/09 was \$11.398 billion, of which a considerable proportion was considered overdue (\$4.754 billion).² The department told us that about 40 percent of the overdue debt arises from penalties and interest. We acknowledge that the department increased the amount of debt it collected overall in 2008/09 by 10 percent over 2007/08. However, given the large amount of penalties and interest, we consider that there is still room for improvement in the department's debt management.

The commissioner confirmed that the average return for every dollar spent on chasing tax debt was \$62.50. The commissioner noted that if the department had more staff it could

¹ Inland Revenue Department, *Annual Report 2009*, p. 78.

² Office of the Auditor-General, Briefing on the Inland Revenue Department, p. 23.

collect more debt or undertake more investigations. However, the more resources applied, the more returns diminish, and it gets harder to collect the incremental dollars.

In 1999 the Finance and Expenditure Committee examined tax debt in an inquiry into the powers and operations of the department, but not all of the committee's recommendations were acted upon.³ Further to this, we wrote to the Minister of Revenue, who explained which recommendations had been implemented and why some had not been. Recently we reported to the House on an examination by the Office of the Auditor-General of the department's management of tax debt. The office noted that tax debt had increased by 91 percent between 2004 and 2008, during which time the total tax base had grown by 35 percent only, and suggested that tax debt was outpacing the department's capacity to deal with debt. If this were to continue unchecked, the office considered that overdue tax debt could double to more than \$8 billion within five years. It recommended improving information collection, analysis, monitoring and reporting, resource allocation, and debt collection techniques.⁴ In our report, we urged the department to do more to help people avoid debt in the first instance and to pay it quickly.

We acknowledge that the department adopted some new approaches to debt management in 2008/09 and we look forward to the department implementing the specific recommendations outlined in the Office of the Auditor-General's report on how to manage this issue better. We encourage the department to continue proactively encouraging people to inform the department quickly if they are unable to pay, or to enter into instalment arrangements, and thus limit the amount of penalty accrued. We will continue to monitor this area closely in future financial reviews.

Tax on structured finance transactions

We asked why the amount of deferred debt had increased by \$233 million in 2008/09 over the previous financial period. The department explained that the increase arose from a few high-value disputed cases, but the amount did not include the assessed tax on several large cases relating to the use of structured finance transactions. The department told us that "there had been agreement in previous years with Audit New Zealand not to report them pending the litigation on the disputes because they were so large".

We note that these cases are largely responsible for a trebling of legal costs to \$13 million in 2008/09. Although this considerable cost would be of some concern if the trend continued, we are assured by the department that expenditure on legal advice should fall in 2009/10, because two major court cases have since been completed.

We were told that the department has recognised taxation revenue assessed for structured finance transactions as tax revenue in accordance with accounting standards—a total of \$1.423 billion for 2008/09.⁵ This is because it considers that recent rulings affirmed its application of tax law to such transactions. We understand that the department plans to

³ Report of the Finance and Expenditure Committee, *Inquiry into the powers and operations of the Inland Revenue Department*, Forty-fifth Parliament, I.3I, October 1999.

⁴ Report from the Controller and Auditor-General, *Inland Revenue Department: Managing tax debt*, June 2009, pp. 5, 7–8.

⁵ Briefing on the Inland Revenue Department, p. 10.

review its tax revenue recognition policies in 2009/10. We will be interested in the outcome of this review.

The department advised us that during 2008/09 four audit cases were closed, where the tax in dispute was in excess of \$10 million and, in addition, at 30 June 2009, there were 18 cases with over \$10 million in dispute, which remained unresolved.

Taxpayer rulings and dispute resolution

We have been concerned for some time that delays in resolving disputes with taxpayers are contributing to spiralling tax debts. In our examination of the Estimates for Vote Revenue for 2009/10 we suggested that the department improve the timeliness of its resolution of disputes.

We are pleased to have learnt that the department has made some progress in this regard. It has been working with the New Zealand Law Society and the New Zealand Institute of Chartered Accountants to revise its processes for providing tax rulings and the management of its disputes process, so that rulings are issued more quickly and the department engages in fewer disputes. As a result, the department can now deliver most rulings in three months or less, and this has led to a decrease in the number of inquiries about progress with rulings. We note that the department plans to dedicate more service-delivery staff to providing rulings, because there is more interest in obtaining rulings since the waiting time has shortened.

The department has also returned to its previous practice of providing indicative, non-binding views, in response to demand from large businesses. We consider this is a good move because clear, transparent rules, especially on complex tax matters, will provide customers with more certainty.

We support further work in this area to reduce the time for providing rulings and thus reduce uncertainty to the parties concerned. However, we need to measure the effectiveness of doing so by monitoring the decrease in new tax debt over time.

Tax avoidance—investment property sector

In Budget 2007 approximately \$14 million was appropriated over three years to help recover \$70 million in unpaid taxes from the property sector. The department told us that it is currently tracking ahead of its recovery target, having recovered \$54 million in the first two years. It has used the additional funds to provide information and education on practices that might constitute tax avoidance, such as the use of LAQCs (Loss Attributing Qualifying Companies) to own personal residences, inappropriate claiming of personal residence costs, and trading in investment property. A large number of voluntary disclosures resulted, and the establishment of new LAQCs in the property sector is declining.

Because the department is now in the final year of the additional funding, we asked whether collection from this sector will decrease with the removal of the additional resources. We consider that the property investment sector remains a significant fiscal risk, and we will be very interested to see how the rate of collection from this sector is maintained.

Tax audit discrepancies

We note that the department underestimated the discrepancies between tax self-assessed by taxpayers (\$877 million budgeted) and the actual liability of \$1.2 billion assessed by the department in its tax audits.⁶ We asked whether the department's approach to taxation assessment is working as well as it should. The department commented that both the legislation and company structures are complex. It regards the amount of discrepancy recorded as normal and comparable with international discrepancy rates. We acknowledge the difficulties but encourage the department to continue its efforts to reduce tax audit discrepancies.

