# Taxation (Annual Rates, Mäori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill

*Commentary on the Bill*

**Hon Dr Michael Cullen**
Minister of Finance
Minister of Revenue

First published in May 2002 by the Policy Advice Division of the Inland Revenue Department,
P O Box 2198, Wellington.

Taxation (Annual Rates, Mäori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill; Commentary on the Bill.
ISBN 0-478-27101-8

## CONTENTS


**Taxation of Māori organisations** **1**

Modernising the tax provisions for Mäori organisations – overview 3
Amendments to the Mäori authority tax rules 7
Other key amendments 19

**Taxpayer compliance, standards and penalties** **25**

Overview 27
Good behaviour 28
Penalties for unacceptable tax positions 31
Onus of proof 33
Tax in dispute 34
Information-gathering powers 35
Capping the penalty for lack of reasonable care 40
Promoter penalties 41

**Other policy issues** **43**

Tax and charities 45
Charitable donee status 47
Tax simplification – tax pooling 49
Tax simplification – PAYE and intermediaries 52
Income tax rates 57
GST and telecommunications services 58
Goods and services tax on domestic legs of international passenger cruises 61

**Remedial amendments** **63**

Depreciation rules on amalgamation 65
Interest component of reimbursement for film production expenditure 68
International tax – remedial issues 69
Rationalisation of terminal tax payment date provisions 72
The inclusion of material facts in private or product rulings 75

# Taxation of Mäori organisations

# MODERNISING THE TAX PROVISIONS FOR MĀORI ORGANISATIONS – OVERVIEW

***(Clauses 5, 7, 10, 11, 17, 18, 19, 21, 22, 23, 24, 25, 30, 31(1) and (5), 32, 33, 34, 36, 39, 40, 41, 44, 59, 60, 61, 62, 63, 64, 65(2), (3), (4), (5), (6), (8), (11), (12), (13), (16), (17), (18), (19), (21), (22) and (24); 66, 67(1), (4), (5) and (6); 68, 70, 72(6) and (10), 77, 78, 79, 84, 86, 87, 88, 89, 94, 107, 108, 128 and 129)***

## Summary of proposed amendments

Amendments to the Income Tax Act 1994 and the Tax Administration Act 1994 will give effect to proposals outlined in the government discussion document *Taxation of Mäori organisations*, released in August 2001. The main focus of these amendments is on modernising the specific tax rules that apply to Mäori authorities and simplifying the income tax requirements for individuals who derive benefits from these organisations. Other amendments clarify the requirements for charitable tax exemption as they relate to marae and those organisations whose beneficiaries are connected by blood ties.

The new rules for Mäori authorities recognise that there is a continued need for a specific tax framework for Mäori organisations that manage Mäori assets held in communal ownership. Such entities are set apart from other entities like ordinary companies and trusts by factors like the difficulty of selling Mäori freehold land and other tribal assets, the legal restrictions placed on the use of these assets, and the unique way in which such assets must be owned and administered.

## Application date

The proposed amendments will apply from the beginning of the 2004-05 income year. However, the amendment relating to relaxing the public benefit requirement will apply from the beginning of the 2003-04 income year.

## Key features

New rules will replace the current tax provisions section HI 1 to HI 5 in the Income Tax Act 1994, which apply to Mäori authorities. These rules incorporate a credit attribution system similar to the company imputation model and provide that:

- The income of a Mäori authority will be taxed in the year the authority earns it, at an income tax rate of 19.5 percent.
- The tax paid by the Mäori authority will be credited to an account known as the "Mäori authority credit account" and this tax will give rise to Mäori authority credits.
- Distributions to members that are made out of tax-paid income can be attributed with Mäori authority credits to reflect the tax paid at the authority level.

- The amount of the distribution and the value of the Mäori authority credit will be included in a member's gross income.
- Mäori authority credits that cannot be offset against the member's individual tax liability will be refundable to the member.

The new rules will apply only to those entities that face the restrictions and constraints that justify the continued need for specific tax rules for Mäori authorities.

Mäori authorities will have the option of electing out of the proposed rules and applying the general tax rules instead – but only if they meet the criteria for these rules. Mäori authorities will also have the ability to re-enter the Mäori authority rules if they wish but they will be subject to the tax consequences of being treated as if they had wound up. Transitional rules for movements in and out of the Mäori authority rules will also apply.

Mäori authorities whose legal form is that of a corporate body will be required to apply the shareholder continuity rules that require the measuring of a shareholder's economic interest for the purposes of the loss and Mäori authority credit account rules.

Other key amendments relate to:

- Standardising the tax rules applying to the Mäori Trustee. The "agent" tax rules contained in section HK 14 will be repealed, and the proposed Mäori authority rules will apply to the Mäori Trustee when it acts as agent in the collection and distribution of rents, royalties and interest.
- Extending the donations deduction for Mäori authorities. Section DI 2 will be amended to extend the deduction available to Mäori authorities for donations to Mäori associations to include donations of money to organisations with "approved donee status". The deduction will continue to be limited to 5 percent of the net income of the authority.
- Relaxing the public benefit requirement for charitable tax exemption. New section OB 3A is being inserted to provide that if an entity meets the "charitable purposes" requirement it will not be automatically excluded from the charitable income tax exemption simply because its members are connected by blood ties. In determining whether an entity meets the public benefit requirement other factors must be considered, such as the nature of the entity, the activities it undertakes, the potential beneficiary class, the relationship between the beneficiaries and the number of potential beneficiaries. Although relevant to iwi-based and hapü-based organisations, the amendment will apply to all organisations seeking to meet the requirements of charitable income tax exemption.
- Clarifying the tax status of marae. New section OB 3A will also provide that marae situated on Mäori reservations that apply their funds solely to the administration and maintenance of the physical structures of the marae will qualify for charitable tax exemption. This change will not preclude marae or marae-based organisations from seeking the general charitable income tax exemption if they meet the common law requirements of a charity (as amended by the public benefit proposal).

## Background

The first specific set of tax rules applying to Mäori authorities appeared in 1939. These rules were intended to apply to the various "working" organisations that administered large blocks of farmland owned in common by individual Mäori (and not in private ownership). These organisations were the first to become known as Mäori authorities. They included the Board of Mäori Affairs, the Mäori Trustee, the Mäori land boards, special statutory trusts (such as the East Coast Commissioner) and various land trusts under the Mäori land legislation.

Although the rules were largely concerned with the taxation of income from Mäori land, they also applied to any income earned by an organisation that administered property, income or reserves in trust for the benefit of Mäori. Thus the essential character of all the organisations covered by the term "Mäori authority" was that of trustee for the individual members.

The 1939 rules were subsequently replaced in 1952 as a result of the recommendations made by a Commission of Inquiry. The Commission had been established to ascertain whether certain Mäori farming operations were fully complying with their tax obligations and whether the law on this could be made clearer. This was the last time the Mäori authority rules were reviewed.

Since then, the number, scope and role of Mäori authorities have changed. The rules have not kept pace with the major tax policy reforms of the last fifty years. As a result, the tax rules now involve unnecessary restrictions, complex processes and high compliance costs and, in some cases, can lead to double taxation of Mäori authority income. It has been claimed that the Mäori authority rules may actually be hindering Mäori economic and social development, and over the years there have been repeated calls from various Mäori groups for them to be reviewed.

The inability of an organisation to qualify for a charitable tax exemption when its beneficiaries are determined on the basis of bloodlines has also been raised by Mäori groups as a major concern, although it is by no means an issue limited to Mäori.

Although Mäori organisations often provide benefits of a charitable nature to iwi and hapü, they might not qualify for an exemption because their benefit extends to a specified group of people connected by blood-ties – that is, they fail to meet the "public benefit" requirement for charitable status. The government recognises that the public benefit requirement is inappropriate to New Zealand society because it fails to recognise New Zealand's unique cultural groupings.

The tax status of marae has also been raised as a significant issue for Mäori. Marae have similar functions to churches and public halls but often cannot gain the same charitable tax exemption as these institutions because of the "public benefit" requirement and the uncertainty about whether maintaining marae is a charitable purpose at common law. This issue has become a matter of priority for marae that wish to access funding from other charitable entities such as community trusts. If marae do not have this exemption, they generally cannot have access to this funding.

The government's review that led to the changes in this bill involved consultation through the generic tax policy process, which in this case was expanded to embrace wider consultation with the Mäori community.

The proposed amendments were developed after consideration of the submissions received and further consultation on the proposals contained in the discussion document *Taxation of Mäori organisations*, released in August 2001.

### Tax consequences of the changes for typical Māori authorities

***Small authority***

A Mäori authority has a single asset consisting of a small block of land suitable for grazing. The land is leased to a local farmer for a period of five years for an annual rental of $4,000. Every year the trustees of the authority gather the rent and distribute it among the owners of the land. There are 20 owners. The authority has disbursements to make for work arising from the administration of the lease, inspections of the leasehold and recovery of arrears of rents of $1000.