On-line trading

In 2008/09 the department identified 55 on-line traders with gross sales of more than \$100,000 who were not registered for GST or had not disclosed the revenue in their tax return. A total tax discrepancy of \$284,612 was found by the department's tax audit.⁷ Although this amount does not overly concern us of itself, we expect the number of transactions made through the internet to grow significantly. For this reason, we questioned whether the department was devoting sufficient resources to targeting people who avoid tax by using on-line trading to operate as a business.

The department acknowledged that a certain proportion of on-line trading fails to return tax, but told us that the department's preliminary work suggested that the risk was not great given the total number of traders in New Zealand. This sector will nevertheless remain a focus for the department, as business transacted via the internet is increasing and the department's ability to analyse compliance risk has improved. We are pleased to see that the department recognises on-line trading as a key risk and look forward to seeing results from the work in this area.

The underground economy

The department expects a slight increase in tax evasion and more activity in the underground economy as a result of the economic recession. We were informed that one piece of international research suggests that the estimated average size of the hidden economy in OECD countries might be as high as 14.8 percent of official GDP. The department cannot quantify the underground economy in New Zealand, nor has it undertaken research in this area. The department told us that this kind of research is very difficult, and there are divergent views on how to go about it. By its very nature a hidden economy is hard to measure.

The department is aware, however, that the underground economy is more prevalent in certain sectors, such as on-line trading, horticulture, hospitality, auto repair, home renovations, and the taxi industry—in short, any place where there is an opportunity to earn substantially on a cash basis. The department commented that it is labour intensive to chase the hidden economy, and the department's efforts generally yield a small return. It nevertheless continues to work on these areas in an effort to discourage more people from

⁶ *Annual Report 2009*, p. 33.

⁷ *Annual Report 2009*, p. 34.

operating outside the tax system. It has made a number of improvements in an attempt to better target those who operate in this space.

While we accept that targeting the underground economy might not yield great financial return on investment, we support the department's ongoing focus in this area. We wonder whether the increasing trend towards conducting business on-line in recessionary times may ultimately require the department to maintain more of a presence to discourage growth in this area.

Collaboration with other agencies

Forecasting tax revenue

We note that actual tax revenue for 2008/09 was \$2.163 billion less than forecast in Budget 2008—a decrease of 4.2 percent across all tax types.⁸ We also note that the tax revenue for the first quarter of the 2009/10 financial period is already \$1.1 billion below that forecast in Budget 2009.⁹ We asked what the department was doing to improve its performance in this area, and particularly how it works with the Treasury to produce tax revenue forecasts.

The department told us that it works hard to produce reliable forecasts in a rapidly changing economic environment, and the variation between its forecasts and actual revenue is consistent with international experience. Its tax forecasting team works closely with its counterpart at the Treasury. Although both teams apply the same macro-economic assumptions, share certain information, and discuss aspects of their work, their forecasts may differ. We acknowledge the difficulty of forecasting tax revenue accurately, but encourage the department to strive for more reliability in its revenue forecasts.

Social benefits and debt collection

We were interested in the extent to which the department is exploring possibilities for sharing business processes and services with other State-sector agencies. By law the department is prohibited from disclosing certain information to third parties, including other departments, which limits direct collaboration with other agencies except for child support purposes. The department is, however, exploring the potential for integrating debt collection with other departments, principally the Ministries of Social Development and Justice; but there are significant policy issues to consider because of its special powers and access to information.

Customer service satisfaction

We remain interested in the department's progress on simplifying its processes and practices and modernising its IT systems to make it easier for customers to comply with their tax obligations. Providing better information and the ability to do more electronically are vital to ensuring that taxpayers are provided with the best service possible. We are pleased with recent improvements to the department's website and the introduction of facilities for confirming personal tax liability and preparing and filing IR3 tax returns.

⁸ Briefing on the Inland Revenue Department, p. 30.

⁹ Briefing on the Inland Revenue Department, p. 31.

As the telephone is the preferred channel of communication for most people we are pleased that the department reduced waiting times and the number of abandoned calls in 2008/09. The introduction of a call-back option appears to have enjoyed some success (61 percent of those offered the service choosing to use it), and we are pleased to note that the department will be investing in new technology in 2009/10 to improve its call management and encourage more use of on-line services.

We note that in 2008 the department introduced a new customer satisfaction perception survey to provide better value for money and to allow benchmarking with other Government agencies. We are pleased that the department records an overall increase in customer satisfaction from 80 percent in 2007/08 to 82 percent in 2008/09. The key features of the survey, we were told, are that it is run independently and interviews people who have had direct contact with the department. We consider it would be useful to report the outcome of the survey in more detail, to show customer satisfaction broken down by customer grouping. We note that the department is investing significant funds in self-management technology in an effort to drive efficiency and to make it easier for customers to self-manage their obligations. We look forward to receiving progress reports on the success of and satisfaction with this initiative.

We acknowledge the improvement in customer services, but encourage the department to do more to make it easier for customers to comply with the tax obligations, and especially not to lose sight of customers' preference for using the telephone.

Staff changes

In May 2009 the department decided to shed 450 full-time equivalent staff over 2009/10 as part of an efficiency drive; 270 staff opted for voluntary redundancy, representing \$15 million in annual savings. We wondered whether the department had considered deploying these staff in high-priority areas such as debt collection, but were told that the savings had been achieved from specific programmes such as KiwiSaver, property compliance, and research and development tax credits, and it was not always possible to redeploy staff with particular skills and capabilities.

We also note that the department expects to move towards a smaller, more highly skilled workforce as more services are provided on-line, and we asked about the implications for staff. The department acknowledges that a logical outcome is that fewer staff will be needed, and that skills requirements will change gradually. The implications for staff and their options are the subject of a project, which the department expects to report on in mid-2010. We will be interested in any initiatives announced at that time.

Consideration of new tax arrangements

The department has been working with the Tax Working Group established by Victoria University of Wellington to consider the direction of tax policy in the medium term. We understand that the group is considering and will report finally on a range of possible taxation options, including a capital gains tax, increases to GST, and other measures by January 2010. We will be interested in seeing the report when released, and the Government's response to it.

We also asked whether the department favoured a tax on all foreign exchange transactions (Tobin tax). The department advised that it had recommended against such a tax when it was under consideration by the (McLeod) tax review in 2001, because it could penalise exporters and would not work unless adopted universally. We note that the department has not revised its view.

Appendix A

Approach to financial review

We met on 18 November and 16 December 2009 to consider the financial review of the Inland Revenue Department. Evidence was heard from the Inland Revenue Department and advice was received from the Office of the Auditor-General.

Committee members

Craig Foss (Chairperson)
Amy Adams
David Bennett
John Boscawen
Brendon Burns
Hon David Cunliffe
Aaron Gilmore
Raymond Huo
Rahui Katene
Peseta Sam Lotu-Iiga
Stuart Nash
Dr Russel Norman

Evidence and advice received

Inland Revenue Department, *Annual Report 2009*.

Inland Revenue Department, *Statement of Intent 2009–2012*.

Inland Revenue Department, Response to supplementary questions, received 7 December 2009.

Office of the Auditor-General, Briefing on the Inland Revenue Department, dated 18 November 2009.

Appendix B

Corrected transcript of hearing of evidence 18 November 2009

Members

Craig Foss (Chairperson)

Amy Adams

David Bennett

Brendon Burns

Hon David Cunliffe

Aaron Gilmore

Raymond Huo

Rahui Katene

Peseta Sam Lotu-Iiga

Stuart Nash

Jonathan Young

Witnesses

Robert Russell, Chief Executive and Commissioner of Inland Revenue

Robin Oliver, Deputy Commissioner (Policy)

Carolyn Tremain, Deputy Commissioner (Service Delivery)

Foss Welcome, we are in open committee. We are here for the IRD's financial review for FEC. Thank you very much. What we do is, as per normal, after your opening remarks—there may be some points you wish to raise, sir—I'll lead off and then pass around the room to various members. We've got about until 12.55 probably at the latest.

Russell Thank you very much. I'll just introduce a few people before I start. *(Introductions)*. It's been a really strong year for us. If you look at our annual report we met 91 percent of our performance targets—59 out of 65. That's the best we've ever done and we're really proud of that. It was a pretty challenging year though. We had a spend of \$658 million. It comes down this year to \$631, and so we were working hard last year towards the end of the year to find ways that we could position ourselves to manage within the budget in 2009-2010. We kept our customers satisfaction up high. In fact, we raised it from 80 to 82 percent. We did some good work with the Law Society and the Institute of Chartered Accountants of New Zealand around redefining how we do rulings and how we manage the disputes process, and I think both of those have real potential to allow us to improve our performance to provide better service to taxpayers in New Zealand over the next while.

We launched our compliance management programme publicly for the first time ever, and that has been well received. You may want to talk about that a bit more. We've taken some new approaches to encouraging compliance, particularly in the property sector, and with really good results. We concluded double tax agreements with Australia and the US, obviously really critical ones, with Singapore as well, and some tax information exchange agreements, doing that in the context of an increasingly open financial system in the world where G20 has encouraged banks and countries to be much more open in exchanging information and so we're positioning ourselves to take advantage of that.

Robin and his team have been actively supporting the Victoria University tax working group throughout their deliberations through the year.

Back to the financial situation of the department. We did a line-by-line review. We returned \$11 million in real savings to the Government this year. We drove our travel costs from \$12 million down to \$8 million last year, and we are forecasting less than \$6 million this year. International travel was cut in half, and we reduced our operating cost per FTE by 11 percent. So we used to spend a little over \$10,000 a year per person in operating costs to run the department. We'll finish this year about 450 people fewer than we had at the end of last year, and a lot of that is accomplished by being able to do things more efficiently and more effectively.

So I think it's been a strong year. There are challenges for us. Our volumes have continued to increase. The PTS intermediaries, as we call them—that's the taxrefund.co types that you see advertising on television and the

newspapers—have hit us with very, very large volumes of requests for PTS, personal tax summaries, and at times that has been challenging. The telephone line, for example, from 2007-08 to 2008-09 jumped from about 300,000 of those to process to over 700,000, so big pressures there.

The future we're looking at is a different kind of organisation that receives much more information in electronic form than we do today. We do a lot of paper processing, particularly employer monthly schedules, and that's a huge pressure point for us. It's costly; it introduces errors. So we want to work with the payroll provider community and business in particular so that we get high quality information in that's accurate and that we can trust and we can run it straight into our systems. We want to generate a lot less paper coming out of the organisation. We're currently doing about 20 million mail-outs a year. We want to drive that down dramatically. The first step to do that will be the modernisation of the student loans programme, which will be a predominantly electronic interface for student loan borrowers in New Zealand.

We want to change our disputes and rulings processes, and the comments I made earlier on the work we've done with the Law Society and the New Zealand Institute of Chartered Accountants will help us position that, so that we actually issue rulings faster and engage in fewer disputes. If we can do all of these things—improve the quality of electronic information we're getting in, drive down the paper that we're sending out, engage with customers electronically so that they can actually self-serve and self-manage a much greater proportion of their interaction with us—then that'll free resource up for two things: to actually reduce the size of our total spend on people. We think we can operate in an electronic world with a smaller workforce, and that's good, that'll save us money as an organisation. But it'll also allow us to free up more resource to do more proactive work, rather than be bound to respond to the stuff that's coming in the door to us—the 4 million phone calls, for example, that we get. It would free resources up for us to be able to make decisions based on a compliance risk and allocate resource where we think we'll get the best return for it.