*Current rules:* The authority is taxed as agent for each member on his or her individual share of the income of the authority. This is so even if the owner does not actually receive the income. If each owner has an equal share in the authority's income, when the $3,000 is distributed among the 20 owners, each owner receives $150. Each individual owner is then taxed on the $150 – this income is assumed to be his or her first income and is taxed at the rate of 19.5 percent. The authority pays the owner's share of the tax on the owner's behalf.

*Proposed rules:* The authority pays tax on its taxable income at the rate of 19.5 percent ($4,000 less $1000 equals $3000). Tax is $585, so the income available for distribution is $2,415. When a distribution is made each owner could receive a distribution of $150, which will comprise $120.75 and Mäori authority credits of $29.25.

***Large authority***

The authority has diversified holdings in farming, horticulture, forestry and other special projects such as tourism and commercial property. The authority has formed wholly owned companies to hold its commercial investments, thereby isolating Mäori freehold land and other tribal assets of cultural significance from commercial risk. The taxable income from its commercial activities is $1.2 million. The authority has approximately 3,500 members.

The authority delivers dividends to its members and provides a wide range of other benefits including education grants and grants for aged members, marae and tangi. Total members' distributions totalled $360,000 for the income year.

*Current treatment:* Mäori authorities must deduct resident withholding tax from distributions made to their members at the rate of 33 percent. The resident withholding tax deduction is $118,800 ($360,000 x 33%). Members receive a cash distribution of $241,200 and resident withholding tax credits of $118,800. At the end of year members can claim a refund or pay additional tax equal to the difference between the resident withholding tax rate of 33 percent and their own marginal tax rate. Assuming all members are on marginal tax rates of 19.5 percent, an amount of $48,600 will be required to be refunded to members. This refund is the difference between the resident withholding tax deducted by the authority and the tax required to be paid by the members on the total members' distributions. Thus the total cash distribution in the members' hands will be $289,800.

The income that is retained by the authority is taxed at the rate of 25 percent, so tax at the authority level will be $300,000. If this tax paid income is distributed **after** four years of it being earned, it will be subject to resident withholding tax as described above, and the large authority is prevented from claiming back the tax that it has paid – the $300,000. This situation results in double taxation.

*Proposed treatment:* The authority pays tax on its taxable income at the rate of 19.5 percent. Tax is $234,000. The authority credits this amount to the Mäori authority credit account. This credit entry gives rise to Mäori authority credits that can be attributed to distributions of tax-paid income. Total members' distributions is $360,000, which comprises cash of $289,800 and Mäori authority credits of $70,200. Members can use these credits to offset their own tax obligations. Assuming all members are on marginal tax rates of 19.5 percent, they will have total tax to pay of $70,200 on the total members' distributions. Members would not need to seek refunds or pay additional tax since the Mäori authority credits are sufficient to meet the members' tax liabilities.

Double taxation of income is avoided by attributing tax paid at the authority level to distributions to members.

# AMENDMENTS TO THE MĀORI AUTHORITY TAX RULES

## New definition of "Māori authority"

The new definition of "Mäori authority" specifically lists those entities eligible to apply the new Mäori authority rules. It provides greater certainty for entities seeking Mäori authority tax status and also removes the present ambiguity caused by archaic and confusing terminology used in the language of the current definition. The new list of entities also ensures that the specific tax rules are confined to those entities that encounter the constraints and restrictions that justify the specific tax framework.

The new definition of "Mäori authority" will comprise:

- entities established in accordance with a court order under the Mäori Land Act 1993;
- the Mäori Trustee in its capacity as agent in the collection and distribution of rents, royalties and interest;
- entities established in accordance with the Mäori Trust Boards Act 1955;
- the initial entities established that hold assets of the Treaty Settlement redress;
- the Treaty of Waitangi Fisheries Commission established under the Mäori Fisheries Act 1989;
- the Crown Forestry Rental Trust, being the forestry rental trust established by deed referred to section 34 of the Crown Forest Assets Act 1989; and
- wholly owned entities of a Mäori authority or a group of Mäori authorities.

Retaining specific tax rules for Mäori authorities recognises that certain Mäori organisations have unique characteristics that set them apart from other entities such as companies and trusts. The most defining characteristic is the non-transferability of property rights, which is particularly evident in relation to Mäori organisations that administer Mäori freehold land on behalf of their owners under the Mäori Land Act 1993. These organisations are shown in table 1.

The Mäori Land Act 1993 imposes restrictions on the ability of owners to alienate or trade their land interests (or shares as in the case of a Mäori incorporation), and on the ability of the trustees of the authority to sell Mäori land vested in them. The Mäori Land Court also has wide powers to control the administration of Mäori freehold land. The impact of these restrictions is to create three major constraints to economic efficiency in the use of Mäori freehold land. The land may not be able to move to its highest value use, it is difficult to borrow money on Mäori land, and the title to the land can be fragmented over time.

## Table 1: Proposed list of Māori authorities

| Māori authority | Members | Income can be spent on or applied |
|---|---|---|
| Ahuwhenua trust – Mäori Land Act 1993<br>(Often used for commercial purposes, it is designed to promote the use and administration of land in the interest of its owners) | The beneficial owners of the land. | The land, money, and other assets must be held in trust for the members of the trust. Income can be applied in any way permitted by the trust order or for Mäori community purposes. |
| Kai tiaki trust – Mäori Land Act 1993<br>(A type of trust established solely for minors or individuals with a disability who cannot manage their own affairs) | Individual beneficiaries. | The land, money, and other assets must be held in trust for the person with the disability. The individual must not be able to alienate the trust property. |
| Putea trust – Mäori Land Act 1993<br>(Often used to manage small and uneconomic Mäori land interests) | The beneficial owners of the land or shares in the Mäori incorporation, and including descendants of named beneficial owners. | The land, money, and other assets must be held for Mäori community purposes. |
| Whänau trust – Mäori Land Act 1993<br>(A whänau-oriented trust that allows Mäori land interests to be managed for the benefit of the whänau) | Same as for putea trust. | The land, money, and other assets must be held, and the income derived from those assets must be applied, for the purposes of promoting the health, social, cultural and economic welfare, education and vocational training, and general advancement in life of the beneficial owners and their descendants or for Mäori community purposes. |
| Whenua topu trust – Mäori Land Act 1993<br>(An iwi-based or hapü-based trust used primarily for receiving Crown land as part of any settlement) | Members of the iwi or hapü named in the order. | The land, money, and other assets must be held for Mäori community purposes. The court may direct that certain interests may be held for certain persons, and any income from those interests can be paid to those persons and their successors. |
| Mäori incorporation – Mäori Land Act 1993 | Beneficial owners of the land. | The incorporation holds the land and other assets vested in it on trust for the incorporated owners in proportion to their several interests in the land.<br>Dividends to shareholders can be made but only out of accumulated profits (including realised capital gains). Revenue can also be applied to costs and outgoings, reserves for contingencies, or a distribution by resolution of shareholders for any purpose.<br>There is no ability to assign equitable interest otherwise than by means of disposition of a member's interest. |
| Mäori Trustee | The beneficial owners of land or shares in a Mäori incorporation which are administered by the Mäori Trustee. | The income must be applied for the benefit of the individuals or group of individuals concerned or for Mäori community purposes. |
| Mäori trust boards – Mäori Trust Boards Act 1955 | Members of iwi or hapü. | A board may, in its discretion, provide money for the benefit or advancement in life of any specific beneficiary, or of any class or classes of beneficiaries. A board may also apply its funds to the promotion of health, social and economic welfare, education and vocational training for the general benefit of members. |

| Māori authority | Members | Income can be spent on or applied |
|---|---|---|
| Treaty of Waitangi Fisheries Commission | No specified members. | The principal functions of the Commission are to facilitate the entry of Mäori into and the development by Mäori of, the business and activity of fishing. The Commission may grant assistance to any Mäori or group of Mäori for the purpose of enabling them to enter into or to continue in or develop the business and activity of fishing. |
| Crown Forestry Rental Trust | No specified members. | The trust provides funding for claimants to assist them in preparing, presenting and negotiating a claim before the Waitangi Tribunal. Claims involve or may involve licensed land. This assistance is funded from the investment income of rental proceeds. The surplus income remaining at the time of the winding up of the trust must be paid to the Crown free from the trust. |
| Treaty settlement entities | These entities must specify exactly what group or groups they represent. They must also have the mandate of the group or groups that they purport to represent. | Depends on what is specified in the trust deeds, settlement documents or legislation. |
| Wholly owned entities of one or more Mäori authorities | Other Mäori authorities. | Depends on their constituting documents. |

The Mäori Trustee is also subject to the same legislative restrictions in respect of its "trustee" role in the administration of properties under the Mäori Land Act 1993.

Mäori trust boards have specific accountability responsibilities to the Minister of Mäori Affairs and, in some cases, to the Governor-General under the Mäori Trust Boards Act 1955. Including these entities in the definition also recognises the unique nature of membership in these entities.