So very quickly, that's been the kind of the year that's been and where we want to go.

Foss

Thank you very much. I've got two questions, and then I'll open up to members. You mentioned in this financial year some issues around the property sector—that's national property assets, hard assets. Could you talk a little bit further to that, and are there any hard numbers you could point to because of some of the work you've done—you've managed to reclaim, if you like, \$x-revenue, or something like that? Then I've a further question, which leads from that, and it's picking up the disputes resolutions, binding rulings, which are probably linked to that. What've you got in plan to provide further certainty, particularly to the larger taxpayers out there, in and around what is and is not allowed under the various tax laws?

Russell I'll talk about property first. Property has been, for some years, a significant area of work for the department, and we have been assessing somewhere in the order of \$100 million a year in discrepancies in the property sector, going back several years. In the Budget 3 years ago, I guess, we were given \$14 million over a 3-year period that ends this year, to do some additional work, and we essentially contracted to deliver about a \$70 million return on that. We're currently tracking substantially ahead of that. The first year we focused more on non-audit kinds of interventions, on getting information out there to people. One of the areas that we identified was problematic was the use of LAQCs—Loss Attributing Qualifying Companies—as personal residences, and inappropriate claiming of what would be, normally, your personal residence costs through that LAQC process. So we made that quite visible. There were media articles on it, and we started to get large numbers of voluntary disclosures and there's some data around that shows a significant diminution in the establishment of new LAQCs in the property sector and the disestablishment of very large numbers of them. We wrote to about 35,000 directors that had LAQCs in the property sector and said: "This is an issue we're concerned about. If you're structured this way we think you should rectify it because that, in our view, constitutes tax avoidance." So rather than just jump straight to audit we took a number of those kinds of approaches.

The audit results, though—we did engage in that activity as well, and we were at about \$54 million after the first 2 years against the \$70 million we contracted for. We're over \$10 million, I think, after the first quarter this year, so it's still a productive area for us to work in.

Foss And the provider certainty around dispute resolutions?

Russell Essentially, we've done a lot of work with Martin Smith, our Chief Tax Counsel, and his team, to improve the productivity in the rulings sector, and in the future we'll be engaging more of Carolyn's people from service delivery so that we can put more resource to the provision of rulings. We've reached the point now, though, where the vast majority of the rulings are being delivered in 3 months or less from that group, and, as a result, we're starting to see the volume of interest in obtaining rulings coming back. There had been some falloff of that because there was a perception it just took too long.

We've also started to provide indicative views, a non-binding view but an indicative view, to companies. Oftentimes that will lead to them wanting a binding ruling and sometimes it will lead to them just going away and deciding not to do something. So that's something we had ceased doing for a few years and we've re-established that process. Again, that was something that large business had been asking us to do.

Cunliffe Mr Nash will run the bulk of our questions. I've just got a couple that relate to the recognition of tax revenue from the structured finance transactions, right upfront recognising the fact that some of these are sub judice, and I

- don't want to go anywhere the rights and wrongs of the cases or the ratio or the principles, but this is a governmental process question. For matters of this magnitude of forecast tax revenue, and again irrespective of the nature of _____ would it be your expectation, commissioner, that the department would consult with its Ministers on its strategy for handling this?
- Russell No, the responsibility to process cases rests with the Commissioner. Once we get into court we are in partnership with the Solicitor-General and the Crown Law Office, but the Ministers are not involved in cases.
- Cunliffe So there was no consultation whatsoever with Ministers on the approach to these cases—
- Russell On the approach to the cases, and how we would—
- Cunliffe General approach—
- Russell In terms of the recognition of revenue, that there were accounting issues that needed to be sorted between us and Treasury and Audit New Zealand on how they would be reported in the books. We worked our way through that, and then certainly advised the Ministers what the reporting process and procedure would be in accordance with IFRS standards. If you've got detailed questions, our chief financial officer can speak to that, but we concluded with the agreement of Audit New Zealand and Treasury that once we had the success in the BNZ case that on that basis we should book in 2008-09 all of the revenue for the structured finance cases, but—
- Cunliffe Absolutely, and I've seen all your treatment and it looks totally appropriate. What I'm trying to square—and that sounds a perfectly fair answer, and a lot of officials from the different agencies would be involved in matters of this interest. It's a judgment call, on the one hand preserving the independence of the operational interests of the department, and on the other hand, with no surprises, the responsibilities in terms of the fiscal forecaster. Sources told me that Ministers were of the view that the department ought to try and settle the cases before going to court, and some, in the order of half a billion collectively, might _____. Does that ring any bells with you?
- Russell No, that doesn't ring any bells with me. Our Minister is absolutely scrupulous about not asking about individual cases.
- Foss That's a question for the Minister.
- Nash Just on that, were the actual cases of banks included in the deferred debt amount?
- Russell Yes.
- Nash They were?

- Russell Well, they weren't included in the deferred debt amount. Sorry, normally when you go to dispute it's in deferred debt. Because of the magnitude of these ones there had been agreement in previous years with Audit New Zealand not to report them pending the litigation on the disputes because they were so large. Audit New Zealand had a differing view, and we've been discussing this back and forth over a couple of years about whether it should or should not be recognised. So that's been rectified now.
- Nash So it should not be recognised because, why? It might be easier to identify—or why?
- Tremain I think the main reason that we didn't put them in is these were new cases, and also going into an area of law that wasn't as well defined through the courts, and we've increasingly as the cases have been moving through the court processes been reassessing our level of confidence of success. I guess after the BNZ decision that sort of said to us, yes, we were taking the right approach and therefore there was an issue around when we would include the revenue in the books, and that then led to the discussions with Treasury and with NZ Audit.
- Nash With regard to your deferred debt, that's increased by \$233 million over the last year due to a small amount of high-value cases. We're not talking about the ones in front of the courts of banks at the moment. Have you any idea how many cases we're talking about, say, under \$10 million in disputed tax?
- Tremain No, but we would be able to provide—
- Russell There's been recent coverage of some of the mandatory convertible note cases that we've got, indicating that there's about 13 cases there with about \$700 million tax at risk, so there are quite a number of cases that are substantial but I don't have a number at this point.
- Nash With regard to managing tax debt _____ what percentage is penalties and interest this?
- Russell It varies by tax type—
- Nash About 40 percent?
- Tremain Yes, I think about 40, 42 percent.
- Nash The reason I ask is in your approach to managing debt you you've got _____ It involves engaging _____ and helping people to avoid debt. This is about working with customers before they get into debt. In fact, 42 percent of your total tax debt is interest and penalties. Does that mean that tax just isn't working as well as it should be?
- Tremain Well, our approach is only a recent change to our approach to managing debt, and so at this stage we don't have a clear indication of what impact it would have on the penalties area. I mean, the key issue that we've been

- working on given the economic situation is that people contact us early if they're unable to pay or enter into instalment arrangements. That limits the amount of penalty that's accruing.
- Nash If I can just move on to Audit, page 33. Audit discrepancies were at \$1.2 billion. Is the law not clear there? Would these guys just get it wrong? It's a lot of money, isn't it?
- Russell You've taken a lot of time to work through the legislation. You know the legislation is rather complex. Companies are often structured in very complex ways and it's not simple to get it all right. So it's a normal result of what is quite a complicated environment on both sides for us, and the taxpayers, and you'd see the same thing in any other country.
- Nash It's sort of back to the point of Mr Cunliffe's about property transactions. You see you've identified about \$122.3 million discrepancy, and I've seen a paper from you that suggests that the top 2,000 property traders, or whatever you want to call them—there's a discrepancy of about \$215 million there. Are you really beefing up—what are you doing about it?
- Tremain We have a team of 50 investigators working in the property-related area that's primarily as a result of the funding that was given to work in this area. Overall I think the level of funding is appropriate. However, I guess in any revenue authority if we have more people we can find more revenue.
- Nash If I go down a bit further on that to online traders. You've got 55 people, \$100,000, 32 audits only \$284,000. It seems quite low.
- Tremain I guess online trading had been identified as a risk area for us. Some of the work that we've done suggests that the risk is not as great across the total number of traders in New Zealand, primarily on Trade Me. But there is a level of trading there that is not returning tax.
- Nash Don't you think it's high when you identify 55 people? Is this the tip of the iceberg as online trading becomes more efficient?
- Tremain We haven't stopped our work in this area.
- Nash I suspect this is going to be an area that sort of increases or becomes more and more prevalent as BNZ becomes—
- Tremain Yes, I mean there's a considerable amount of commerce now being transacted across the Internet, as everyone knows. Our ability to actually analyse what's going on is improving. In fact, one of the spin-offs of some of the property work we've been doing is understanding a lot more of the analytics that we can put around some of the work that we see or some of the activity being traded in areas like Trade Me.
- Russell About 3 years' ago in Carolyn's area we established a strategic compliance risk assessment capability and brought in people with PhDs in maths and

- things like that to be able to do the kinds of analysis that we didn't have the capability to undertake before. So it's their work that's leading us into these new areas.
- Nash What the hell was going on with horticultural contract laws? Again was the law unclear or was it a whole lot of blokes who together and said "We can rip off the IRD."? I mean, 20 different companies.
- Russell Probably the latter. There were people who thought they could rip off the IRD. It was fairly simple schemes of false invoicing and therefore under-reporting of tax and the fraudulent claiming of GST refunds.
- Nash Just one last question on your prosecutions litigation. The Penny and Hooper case—I assume it's before the courts—have you quantified the fiscal risk of losing that case? (*Interruption*)
- Oliver We haven't quantified it. It's significant. It's all about the ability for high-income taxpayers to reallocate their income to companies or trusts, or companies owned by trusts, normally, and therefore reduce tax from 38 percent down to 30 or 33 percent. In our briefings to various Governments we have continuously emphasised great concern with the integrity and fiscal effects of basically the holes in the tax system allowing high-income payers to pay 30 percent or 33 percent and not 38 percent tax. This is an important area, not so much in the case per se, but just that the principle of when can you allocate income into a company but on the other hand providing business certainty so people know what is the acceptable side of the line versus the other side of the line.
- Nash Just one more question. I note on page 59, "Expenses for services to inform the public about entitlements re obligations" at \$253 million. I suppose it ties into the property area a little bit. There was an editorial in the *Listener* in September where the editor wrote that medium house prices had doubled in 2000-06, or something. People had been buying and selling second, third, fourth, even fifth, houses and making tax-free profits. This was the editor of the *Listener* _____ 8 people. That just shows that perhaps the education around property trading is either really unclear or isn't getting through. I'm just keen to know how that \$253 million is made up, and you may want to come back on that. But that's a lot of money, and some of the messages _____
- Russell A lot of it is in Carolyn's area. The whole assistance group—
- Tremain A good proportion will be brochures—provision of our brochures. We also have a team of people who specifically work in the community and work with specific industry groups—work with new businesses who've recently established; it's a whole range of activity. We can detail a lot more of that if you'd like us to.
- Nash We wouldn't mind that.