The membership of such an entity is a right that comes with whakapapa (genealogy). It brings with it rights to participate in the political processes and to access benefits when the nature of those benefits is determined through a collective decision-making process. Exercise of these membership rights is optional but rights cannot be transferred. Members also do not have a measurable interest in the assets of the entity and are unable to trade their "interests" in the same way as someone who holds shares in a company. Furthermore, members of Mäori trust boards have no universal right to receive an annual dividend.

Entities established to receive assets of the Treaty Settlement redress are similar to Mäori trust boards in terms of their purpose and membership structure. However, they are not subject to a legislative framework that regulates their ability to alienate settlement assets. Even so, it is important to bear in mind why these organisations were established.

For both the Crown and iwi, it has become essential for the entity that receives assets in settlement of a claim to be properly constituted and represent a clearly identified Mäori group or groups. The organisation must also have the mandate of those whom it purports to represent. These entities are also established for iwi or hapü groups, so the membership issues described in relation to trust boards are also applicable to treaty settlement entities.

The Crown Forestry Rental Trust and the Treaty of Waitangi Fisheries Commission have unique roles in New Zealand society. Both entities were created to receive and manage settlement assets until such time as the ownership rights of these assets is established or confirmed through the appropriate settlement redress process.

Mäori authorities may use wholly owned subsidiaries to undertake commercial activities in order to quarantine commercial risks. The new definition of "Mäori authority" also includes wholly owned subsidiaries of one or more Mäori authorities. Such entities will often have their own governance structures and are generally unfettered by the constraints of the parent Mäori authority, so it could be argued that they should be excluded from the Mäori authority tax rules. However, including wholly owned subsidiaries in the definition will allow parent authorities to apply a single tax framework to their activities. If wholly owned entities were excluded from being Mäori authorities, the authorities would have to operate their commercial activities themselves and in doing so, they would lose any benefit of quarantining commercial risk and could be discouraged from setting up more efficient commercial structures.

The glossary contains descriptions of the proposed entities that will be eligible to apply the new rules.

## The proposed credit attribution system

The new rules incorporate a credit attribution system and share many of the same features of the company imputation model.

Under the proposed system, the income of a Mäori authority will be subject to an income tax rate of 19.5 percent. The tax paid by or on behalf of Mäori authorities will give rise to Mäori authority credits that can be attached to distributions of tax-paid income to members. Recipient members can use these tax credits to offset their own tax liabilities. Any unused tax credits will be refunded to the recipient members who are New Zealand residents for tax purposes. The tax paid at the authority level can be viewed as a withholding tax as members can use this tax against their own tax liabilities.

Mäori authorities will also be able to pass out capital receipts, such as treaty settlement assets, tax-free to their members. This measure preserves the current tax treatment of such distributions.

A credit attribution system is both fair and accurate, as it avoids the incidence of double taxation of Mäori authority income (which occurs at present) and provides the opportunity to align the tax paid at the authority level with the marginal tax rates of individual members of the authority.

The technical requirements of the proposed rules involve:

### *Definition of "member" of a Māori authority*

"Member" of a Mäori authority will be defined to mean any person legally or beneficially entitled to the gross income of a Mäori authority. The new definition recognises that Mäori authorities may have members that are individuals, non-individuals or both.

### *Definition of "distribution" made by a Māori authority*

New section HI 2 sets out a broad definition of "distribution", which is necessary to accommodate the wide range of financial and non-financial benefits that Mäori authorities provide to their members.

"Distribution" will be defined to mean all sums in money that are paid, credited or advanced by a Mäori authority for the benefit of one of its members. The term will also include property transfers between Mäori authorities and their members to the extent that the consideration paid does not equal the true value of the property.

Thus it will be possible for a member of a Mäori authority to receive both a dividend payment (if the authority is a Mäori incorporation) and an education scholarship or some other assistance grant. Even so, these payments will be treated as a distribution under the proposed tax rules. The tax treatment of these distributions in the hands of the recipient members will depend on whether such distributions were made from tax-paid income sources or non-taxable income sources of the authority.

### *Tracking income sources*

Allowing the pass through of non-taxable sources, such as treaty settlement assets or other capital receipts, to be tax-free to members will require Mäori authorities to track their income sources. In doing so, they can mark distributions to members as being out of taxable sources or out of non-taxable sources.

### *Distributions and the credit attribution rule*

Mäori authorities can make two types of distributions: taxable distributions and tax-exempt distributions.

Taxable distributions will be attributed with Mäori authority credits. The credit attribution rule provides that the maximum rate at which taxable distributions can be attributed with tax credits will be 19.5 percent. Resident withholding tax at the rate of 19.5 percent will apply to that portion of the taxable distribution that has not had tax credits attributed to it. Such distributions will be taxable in the hands of the recipient members.

Transfers of property between Mäori authorities and their members to the extent that the consideration paid does not reflect the true value of the property will also be treated as taxable distributions. However, there is one exception to this rule. Property transfers that relate to the allocation of treaty settlement assets will not be regarded as a taxable distribution. Instead, it is intended to treat such distributions as capital distributions. This measure is consistent with the policy to allow Mäori authorities to pass through capital receipts tax-free.

Distributions from non-taxable sources will not be fully credited with Mäori authority credits nor will they be subject to resident withholding tax. Such distributions will not be subject to the credit attribution rule and, therefore, will be tax exempt to the recipient members.

### *Maintaining a "Māori authority credit account"*

New Part MK requires Mäori authorities to establish and maintain a "Mäori authority credit account". This account will operate in a similar way to the imputation credit account that companies are required to operate and will be subject to similar rules. The Mäori authority credit account will record:

- All income tax paid and tax credits available to a Mäori authority as credit entries. These credit entries increase the level of Mäori authority credits available to attribute to distributions paid to members.
- All taxes refunded to the Mäori authority or any Mäori authority credits passed on to members as a debit entry in the Mäori authority credit account. Debit entries to the account result in a reduction in the tax credits available for distribution to members.

Resident withholding tax withheld from, and imputation credits attached to, the income received by a Mäori authority will flow through the account. Any unused resident withholding tax credits will be refundable to the authority at the end of the year. Any unused imputation tax credits will not be refundable to the authority but will be converted to a loss and carried forward for offset against income in subsequent years.

The end of year requirements and the general penalty provisions relating to the imputation credit account will also apply to the account.

If the account is in debit balance at as 31 March, the authority will be liable to pay additional income tax equal to the debit balance, since the authority has allocated more tax credits than it should have. The authority is liable to pay the additional income tax no later than 20 June following the end of the relevant income year in which there was a debit balance. A "Mäori authority distribution penalty" of 10 percent will apply to the debit balance. If an authority fails to pay its additional income tax liability and the 10 percent penalty by the due date, the general compliance and penalties rules will apply.

### *Anti-streaming rules for distributions*

Under the proposed rules Mäori authorities will be able to make distributions from either taxable or non-taxable sources. It is possible that, since some members may benefit more from a non-taxable distribution, a Mäori authority might wish to direct its income from non-taxable sources to those members best able to use them. This is known as "streaming". The risk here is that, for tax purposes, some members might be treated more favourably than others unless safeguards are in place to mitigate this risk.

For example, a Mäori authority proposes to grant two scholarships as part of its education scholarship programme. The funding for this initiative comes from both taxable and non-taxable sources. A member on a 33 percent tax rate will pay no further tax if he or she receives a non-taxable distribution. However, if the member receives a taxable distribution, there will be further tax to pay.

Another problem arises where two Mäori authorities, MA1 and MA2, have incorporated a subsidiary company, MACOY. MA1 has tax to pay and MA2 is in a loss position. MACOY could distribute non-taxable distributions to MA1 and distribute taxable distributions to MA2. Again, there would be unequal tax treatment. This situation is not permitted under the current rules, since MACOY is taxed as a company and is prevented from passing out capital distributions tax-free.

To address this potential streaming issue, when a particular distribution is made, all recipient members of that distribution will be treated as having received a proportionate share of the taxable or non-taxable amounts distributed. This rule aims to ensure parity among recipient members while allowing Mäori authorities to continue to make distributions from different sources. For example, if MA1 distributes education scholarship money, the successful recipients must receive a proportionate share of any taxable or non-taxable amounts available for distribution.

Also, a new section GC 27A provides an anti-avoidance rule to deal with streaming that forms part of an arrangement to obtain a tax advantage. This is similar to the current rule for imputation streaming.

Finally, new section MK 7 will require that every taxable distribution is attributed with Mäori authority credits at the same level. The first taxable distribution paid by the authority during the year will be referred to as the "benchmark distribution". All subsequent taxable distributions paid during the year must carry tax credits at the same ratio as the benchmark distribution. An authority may attribute tax credits to a distribution at a different level to the benchmark distribution provided the authority advises the Commissioner of Inland Revenue that the distribution is not being credited at a different level as part of an arrangement to obtain a tax advantage.

The government acknowledges, however, that these rules may not be sufficient to address the full potential of the problem of streaming. The issue will be closely monitored and, if necessary, the government will consider introducing countervailing legislation should streaming emerge as an issue.