- Russell It would include all of call centres, for example, where we have almost 800 full-time people answering phones and providing information to the public.
- Foss Are you continuing to see a plateauing of PAYE payers at \$60,000? _____ Basically you're looking at 38 percent, a high margin on a 33c trust_____ Regardless of the philosophy of maybe should they be lower, higher, or whatever, the inherent difficulty and the arbitrage, or the time spent making one's tax affairs as efficient as possible, are you—
- Oliver This is the famous spike at \$60,000. That spike is still there. We expect it to become \$70,000 obviously, which is the new 38 percent threshold, and we are seeing, if anything, a growth in the spike at the lower level, which will become \$48,000 when the lower level of tax comes in. So, yes, the spikes are there and they're still growing.
- Adams I want to start off going back to some of the areas I talked about last year, because I remember very clearly giving you a bit of a hard time around some of the spending in property and travel particularly. I just want to recognise that that has made a big improvement this year, so I think that's recommended. But in that line we also spent a bit of time last year talking about the expense on consultants and contractors, and I see that that has come back this year. But, still, at \$59 million it's still a reasonable chunk of cash. Can you see that coming back further, or is that a reasonably in-built part of your operations unit?
- Russell Probably a mix of both things. It will continue to come back. It's comprised of a large spend on continuing to implement legislative programmes. So in 2008-09 we were finishing KiwiSaver and working the bugs out of that programme after it became operational. Implementing new things like the IETC and those kinds of things require us to bring in contractors to do IT work in particular. The IT spend though, that work is falling off quite dramatically compared to where we were a couple of years ago when we were heavily into building KiwiSaver. So our IT share of that went from 73 down to 59, and the IT went from 46 down to about 25 or 26, I think. The one that went up substantially is tax advice, and that's essentially the structured finance cases, and we were incurring large legal and expert witness costs for those.
- Adams Are you saying your legal bills are included in that?
- Russell Yes.
- Adams I would have thought there would be a different highlight in the accounts for next year.
- Russell No, they are still external contractors, so the legal or tax technical advice went from about \$4 million last year to \$13 million in 2008-09. So it's come down substantially. The project build part of it has come down quite a lot, but as we got into those cases that one went up.

- Adams The next thing I want to ask you about was your cross-agency work. Information sharing between you both, I guess, will focus on your debt management and recovery, but also I'm particularly interested in how that works in your tax forecasting aspects, because obviously the tax forecasting has been a bit of an interesting exercise for you in recent times. No one could get it right, but obviously it has been all over the place. How well do you work with other agencies in your information sharing both in your work and tax debt management collection and also tax forecasting?
- Russell In tax forecasting the principal interface is with Treasury and we have a team and they have a team, and they work very closely together—use the same macro-economic assumptions. We've got more taxpayer-based kind of data than they do and there's that constant checking going back and forth. Robin has responsibility for that area. I might let Robin make any comment he wants.
- Oliver Yes, mainly obviously we work with the Treasury. We tend to do forecasting bottom-up, The Treasury bottom-down, then we discuss it and we have different forecasts. But we share a lot of information before doing that. We also have some contact with the private sector on our forecasting—large corporates and their future forecasts. Obviously it's sensitive information, but we get a lot of cooperation from them. Those are the main sources, and then as well as Treasury, obviously, and places like MED, and what have you. But the main area of focus is company tax.
- Adams Looking really at the cross-agency work with information sharing around your debt management and tax collections—how well is that working and when can that be improved?
- Russell In terms of most of our debt collection work we're prohibited under the law to kind of provide much information to third parties, including other departments, about taxpayer situations. So there's not a lot of direct collaboration with other agencies. On child support there is, and our data exchanges between us and MSD that allow MSD to identify cases, perhaps, of fraudulent benefit claim. We're also doing some work with MSD, Justice, and others looking at whether there couldn't be a more integrated collection activity for the Government, broadly, because there are other places that have debts to collect.
- Adams I guess that's the nub of my question. What else can you be doing in that space to improve the performance?
- Russell We are working with those two departments, in particular. There are other possibilities as well, but MSD and Justice would be probably the two biggest and obviously immediate ones. We're effective in collecting debt primarily because we have special powers that allow us to do that and access to information that other agencies don't. So there are some policy issues to be thought through if we're to move towards some kind of integrated debt collection.

- Bennett With the movement towards less paperwork within the organisation and especially in regards to taxpayers trying to get more notifications done online, for example, there's talk about the role of different processing centres. Do you just want to give us an update on those?
- Russell We have three processing centres, one in Hamilton, one in Upper Hutt, and one in Christchurch. If we're successful in inducing more employers to provide information to us in electronic form—currently about 80 percent of our 180,000 schedules a month come in in paper, and so processing centres really take that and scan it, and when the scanning doesn't work keypunch it in. If we're successful in migrating to a much more electronic interface we won't need to do as much of that kind of work, so we're doing an analysis right now to see if we could work with two centres instead of three centres, when do we think that would be possible, and which of the centres might we eventually close, and how would we do that in the most effective way, and where would the best opportunities be to integrate staff into other parts of the operation—those kinds of questions—and that analysis is ongoing. But the logical extension of the remarks I made at the outset around trying to get an electronic interface driving down the total employment base of the department means we will have to make some of those difficult decisions.
- Lotu-Iiga Just focusing on the customer service and satisfaction aspect of your organisation, I've just got a couple of questions around this. Obviously your contacts are going up into the telephone contacts, probably 4½ million at the moment, and your website visits. I'm just trying to break down some of the stats that you've provided on pages 26 and 27 of your annual report. In terms of the response time for correspondence you seemed to have just lumped it all together. Have you got a breakdown of telephone calls versus, say, correspondence? It's hard to get a fix here between the different ways of responding.
- Tremain We can provide some further detail, on voice channel, paper, email, for example.
- Lotu-Iiga In terms of figure 11—your customer satisfaction surveys. Can you give us a methodology around that, because it's easy to just plump numbers and stick them on a sheet. I can't get a feel for the number of respondents, the methodology that you use, because if some people are not satisfied that they're not even getting to IRD, how are they—
- Russell What we've done historically and we're continuing to do is to use an outside contractor to provide statistically valid results for us, broken down by category of customer—so child support customer, or whatever—and they do that by ringing and interviewing people that have had direct contact with us. So we know we're talking to someone who's had experience with the department and has a basis for making a judgement about their level of satisfaction with us.