## Applying the shareholder continuity requirements

The shareholder continuity rules measure the economic interests that shareholders have in a company based on their voting rights or market value interests. These rules govern whether a company can carry forward its losses, use its imputation credits and offset its losses against the income of another company in the same group structure.

The shareholder continuity rules will apply to Mäori authorities whose legal form is that of a corporate body, in all situations that require the measuring of a shareholder's economic interests.

Corporate Mäori authorities will be required to maintain continuity of shareholding in respect of the Mäori authority credit account. This requirement will limit the carry-forward of Mäori authority credits for subsequent utilisation to situations where at least 66 percent of those persons who will benefit from such utilisation bore the tax liability that gave rise to the credit. In other words, Mäori authority credits cannot be retained by a Mäori authority that is later sold to shareholders who can make effective use of the Mäori authority credits.

Corporate Mäori authorities will also be required to maintain continuity of shareholding in respect of their ability to carry forward losses. This requirement will limit the carry-forward of losses by a Mäori authority to situations where at least 49 percent of those persons who will benefit from those losses actually incurred them.

The discussion document proposed that the continuity rules not apply to Mäori authorities on the basis that the majority of Mäori authorities would experience practical difficulties in satisfying the technical requirements of those rules. However, because of the proposed inclusion of wholly owned companies in the definition of "Mäori authority", it is necessary to introduce safeguards to protect against any potential for "trading" of Mäori authority credits and tax losses. Furthermore, introducing the continuity rules now will be important should the government decide in the future that Mäori authorities should be able to offset losses within a group structure.

Restricting the application of the rules to corporate Mäori authorities is appropriate since these bodies should be able to meet the technical requirements of the continuity rules or, alternatively, qualify for the existing relief provisions under those rules. Mäori incorporations and wholly owned companies can apply the rules, since they issue shares, whereas Mäori trust boards and the Treaty of Waitangi Fisheries Commission, who do not issue shares, should qualify for the "special corporate entity" relief. The shares in a special corporate entity are treated as being held by a single person. Consequently, a special corporate entity will always be 100 percent owned and no breach in continuity is possible.

Mäori authorities whose legal form is in fact a trust such as the Mäori land trusts and the Crown Forestry Rental Trust will not be subject to the shareholder continuity rules because such rules are intended to apply to measure economic interests in corporate entities only.

## New tax requirements for members of a Māori authority

Members who receive taxable distributions can use the attached Mäori authority credits or any resident withholding tax credits to offset their own individual liabilities. If their marginal tax rate is less than 19.5 percent, members may file a tax return or request a personal tax summary to claim the difference between 19.5 percent and their marginal tax rate. If their marginal tax rate is greater than 19.5 percent and they are required to file a tax return or request a personal tax summary, they will have to pay the difference between their marginal tax rates and 19.5 percent. Distributions of non-taxable income sources will not be taxable to members.

Taxable distributions from Mäori authorities will be treated in the same manner as dividends for the purposes of the low-income rebate and tax return filing requirements.

Charities and other exempt entities who are members and who receive taxable distributions will be required to file a return at the end of the year in order to claim a refund of their Mäori authority credits.

## Proposed tax rate on Māori authority income

The income of a Mäori authority will be subject to an income tax rate of 19.5 percent. This rate is based on the fact that the majority of people that derive benefits from a Mäori authority will be on incomes of less than $38,000, the income threshold below which the statutory tax rate of 19.5 percent applies.

Although this tax rate may be seen as more favourable than that applying to companies and trusts, it is fair and reasonable in that it reflects the income levels of the underlying members of a Mäori authority and the restrictions and limitations that encompass communally owned Mäori assets held for the benefit of future generations.

A tax rate more aligned to the marginal tax rate of the majority of members will reduce administrative costs and compliance costs as there will be less need for members of a Mäori authority to file a tax return or request a personal tax summary to seek a refund of overpaid tax at the authority level.

## Electing in or out of the Māori authority tax rules

Mäori authorities differ in their size and sophistication, as well as their economic and social objectives. This will influence the likely range of activities an authority could seek to become involved in, so the Mäori authorities of the future may look different. It is important that the tax system not inhibit Mäori authorities but that it has the flexibility to accommodate their evolution. This will mean providing authorities with the flexibility to be taxed under the general tax laws and not as a Mäori authority.

New section HI 1 enables Mäori authorities to elect in and out of the Mäori authority rules.

### *Ability to elect to apply the general tax rules*

Mäori authorities will be able to choose to apply the general tax rules, if they meet the requirements of those rules, at any time after the implementation date. They will determine for themselves whether they wish to apply the Mäori authority rules or the general tax rules if they meet the requirements of those rules. They will do so by filing the appropriate tax return.

### *Ability to elect back into the Māori authority tax rules*

Mäori authorities will also be able to re-enter the Mäori authority tax rules. However, the government is concerned that this additional measure may create the risk of Mäori authorities moving in and out of the Mäori authority rules to obtain tax advantages. For this reason, if a Mäori authority re-enters the rules it will be subject to the tax consequences as if it had wound up and disposed of its property at market value. These consequences would have arisen had the Mäori authority, in fact, wound up and constituted a new entity for re-entry into the Mäori authority tax rules. New section HI 7 deems property to be sold at market value and reacquired at that value. However, for depreciation purposes the Mäori authority will only be able to claim depreciation on the original cost price of the property.

If an entity is taxed as a Mäori authority before enactment of the legislation but later chooses to be a company and files a company tax return in respect of the transition year, that entity has made a deliberate choice to elect out of the Mäori authority rules. If it then elects to apply the Mäori authority rules in a subsequent year, the entity has re-entered the Mäori authority rules, so the tax consequences for wind-ups will be triggered.

If an entity is taxed as a company before the reform but under the new rules chooses to be a Mäori authority and files a Mäori authority tax return in respect of the transition year, that entity has made a deliberate choice to elect into the Mäori authority rules. However, because the entity never used the Mäori authority tax rules, the consequences for wind-ups will not arise unless the entity re-enters the rules.

Allowing Mäori authorities to re-enter the Mäori authority tax rules provides flexibility for governing boards and trusts to cope with changes in the nature of a Mäori authority's operations over time. This measure also means that Mäori authorities can avoid the costs associated with winding up an authority and reconstituting a new entity.

## Safe-harbouring pre-reform income

Income earned under the present rules will be exempt from tax when it is distributed under the proposed rules, to avoid double taxation of tax-paid income reserves. New section HI 3 provides that any pre-reform income will be regarded as a "non-taxable" source so that subsequent distributions from this source will be treated as tax-exempt distributions in the hands of the recipient members. Distributions of the pre-reform income will not be subject to the credit attribution rule.

"Safe-harbouring" pre-reform income in this way is consistent with the principle that transitional measures relating to new reform proposals should not give rise to additional tax consequences.

## Transitional rules for movements in and out of the Māori authority rules

If an authority moves from one group of tax rules to another, either in the year of implementation or by opting out, it will need to consider what rules will regulate its exit or entry from the proposed rules.

New section HI 6 provides:

- If a trust exits the Mäori authority rules, tax-paid income sources will be treated as trustee income, and subsequent distributions of that income will be exempt from tax. If the entity consists of property administered by an agent (as frequently occurs with the Mäori Trustee), a similar treatment will apply. In that case, any income taxed as Mäori authority income will be treated as being non-taxable if distributed by an agent in subsequent periods.
- If a trust enters the Mäori authority rules, trustee income will be treated as a non-taxable source, and subsequent distributions of that income will be exempt from tax.
- If a company exits the Mäori authority rules, the balance in its Mäori authority credit account will be transferred to the company's imputation credit account provided the continuity requirements have not been breached on exit. While the credits available will not be sufficient to enable distributions to be paid fully credited, those that are transferred provide a fair reflection of the tax paid by the entity. If necessary the company can impute at a lower rate until further tax is paid. Any pre-reform income will be converted to available subscribed capital, and any subsequent distributions of this source will be exempt from tax. Any post reform tax-paid income will be a taxable source to which imputation credits can be attached. It should be noted that the entity will lose its ability to make non-taxable distributions from any capital reserves, as taxable distributions are a feature of the company tax rules.
- If a company enters the Mäori authority rules, any imputation credits will be extinguished and any tax-paid income reserves, capital gains, available subscribed capital and other non-taxable sources will be treated as non-taxable sources.

These transitional measures ensure that Mäori authorities will not be subject to any additional tax consequences arising from movements into or out of the Mäori authority rules.

## Related amendments

### *Tax return filing and other notification requirements*

Section 31 of the Tax Administration Act 1994 is being amended to require Mäori authorities to provide their members with information about any distributions they receive so that members can comply with their tax obligations.

New section 68B is being inserted in the Tax Administration Act 1994 and will require Mäori authorities to provide the Commissioner of Inland Revenue with a complete statement of their distributions for the income year.

New section 69A in the Tax Administration Act 1994 requires Mäori authorities to file a Mäori authority credit account.

### *Māori authorities can elect a RWT rate of 19.5 percent to apply to their interest income*

An amendment is being made to Schedule 14 which will allow Mäori authorities to choose a resident withholding tax rate of 19.5 percent to apply to their interest income. This choice is available to other taxpayers except companies.

## Standardising the tax rules for the Māori Trustee

The specific agent tax rules in section HK 14 will be repealed, as they are obsolete and result in unnecessary compliance costs for the Mäori Trustee. The Mäori authority rules will now apply to the taxation of income derived by the Mäori Trustee when it acts as agent in the collection and distribution of rents, royalties and interest.

The inclusion of the Mäori Trustee in the definition of "Mäori authority" clarifies that the Mäori authority rules will apply to the Mäori Trustee in all situations.

## Extending the donation deduction for Māori authorities

The current deduction available to Mäori authorities for donations to Mäori associations will be extended to donations to organisations with "approved donee status". The maximum level of deduction will remain at 5 percent of the authority's net income (calculated before taking into account the deduction), which is consistent with the deduction that will apply to ordinary companies. This measure will recognise the greater range of community benefits that are assisted by Mäori authority funding.

To qualify for approved donee status, an organisation must be established for charitable, benevolent, philanthropic, or cultural purposes within New Zealand or must be specifically listed in section KC 5. As only organisations can qualify for donee status, Mäori authorities will not be able to claim this deduction for distributions to individuals.

## Relaxing the public benefit requirement for charitable tax exemption

New section OB 3A relaxes the public benefit requirement so that an organisation that meets the "charitable purposes" requirement will not be automatically excluded from the charitable income tax exemption simply because its members are connected by blood ties.

This measure will apply to both Mäori and non-Mäori entities, but it is especially relevant to iwi-based and hapü-based entities. However, these entities must still meet the other requirements of a charity – that is, they must have a "charitable purpose" and they must be for the benefit of the public or an appreciably significant section of the public.

In determining whether an entity benefits the public or an appreciably significant section of the public other factors must be considered, such as the nature of the entity, the activities it undertakes, the potential beneficiary class, the relationship between the beneficiaries and the number of potential beneficiaries. In practice, the application of this proposal will require some guidance so that an entity can determine whether it benefits the public.

The proposed change will provide greater certainty about how the requirements of charitable income tax exemption applies to Mäori and non-Mäori organisations whose beneficiaries are defined by reference to blood ties.

## Clarifying the tax status of marae

Under the new section OB 3A, marae situated on Mäori reservations that apply their funds solely to the administration and maintenance of the physical structures of the marae will qualify for charitable tax exemption.

The amendment will apply only to marae that are established on a Mäori reservation in accordance with the Mäori Land Act 1993.

If a commercial business is carried out on the marae and the income for that business is applied towards the maintenance and upkeep of the marae premises, that marae will be regarded as charitable for tax purposes. Limiting the application of marae funds to the administration of the physical structures of the marae means that no individual who is associated with the marae is able to receive any private financial benefit from the marae. Marae will also need to ensure that payments to individual members for services rendered are reasonable and do not exceed what would normally be paid for those services.

This change will not preclude marae or marae-based organisations from seeking the general charitable income tax exemption if they meet the common law requirements of a charity (as amended by the public benefit proposal). If a marae does not meet the general exemption or the proposed exemption it would be treated as a non-profit body if it meets the requirements. Non-profit bodies can claim a tax deduction each income year of an amount equal to the lesser of their net income or $1,000. As non-profit bodies tend to derive little (if any) income, most of them do not pay tax.

This measure recognises the important role marae play in supporting a way of life for New Zealanders within a structure of Mäori culture and values. It will also provide comparable treatment to marae that applies to other bodies that carry out similar functions such as churches and public halls.

# Glossary of terms relating to taxation of Māori organisations

### Approved donee status

To qualify for donee status an entity must meet the requirements in section KC 5(1) of the Income Tax Act 1994, which includes entities established for charitable, benevolent, philanthropic, or cultural purposes within New Zealand **or** that are specifically listed in this section. Entities interested in obtaining donee status must apply to the Inland Revenue Department.

### Beneficial owners

The owner of a beneficial interest in land. If the land is vested in trustees, those trustees own the land as legal owners on behalf of the beneficiaries who hold their individual shares in the land.

### Charitable purpose

A charitable purpose is a purpose for:

- the relief of poverty;
- the advancement of education;
- the advancement of religion; or
- any other purpose that is beneficial to the community.

These categories of charitable purpose are prescribed by common law and may appear to be quite wide. However, the courts in determining whether the purpose of an entity is for "any other purpose that is beneficial to the community" have restricted the purposes similar to those listed in the preamble to the United Kingdom's Charitable Uses Act 1601.

Modern examples of type of activities that come within this purpose are:

- providing public halls, public recreational facilities, botanical gardens, parks, libraries and museums;
- social rehabilitation – integrating people back into the community;
- providing an ambulance service, district fire brigade or life saving service;
- repairing highways and bridges, providing a water supply, paving and lighting a town; and
- the afforestation or making of public domains or national parks.

### Company

The definition of a "company" for tax purposes is broad. It includes any body corporate or other entity that has a legal personality or existence distinct from those of its members, whether that body corporate or other entity is incorporated or created in New Zealand or elsewhere. Certain entities such as unit trusts are deemed to be companies for tax purposes, whereas Mäori authorities are specifically excluded from that definition.

### Company tax rules

Key features of company tax rules in the Income Tax Act 1994 are:

- Companies are subject to a flat tax at a rate of 33 percent.
- Companies are separate legal entities, and the members have an "interest" in the company, usually defined by shareholding.
- The benefit of tax paid by a company can be passed on to shareholders as imputation tax credits attached to dividends. Gross dividends are included as gross income of the shareholder, but individual tax liabilities are satisfied in part by the amount of any tax credits that have been allocated to the dividend.
- If a taxpayer receives a dividend that has more imputation credits attached than the level of tax payable on that dividend, and the taxpayer has other income, the excess tax credit can be used to satisfy this tax liability.
- Tax losses can be carried forward to be offset against the future income of the company, subject to maintaining certain membership requirements from the beginning of the year of loss to the end of the year of carry forward.
- Charitable gifts may be deductible if they are provided to organisations with approved donee status. (This concession is not available to closely held companies.) The deduction is subject to certain limits.
- Capital gains are taxable when distributed to shareholders but not when distributed in the course of liquidation.
- Available subscribed capital for initial investment in a company is defined as capital, and is non-taxable when distributed.

### Compliance costs

Compliance costs are the other costs that people and businesses incur when they pay their tax, over and above the actual amount of tax they pay. These other costs can have a money value, in that they may involve time, fees paid to tax advisers, and other costs. They can also be "psychological" costs, such as the stress that comes from not being certain that you have met all the rules correctly, or even what those rules are.

### Court order

A document prepared by and signed under the seal of a court to give effect to a decision of a judge of the court.

### Crown Forestry Rental Trust

The Crown and Mäori entered into an agreement in 1989 permitting the Crown to dispose of its forestry interests, while protecting the ability to provide redress for Treaty claims. The agreement arose from action taken by Mäori to the Court of Appeal to protect their claims to Crown forestry interests. The Court of Appeal action was adjourned (*sine die*) following the negotiated agreement between the parties. If no agreement had been reached or if the agreement is broken, Mäori had the right to return to the Court of Appeal in order to protect their interests.

The agreement was embodied in legislation, the Crown Forest Assets Act 1989. The Trust was formed in April 1990 with the signing of the Trust Deed. The 1989 agreement, the Crown Forest Assets Act and the Trust Deed were all negotiated and approved by the Mäori Appointors.

The Trust was established to:

- Receive rental proceeds from Crown forest licences; and
- Make the interest, earned from investment of the rental proceeds, available to assist Mäori in the preparation, presentation and negotiation of claims before the Waitangi Tribunal which involve, or could involve, certain Crown forest land.

### Hapū

Subtribe or kin group linked by a common ancestor.

### Imputation tax credits

Imputation tax credits reflect the tax paid by a company. When companies pay dividends to their shareholders they can attach imputation tax credits to the dividends. The dividends are taxed in the hands of the shareholders, who can use those credits to offset their personal tax liability. If the credits cannot be used, they can be converted into a tax loss by shareholders and used in the next income year.

### Individuals

Natural persons.

### Iwi

Traditional Mäori tribal hierarchy and social order made up of hapü (kin groups) and whänau (family groups) having a founding ancestor and territorial (tribal) boundaries.

### Māori associations

A "Mäori association" is defined in the Mäori Community Development Act 1962 and means a Mäori Committee, a Mäori Executive Committee or a District Mäori Council. All of these bodies are committees of the New Zealand Mäori Council.

### Māori authority credit account

A proposed measure that will record Mäori authority income tax payments and refunds, and account for the number of tax credits available for distribution.

### Māori community purposes

Mäori Community Purposes include the promotion by financial support, loans and grants, in support of health, social, cultural and economic welfare, educational and vocational training and anything else the trustees deem appropriate, provided the Mäori Land Court approves. For a full definition of Mäori Community Purposes refer to section 218 of the Mäori Land Act 1993.