There's another survey that's been started across Government called Kiwis Count. That is a perception survey of satisfaction levels with service across basically all Government services. So we're also redesigning some of the kinds of questions that we do to fit with that, because typically that one—and you know from my voice that I'm not a Kiwi by birth—is modelled on a survey that the Canadians stated about 10 years' ago and typically a tax authority is at the bottom and your national parks and your nurses are at the top. I mean, that's generally where you're going to be. So we think it's important. We'll never be the most loved part of the Public Service in New Zealand. (*Interruption*). So we think it's important that we have both. If we're going to be in that survey we will probably be in the lower part of it somewhere. A lot of those people may or may not have even had a direct contact with us. So it is independent, it's done outside, and it asks people who've had direct contact with us.

- Lotu-Iiga On the call-back option, I commend you for doing that; I think it's a useful way forward. You've got 828,700 calls, then there was 61 percent that accepted that option, which I think is good, then it states that 6 percent weren't successfully responded to. I calculated that out to 6,000 to 7,000 people.
- Tremain It could be that when we called back that the person was not available, so that would be counted as one—
- Lotu-Iiga And you just leave it at that?
- Tremain I think they get two or three call-back attempts and if it failed on all three it would go under that statistic.
- Lotu-Iiga And then you measure the response time? That particular graph, I wouldn't mind teasing it out in terms of telephone responses—how long it takes to get back to people in terms of not just telephone?
- Tremain It depends. Sometimes they specify a time. So virtual-hold gives them the opportunity for a call-back when they come to the front of the queue, or alternatively if we have the opportunity to arrange a time. If we call back and it's not convenient we can arrange another time with them.
- Lotu-Iiga Are you measuring the satisfaction of website visits as well? Can you break the website visits down as well?
- Tremain That would come through in our normal customer satisfaction surveys. We can break down quite a lot of the information around virtual hold. There's a lot of statistics that are captured as part of that technology having been implemented.
- Russell We do it with the website. We periodically do user tests to see how they're working with the website, and our website has won best Government website awards a number of times. We're not satisfied with it right now. There're a bunch of areas where we think our website needs improvement,

and that's an area we will be focusing on. But generally it is fairly well regarded among Government sites.

Cunliffe Just a supplementary to that. The panel might be able to share some of the breakdowns that you've had on customer satisfaction around the use of home service_____

On the question of the reduction of head count, _____ 450 FTEs sounds quite a significant reduction in human resource, and while fully accepting that you've got horses for courses and you can't automatically take someone out of one part of the department and put them somewhere else when you change functions, and given that you also told us that if you had more resource you could chase more tax debt or clamp down on property speculators and you're doing a positive return to the Crown, why did you not use some of the departmental expenditure that you would have spent on employing those 450 to employ other people in areas that you consider to be of growing importance? How did you make the decision about the boundary line that led you to a net headcount reduction as big as that?

Russell There are various components to the headcount reduction. Part of it is projects coming to an end that were built—KiwiSaver being the biggest example there. So you're going to shed contractors and you're going to reduce staff in areas where you don't have as much work.

Cunliffe That included external contractors. So it's not just IRD staff?

Russell If there were long-term contractors working in a job in the department, that would be included in that number, I think. I'm not positive on that.

Cunliffe My guess is that excludes short-term contracts.

Russell We would definitely exclude the short-term stuff. We're always making trade-offs between the amount of resource we've got and the areas of work that we want to undertake to try to make sure the resources are applied in the best way to get the most productive work. We will spend, I suspect, the budget that we've got available, and we'll try to do that in the most effective way. We under-spent last year by \$123,000 so we actually allocated all the resource we had and we'll do the same this year. If we had more resource, certainly we could apply it.

Cunliffe Supplementary on that. How much departmental expense will be saved on an ongoing basis from the 450 headcount reduction?

Russell We did a voluntary reduction programme that was about 270. Scott, do you recall what the—

Scoullar About \$15 million annual savings.

Russell \$15 million annual savings on that one.

- Cunliffe So if you've already maxed out your budget you therefore fully spent that money?
- Russell My obligation under the Act is to collect the greatest amount of revenue over time with the resources available, so we will be endeavouring to spend all of the appropriation we get in the most effective way we can for New Zealand.
- Burns Can I pick up on that point? Four hundred and fifty staff shed, and Ms Tremain made a comment just before, as a revenue authority the more you have the more you can get. The figures you presented to this committee earlier in the year were that for every dollar invested in debt recovery you can get \$60 back, and if you're saving \$15 million a year and you have shed 450 staff and you're carrying \$6.5 billion in overdue debt, it doesn't seem to stack up.
- Russell The \$62.50 figure is an average for the debt collection, so that the more resource you apply your returns diminish. It gets harder to collect the incremental dollars. But certainly there's a good return on additional investment.
- Burns So if you had more staff, as Ms Tremain said, you could collect more of that debt.
- Russell Yes, we could, or we could undertake more investigations.
- Burns Should you surely not then be putting a case to your Minister for more staff to pursue not only the current debt liability that you have at \$6.5 billion but your own projections that in the next 2 years that debt's going to go to \$9 billion?
- Russell As I said, we will spend the appropriation we get in the most effective way we can and we will be giving the best possible advice we can to our Minister about what the appropriation should be. Those are budget discussions—
- Burns Did you put a case to your Minister to retain some of those 450 staff on the basis of for every \$1 invested you can get up to \$62 return?
- Tremain Of the 450 staff, some of them have gone already under the voluntary redundancy programme. Some of the reduction that's envisaged relates to finalisation of some Government spending around specific initiatives. So, for example, R and D tax credit resource and funding relates to some of those positions that add up to 450 by the end of the year, as does some KiwiSaver work and some property compliance work that has been previously funded. So some of the funding for the skills of the people who are doing those types of activities is not for the same skills and capabilities that we would apply in the debt area. So sometimes when you aggregate the numbers you can't necessarily always just shift the person who has a particular profile of skills to do a different type of work.