### Māori freehold land

This is land whose beneficial ownership has been determined by the Mäori Land Court (that is, the Mäori Land Court has created a title for the land and has determined the beneficial owners of that land). Under current law, the status of the land will continue to be Mäori land unless the Mäori Land Court makes an order changing the status of the land.

### Māori incorporations

A Mäori incorporation is a structure similar to a company established to facilitate and promote the use and administration of Mäori freehold land on behalf of the owners. Mäori incorporations were designed to manage whole blocks of land and are some of the most commercial types of Mäori-land management structures. Mäori incorporations are established under Te Ture Whenua Mäori Act 1993 (also known as the Mäori Land Act 1993).

### Māori land trusts

The purpose of these trusts is to reduce the high transaction costs of managing fragmented lands with numerous owners, by amalgamating the land titles under a single entity and by delegating the management of the entity to a committee of owner representatives.

The different types of Mäori land trusts are:

- *Ahuwhenua trust* – the most common Mäori land trust. It is designed to promote the use and administration of land in the interest of its owners. These trusts are often used for commercial purposes.
- *Whenua topu trust* – an iwi-based or hapü-based trust designed to facilitate the use and administration of the land in the interest of the iwi and hapü. This type of trust is used for receiving Crown land as part of any settlement.
- *Kai tiaki trust* – established solely for individuals who are minors or have a disability, and who are unable to manage their own affairs.

- *Whänau trust* – a whänau-oriented trust. It allows the whänau to bring together their Mäori land interests for the benefit of the whänau and their descendants.
- *Putea trust* – allows owners of small and uneconomical interests to pool their interests together.

Ahuwhenua and whenua topu trusts are land-management trusts and involve whole land blocks. Whänau and putea trusts are share-management trusts and relate primarily to specified shares in land. Kai tiaki trusts are for minors or persons with a disability, and can include all their assets.

Whenua topu and putea trusts allow spending for "Mäori community purposes". Mäori community purposes are defined in Te Ture Whenua Mäori Act as purposes that are for the promotion of education and vocational training, health, and social, cultural and economic welfare.

Whänau and ahuwhenua trusts may also use funds for Mäori community purposes, if their trust orders allow and if the owners agree. The trust order will define who will benefit from Mäori community-purpose funds.

### Māori reservation

An area of land that is set aside as a "Mäori reservation" under section 338 of the Mäori Land Act 1993 for specific purposes. One of those purposes could be for a marae.

### Māori trust boards

Mäori trust boards are established under the Mäori Trust Boards Act 1955 to manage tribal assets for the general benefit of their members. The boards are able to provide money for the benefit or advancement of their members and to apply their funds towards the promotion of health, social and economic welfare, and education and vocational training. Some boards were set up to administer compensation received as settlement of grievances by Mäori against the Crown, while other boards were established to secure government recognition (in order to take up service contracts), or to secure a mandate in order to pursue Treaty of Waitangi claims.

### Marae

Meeting place for the Mäori community. Often an area of land set aside for the use of hapü or iwi, with buildings on it, such as a meeting house and dining hall.

### Marginal tax rates applying to individuals

"Marginal" tax rates are the rates that apply to the last dollar earned by a taxpayer. These rates take into account the low-income rebate. This means that a taxpayer has an "effective" tax rate of 15% when his or her gross income is less than or equal to $9,500. The low-income rebate abates progressively until the taxpayer earns $38,000. The marginal tax rates for individuals are:

| | |
|---|---|
| 0 – 9,500 | 15% |
| 9,501 – 38,000 | 21% |
| 38,001 – 60,000 | 33% |
| 60,001 and over | 39% |

### Personal tax summary

Most individuals who receive salary, wages, interest, or dividends will have their final income tax liability determined by means of an income statement instead of being required to file an annual tax return. These statements are commonly referred to as "personal tax summaries". The personal tax summary is a summary of a taxpayer's income and tax information. It tells you whether you will need to pay tax or if you are due a refund.

### "Public benefit"

All entities other than those established for the relief of poverty must satisfy the "public benefit" test. This means they must be established for the benefit of the public or at least an "appreciably significant section" of the public.

In determining whether an entity benefits "an appreciably significant section of the public", it will be necessary to consider factors such as the nature of the entity, the number of potential beneficiaries, and the degree of the relationship between beneficiaries.

### Shareholder continuity rules

Rules in the Income Tax Act 1994 that involve measuring a shareholder's economic interest in a company by reference to his or her voting rights, or market value interests.

### Special corporate entity

The definition of "special corporate entity" contains a list of entities. Such entities generally do not have share capital or shareholders that are natural persons. The shares of the special corporate entity are deemed to be held by the same single person. Consequently, it will always be 100 percent owned and no breach of the shareholder continuity in the special corporate entity is possible.

### The Treaty of Waitangi Fisheries Commission

The Treaty of Waitangi Fisheries Commission/Te Ohu Kai Moana (the Commission) is a statutory body established under the Mäori Fisheries Act 1989, as amended by the Treaty of Waitangi (Fisheries Claims) Settlement Act 1992. It was set up in 1992 to replace the Mäori Fisheries Commission that was established in 1989 to hold fisheries assets returned to Mäori by the Crown, and to arrange for their eventual distribution to iwi.

Under the Deed of Settlement, the Crown agreed to fund Mäori into a 50/50 joint venture with Brierley Investments Ltd to bid for Sealord Products Ltd, New Zealand's biggest fishing company. In return, Mäori agreed to relinquish all current and future claims for commercial fishing rights in New Zealand.

The role of the Commission is set out in the Mäori Fisheries Act. Its main function is to facilitate and assist the entry of Mäori into, and the development by Mäori of, the business and activity of fishing. A portion of the income it derives from the assets vested in it by the Crown (essentially cash, fishing quota and interests in fishing companies) funds the activities of the Commission.

The assets can be categorised as "pre-settlement assets" and "post-settlement assets". Pre-settlement assets are those vested in the Commission under the Mäori Fisheries Act when originally enacted up to the date of settlement (23 September 1992) and the acquisition of Sealord Products Ltd on 6 January 1993 ("settlement date"). Post-settlement assets are those vested in the Commission after the settlement date in accordance with the Deed of Settlement.

The Commission is holding the pre and post-settlement assets ultimately for the benefit of all Mäori, until an agreed allocation model is finalised.

### Trust

A trust is an equitable obligation under which a person (the trustee) who has control of a property is bound to deal with that property either:

- for the benefit of identifiable persons (referred to as "beneficiaries") and any other person who may enforce the obligation; or
- for some object or purpose permitted by law.

The property concerned is referred to as "trust property". The person who created this trust relationship is referred to as the "settlor" and is the source of the trust property. The trustee has legal ownership of the trust property while the beneficiaries have a beneficial entitlement to that property.

The trustee may also be one of the beneficiaries in a trust.

### Trust tax rules

There are three types of trusts for tax purposes: qualifying, foreign and non-qualifying. The most common trust is a qualifying trust, which is defined for tax purposes as a trust that has been continuously liable for tax in New Zealand since being settled and which has met all of its tax liabilities.

Trusts can also be "discretionary" or "non-discretionary". Under a discretionary trust, a trustee has the power to determine who the beneficiaries are and the amounts distributed to them.

The key features of the trust tax rules are:

- A trust's annual income is separated into two classes: "beneficiary income" and "trustee income". "Beneficiary income" is the annual income earned by the trustee that is paid or applied to the beneficiary in that year or six months after, or that vests in the beneficiaries in terms of the trust deed. "Trustee income" is annual income earned by the trustee that is not beneficiary income – that is, income earned by the trust that has not been distributed within that timeframe or has not been vested in the beneficiaries.
- Trustee income is taxed at 33 percent, while beneficiary income is taxed at the beneficiary's marginal tax rate (unless it is beneficiary income of a minor, in which case it is taxed in some circumstances at the trustee rate of 33 percent).
- Losses cannot be passed on to beneficiaries.
- Income retains its nature when it is distributed. Capital gains are distributed tax-free, and dividends with imputation credits attached may be distributed to beneficiaries.
- Any income that is taxed as trustee income or that is added to the trust's "corpus" can be subsequently distributed to beneficiaries tax-free.
- Trustees are obliged to deduct tax from beneficiary income at an appropriate rate as agent for the beneficiary.

### Waahi tapu

An area (usually of land) that is sacred to Mäori.

### Whānau

Family – extends beyond the concept of immediate family (parents and siblings). "Whänau" links people of one family to a common tipuna or ancestor.

### Winding up

Termination of a business. Liquidation. Ceasing to operate as a business.

# Taxpayer compliance, standards and penalties

# OVERVIEW

The compliance and penalties legislation in the Tax Administration Act 1994 came into effect on 1 April 1997. It was designed to promote effective and fairer enforcement of the Inland Revenue Acts by providing better incentives for taxpayers to comply voluntarily with their tax obligations.

The post-implementation review of the compliance and penalties legislation began in October 1999. Since the introduction of the legislation the rules have been considered in several forums, including the Committee of Experts on Tax Compliance and many of the recommendations from the inquiry into the powers and operations of Inland Revenue by the Finance and Expenditure Committee in 1999 related to the compliance and penalties legislation.

The discussion document *Taxpayer compliance, standards and penalties: a review*, released in August 2001, represented the findings of the first stage of the review. The proposals in that document relating to debt and hardship and transfers of excess tax were included in the Taxation (Relief, Refunds and Miscellaneous Provisions) Bill. This bill contains most of the remaining proposals. The proposal relating to tax agents who breach standards of care is being considered further, as are certain measures to the department's information-gathering powers.

The next stage of the compliance and penalties review will:

- consider the changes in taxpayer behaviour resulting from the introduction of the current rules;
- consider whether the current rules maximise voluntary compliance;
- compare New Zealand's rules with those of other countries, including the extent of non-compliance, audit practices and the range and scale of penalties applied in other countries; and
- address a large number of technical matters.

A discussion document will be released in due course.

## GOOD BEHAVIOUR

***(Clauses 110 and 111)***

### Summary of proposed amendments

Amendments to the Tax Administration Act 1994 will give effect to the recommendations outlined in the discussion document *Taxpayer compliance, standards and penalties: a review* that taxpayers' past compliance should be taken into account when imposing shortfall penalties.

The rate of the shortfall penalty for lack of reasonable care and unacceptable interpretation will be reduced to 10 percent if within the previous four years the taxpayer has not been liable to pay a shortfall penalty on a tax shortfall identified during an audit for the same type of offence. For example, if a taxpayer is audited, a tax shortfall is ascertained and a shortfall penalty for not taking reasonable care is imposed and within four years of that audit the taxpayer again does not take reasonable care, the shortfall penalty on that subsequent breach will be imposed at the rate of 20 percent.

The shortfall penalty on the subsequent offence does not have to be imposed within the four-year period; it is the offence that must occur within the four years for the higher penalty rate to apply. The discussion document proposed that this period be seven years. Submissions on the discussion document expressed concern that this period will be too long. The government agrees and has reduced the period to four years.

This amendment will apply separately for each type of tax. For example, the rate of the shortfall penalty imposed on a taxpayer for not taking reasonable care in relation to GST will not be affected by a previous breach of the reasonable care test in relation to another tax type such as income tax.

### Application date

The proposed amendments will apply on or after 1 April 2003.

### Key features

Sections 141A and 141B will be amended to reduce the rate of the shortfall penalties for not taking reasonable care and unacceptable interpretation to 10 percent. Taxpayers who are audited and are found to have breached either of these standards, and within four years of the audit breach the standard again, will have the subsequent breach penalised at the current rate for the shortfall penalty of 20 percent.

## Background

The Finance and Expenditure Committee recommended that:

> …a past record of "good behaviour" be taken into account when deciding whether to impose a penalty[1]

The Committee of Experts on Tax Compliance also considered this issue. Its report recommended that:

> …the government should specifically require the review team to report on:
>
> whether the government's performance expectations of taxpayers are reasonable;
>
> whether, and to what extent, a past record of 'good behaviour' should be taken into account in deciding to impose penalties or to escalate enforcement;…[2]

This matter was also considered by the Ministerial Panel on Business Compliance Costs. In its report it stated:

> The policy of imposing tax collection obligations on employers/small businesses, and then punishing them with penalties for getting it wrong builds strong resentment from those that have good 'track records'.[3]

The government addressed all of these concerns in its discussion document *Taxpayer compliance, standards and penalties: a review*, released in August 2001. The discussion document noted that applying a test for good behaviour and determining whether taxpayers had met that test would incur considerable compliance and administrative costs. The government was also concerned as to how such a test could be applied consistently to all taxpayers.

As a way of taking into account good behaviour at low compliance and administrative costs, the government proposed that the lack of reasonable care shortfall penalty be reduced to 10 percent if the breach was the taxpayer's first breach of that standard. Submissions on the discussion document recommended that "good behaviour" be taken into account when imposing all shortfall penalties. The government agreed in part and extended the proposal to apply also to unacceptable interpretations. The government considers that given the culpability associated with breaches of the other standards, good behaviour should not be a factor that is taken into account when imposing shortfall penalties for gross carelessness, taking an abusive tax position or evasion.

---

[1] *Inquiry into the Powers and Operations of the Inland Revenue Department: Report of the Finance and Expenditure Committee*, New Zealand House of Representatives, October 1999, page 4 – recommendation 7 and page 27.

[2] *Tax Compliance*, Committee of Experts on Tax Compliance, December 1998, paragraph 12.7.

[3] *Finding the Balance: Maximum Compliance at Minimum Cost, Final Report of the Ministerial Panel on Business Compliance Costs*, July 2001, page 121.

Submissions also expressed concern that the proposal could discourage voluntary disclosures for tax shortfalls. The government agrees with the concerns raised in submissions. In order to resolve this issue the original proposal has been amended so that if a taxpayer voluntarily discloses a tax shortfall, disclosure of that shortfall will not lead to higher rates of shortfall penalties applying to subsequent breaches, whether those subsequent offences are voluntarily disclosed or not. It will only be when the taxpayer has been audited and a shortfall penalty is imposed that the "probation" period will begin.

## PENALTIES FOR UNACCEPTABLE TAX POSITIONS

***(Clauses 72(2) and (7), 111, 112, 113 and 116)***

### Summary of proposed amendment

The Tax Administration Act will be amended to provide that a shortfall penalty for not having a tax position that is "as likely as not to be correct" can be imposed, including cases where the taxpayer has not interpreted the law. The amendment prevents taxpayers choosing not to "interpret" the legislation to avoid possible shortfall penalties. To avoid any confusion, the name of the shortfall penalty will be changed from "unacceptable interpretation" to "unacceptable tax position".

While the amendment reflects the original intent of the legislation, the government is concerned that associated compliance costs will increase. Therefore, to mitigate the compliance cost impact of the amendment, the thresholds at which the penalty is imposed will be increased. The minimum threshold increases from $10,000 to $20,000 and the maximum threshold from $200,000 to $250,000. This means that before the penalty can apply, the total amount of the tax shortfall must exceed $20,000 and one percent of the total amount of tax the taxpayer has returned for the period. It will apply in all cases when a tax shortfall exceeds $250,000.

### Application date

The amendment will apply on and after 1 April 2003.

### Key features

Section 141B will be amended to change the name of the shortfall penalty for "unacceptable interpretation" to "unacceptable tax position". This amendment is to ensure that the penalty will apply to tax positions that do not meet the criteria, regardless of whether the taxpayer has considered the legislation or not.

The thresholds in section 141B at which the penalty will be imposed will be increased.

### Background

The shortfall penalty for unacceptable interpretation is intended as a signal to taxpayers who take tax positions where there is a significant amount of tax at stake. It indicates that they should take extra care and that, when viewed objectively, their interpretations should be likely to be correct.

However, the current interpretation of "unacceptable interpretation" allows taxpayers to avoid making reasonable efforts to determine what the law is. The government is concerned that taxpayers could choose not to interpret the legislation on a complex tax issue, as a means of avoiding possible shortfall penalties. It therefore weakens the standard that larger taxpayers are required to meet, and makes a penalty more difficult to impose in cases where it is fair that it be imposed.

The Finance and Expenditure Committee recommended that:

> The Inland Revenue Department reinforce both publicly and internally that if a taxpayer or adviser has not interpreted legislation a penalty for unacceptable interpretation cannot apply.[4]

Some submissions on the discussion document noted that this proposal is contrary to the recommendation of the Finance and Expenditure Committee following its inquiry in 1999 into the powers and operations of Inland Revenue. However, as noted in the discussion document, the current interpretation of the legislation allows taxpayers to avoid making reasonable efforts to determine what the law is. This interpretation is contrary to the original intent of the legislation.

Some submissions also recommended that if taxpayers have not interpreted the legislation and should have done so, the shortfall penalty that should be imposed is the lack of reasonable care penalty, not the unacceptable interpretation penalty. The government agrees with submissioners that in some cases if a taxpayer has not interpreted the legislation a shortfall penalty for lack of reasonable care could be imposed. However, there is concern that there could be cases where a penalty cannot be imposed. For example, a taxpayer investing in a scheme asks the promoter if an interpretation is necessary on a particular point and the promoter says that the point is very clear and an interpretation is not necessary; the taxpayer has taken reasonable care and no shortfall penalty can be imposed.

[4] *Inquiry into the Powers and Operations of the Inland Revenue Department: Report of the Finance and Expenditure Committee*, New Zealand House of Representatives, October 1999, page 4 – recommendation 9 and page 28.

## ONUS OF PROOF

***(Clause 105)***

### Summary of proposed amendment

If a taxpayer can prove on the balance of probabilities that an assessment is wrong by a specific amount, the court must reduce the assessment by that specific amount. This will allow taxpayers to correct assessments they show to be wrong in part.

### Application date

The amendment will apply to challenges brought on or after the date of enactment.