- Burns But of those 450 staff that have you have shed or are being shed, some of those may have been able to transfer across into debt recovery and to have been able to achieve for IRD returns of magnitude of up to \$62 per \$1 invested?
- Russell Again you come back though to looking at the resource you've got globally and making the best possible decisions. Even we had an extra 100 FTEs the best application might not be to debt work; it might be to investigations work. We look to about an \$875 per hour return for our investigations activity.
- Foss There's a difficulty there, because if you got one more dollar in your budget tomorrow, it doesn't actually mean you're going to get \$64 back.
- Russell No.
- Foss If you got one more dollar—that may be the person who brings you in a \$300,000 dispute. You know, we're talking huge in averages here—
- Cunliffe Chair, with respect, my colleague asked a pretty specific question, much better than I did, by the way, which was asking how you made the decision at the boundary about where to deploy resource. Commissioner, with respect, you've answered it in a kind of a priori fashion, which is, I always make the best decisions, therefore I have, because that's what I'm obligated to do, and that doesn't really help us with any factual information about how you made those decisions.
- Russell If you look at the compliance management programme I talked about earlier, that essentially talks about the areas where we'll prioritise our work, and that's the basic overall thought process that allows us to make allocations among functions. We've got a very substantial array of responsibilities from providing service support and information to taxpayers' right through to the sharper end of audit, investigation and litigation and prosecution. So last year, for example, we had to deploy more resource to the litigation because of of the structured finance cases than we had in previous years.
- Gilmore If you look at page 86 of your report, you actually paid significantly more in total salaries and wages. You are up about 10 percent even though your staff numbers are about constant. So would it be fair to say you are employing better quality people to undertake the work? All the outputs went up as well, so you're obviously paying the same number of people more and your outputs have gone up. *(Interruption)*
- Russell A small comment is that the 2008-09 spend was up above 2007-08. The numbers we're talking about now in the context of that 450 that I mentioned is where we'll end up at the end of 2009. So essentially that number is talking about the number that you'll see in next year's annual report.

- Katene There're two questions that I have. One is around policy. What is your view of the capital gains tax?
- Oliver There are arguments for capital gains tax, arguments against. The arguments against are largely that in the real world you exclude owner-occupied housing, you only have it on a realisations basis, and you have very complex rules, and it takes time to get them through. On balance we think the arguments against are higher than the arguments for.
- Katene My next question is around the Tobin tax. Do you have any solutions or for initiatives around Tobin tax—
- Oliver Tobin tax is a tax on, you know—every time that you have a foreign currency transaction you take a small percentage of it. That would obviously be a Government decision. The arguments against the Tobin tax are basically that it would jam up foreign exchange markets, and you would basically have cascade effects. You'd have tax upon taxes of different transactions happening. You'd basically jam up the ability of businesses to cover their foreign exchange exposure, and so forth. The arguments against it are quite strong, but it's not something we have done much work on and it's not in the Government's work programme.
- Katene And my final one is: do you expect an increase in tax evasion given the recession?
- Russell Typically, we'd see a bit of an increase in tax evasion and a greater activity in the underground economy. There was some recent work, I think, by the OECD or the World Bank, one of them, that estimated that you'd see about half a percent GDP kind of increase in underground economy activity in most countries. So we would expect to see a bit, and our compliance management programme has some more focus on the hidden economy this year than in past years.
- Huo My question is twofold and relevant to what that member just asked: (a), can the IRD provide the committee with the current aspect of the size of the hidden economy, and, (b), if we look at issues beyond the traditional GST fraud and horticultural contractors, what impact, if any, does the business immigration have on those living in the economy, especially at a time when the Government has just lowered its threshold and will undoubtedly bring more business migrants to New Zealand?
- Russell We don't have an estimate of the size of the underground economy in New Zealand and haven't undertaken the research to do that, nor has Australia, nor has Canada. A number of countries just recognise that it's a very difficult thing to do in economics and there are quite wide-ranging views of how one should go about it. By definition it's hidden, so it's hard to measure. We do know, though, that there is an underground economy or hidden economy in New Zealand and we're quite sure that in certain sectors it's more prevalent. We looked at online trading and talked about that

earlier. The horticultural sector, we knew about that. The hospitality sector, auto repair, home renovations—those are sectors where you often see— Any place where there’s an opportunity to earn substantial area on a cash basis, the taxi industry, you’re prone to having hidden economy issues. So we, in our compliance management programme, will continue to work in those areas.

If you go back to that broader question about how much resource do you apply to it, it’s a tricky balance, because typically you don’t get much money for it. The hidden economy tends to be small, it’s labour intensive to try to chase it, and so the return for tax authorities’ efforts is quite a small return. But you need to do enough and have a presence to discourage more people from going into the hidden economy. So that’s the balance that we would try to achieve.

Foss Thank you very much officials and IRD. We will see you again whenever the next review is. Have a good Christmas and thanks for your work.

conclusion of evidence