### Key features

A new subsection (1A) is added to section 138P to provide that if a taxpayer proves on the balance of probabilities that the assessment is excessive by a specified amount, the court will reduce the assessment by that amount.

### Background

The Committee of Experts on Tax Compliance noted that a taxpayer who wishes to challenge an assessment is required to prove not only that the Commissioner of Inland Revenue's assessment is wrong, but also by how much it is wrong. It recommended that the law be clarified to provide that if a taxpayer proves, on the balance of probabilities, that the assessment is excessive by a specified amount, the court should reduce Inland Revenue's assessment by that amount.[5] In the discussion document *Taxpayer compliance, standards and penalties: a review* the government said that it agreed with the Committee's recommendation.

[5] *Tax Compliance*, Committee of Experts on Tax Compliance, December 1998, paragraphs 10.12 and 10.13.

## TAX IN DISPUTE

***(Clauses 72(5), 98, 99(2), 100, 101, 102(2), 103 and 104)***

### Summary of proposed amendment

It will no longer be necessary for taxpayers to pay 50 percent of the tax in dispute at the beginning of the dispute, since the rationale for this was removed by the introduction of use-of-money interest on overpaid and underpaid tax. However, Inland Revenue will be given the power to require payment of all of the amount in dispute when it considers that there is a risk that the amount will not be paid.

### Application date

The amendment will apply on or after 1 April 2003.

### Key features

Section 138I will be amended to remove the requirement to pay 50 percent of the tax in dispute at the beginning of the dispute. Inland Revenue will be given the power to require payment of all of the tax in dispute when there is a risk to the revenue.

### Background

As noted in the discussion document *Taxpayer compliance, standards and penalties: a review*, the Tax Administration Act requires that the taxpayer pay the non-deferrable tax relating to the amount in dispute – that is, 50 percent of the amount of tax that is being disputed. The justification for requiring payment, however, was significantly reduced with the introduction of two-way use-of-money interest.

The government is still concerned that in rare cases there is a risk that the tax will never be paid. For example, if a taxpayer enters a dispute merely to delay payment of tax and then leaves the country. To reduce the risk to the revenue, Inland Revenue will be given the power to require payment of all of the tax in dispute when there is a risk that that amount will not be paid.

## INFORMATION-GATHERING POWERS

***(Clauses 73, 74 and 75)***

### Summary of proposed amendments

The amendments give effect to the government's proposals set out in the discussion document *Taxpayer compliance, standards and penalties: a review* in relation to information-gathering powers. The amendments aim to clarify and correct deficiencies in the existing rules.

They will affect only a small number of taxpayers, and will improve the Commissioner's ability to access the necessary information to confirm taxpayers' correct tax positions.

### Application date

The amendments to the information-gathering powers of Inland Revenue will apply to information requests made on or after the date of enactment.

### Key features

The amendments will extend and clarify Inland Revenue's information-gathering powers. Section 16 will be amended to:

- clarify that third parties can be required to give reasonable assistance and facilities in an investigation;
- clarify who may be given authority to enter a taxpayer's premises; and
- allow Inland Revenue to remove and photocopy documents.

Section 17 will be amended to:

- allow Inland Revenue to requisition information held by offshore entities controlled by a New Zealand resident; and
- give Inland Revenue the discretion to require documents to be sent to a particular Inland Revenue office.

### Background

Inland Revenue relies on taxpayers being honest in the provision of information about their income. Information is, in many cases, almost exclusively within their possession and control. If Inland Revenue decides to audit a taxpayer, the value of the audit process is compromised if it cannot independently verify the taxpayer's tax position. Therefore Inland Revenue's information-gathering powers in sections 16 and 17 are critical to the department carrying out its statutory function of collecting the correct amount of tax.

In December 1998 the Committee of Experts reported to the then government. The committee raised several issues relating to Inland Revenue's information-gathering powers and made several recommendations that have formed the basis of the proposed amendments.

In August 2001 the government released a discussion document *Taxpayer compliance, standards and penalties: a review,* which included a chapter on information-gathering powers.

The proposals in the discussion document were in line with the recommendations of the Committee of Experts. The discussion document also proposed that the legislation be amended to clarify who may be given authority to enter a taxpayer's premises.

## Detailed analysis

### *Reasonable assistance from third parties*

Under section 16(2), Inland Revenue has the authority to require the owner, manager, and current or former employees of any business that is being investigated to give reasonable assistance in an investigation or to answer questions relating to an investigation. There is uncertainty, however, over whether third parties – for example, a taxpayer's bank manager – are required to give reasonable assistance or answer questions.

The Committee of Experts recommended that section 16(2) be clarified. It commented that in principle, third parties should be required to give reasonable assistance and answer questions because the information being sought can be requisitioned under section 17. This statutory requirement would also protect third parties from actions for breach of confidence or infringement of the Privacy Act 1993.

The amendment to section 16(2) will clarify that occupiers must provide Inland Revenue with reasonable assistance and facilities. "Occupier" under Australian case law has been interpreted to mean all persons entitled to be on the premises, including employees, and is not restricted to the owner or lease holder.

Submissions on the discussion document raised concerns that Inland Revenue may request facilities that may not be available or appropriate. A taxpayer is not expected to provide Inland Revenue with facilities other than those already existing. It is essential that basic facilities such as lighting are available to Inland Revenue.

### *Authority to enter a taxpayer's premises*

This issue was not raised by the Committee of Experts but was included in the discussion document as a result of the government's own concerns.

The ability to have other persons accompany Inland Revenue officers onto taxpayer's premises is necessary as those other persons may have specialist skills not possessed by Inland Revenue officers, such as computer forensic skills. The ability to have the Police accompany officers may be necessary to discourage physical violence. Accordingly, section 16 will be amended to allow other persons, whose assistance is considered necessary, to enter taxpayers' premises.

Currently, a taxpayer's consent or a judicial warrant must be obtained before Inland Revenue officers can enter the taxpayer's private dwelling. Section 16 requires a warrant to specify the individual investigator who may enter the premises. Practical difficulties can arise if circumstances require another Inland Revenue officer not named in the warrant to take part in the investigation.

Section 16 will be amended to allow warrants to authorise Inland Revenue officers in general to enter a private dwelling.

These amendments will reduce practical difficulties in enforcing the Inland Revenue Acts.

***Removing documents for photocopying***

Although section 16 confers on Inland Revenue full and free access to all premises to inspect and copy any books, documents or anything else that Inland Revenue considers necessary or relevant for tax purposes, it has no authority to remove documents for copying elsewhere.

The Committee of Experts was concerned that the current wording of section 16 could create problems in cases where it is not possible or practicable to make copies of documents on the taxpayer's premises.

The government is concerned that the risk of documents being altered or destroyed exists despite the availability of inspection. The value of an audit is compromised if Inland Revenue cannot independently verify the taxpayer's tax liability. If Inland Revenue is to discharge its statutory duty of collecting the right amount of tax, documents must be able to be protected from being altered or destroyed.

Section 16 will be amended to provide Inland Revenue with the power to remove documents for photocopying. Documents will not be removed if it is practicable to make copies on premises.

The power to remove documents will be tightly controlled, and guidelines will be developed around the use, handling and storage of information. The amendment will expressly state that documents removed from a taxpayer or third party for the purpose of copying will be returned to the taxpayer as soon as practicable. The taxpayer will be given a list of the documents removed.

A submission on the discussion document *Taxpayer compliance, standards and penalties: a review* suggested that if given the power to remove documents for photocopying, Inland Revenue should have a duty to provide an identical set of copied documents to the taxpayer. This would ensure taxpayers were aware of the specific documents obtained from their records. Administrative guidelines will require taxpayers to be provided with a copy of the specific documents photocopied, unless all the documents removed were photocopied.

***Requisition of information held by offshore entities***

Under section 17 Inland Revenue can require a person to produce for inspection any records under the control of that person. However, there is uncertainty over the meaning of "control" and, in particular, over whether documents can be regarded as

being under the control of a New Zealand resident if that resident has control of an offshore company which has those documents in its possession.

The Committee of Experts recommended that section 17 be amended to ensure that New Zealand resident individuals and companies can be required to produce such records for inspection in New Zealand.

The amendment will allow Inland Revenue to requisition from New Zealand residents records held by offshore entities controlled by them and provide that foreign secrecy laws restricting the production of records in New Zealand be ignored.

The Committee of Experts noted that foreign secrecy laws are an important reason for companies establishing subsidiaries in certain countries in the first place so as to exploit such laws to frustrate investigations by tax authorities in their home countries. Countries such as Australia and the United States already have such provisions for ignoring foreign secrecy laws.

### *Documents to be sent to a specified Inland Revenue office*

The Committee of Experts noted that section 17 requires a person to produce documents for inspection only at the person's premises. The committee considered that it could be more efficient in some cases for documents to be sent to a particular Inland Revenue office. Therefore it recommended that section 17 be amended to give Inland Revenue the discretion to require that documents be sent to a particular Inland Revenue office.

Submissions on the discussion document recommended that the legislation provide that documents be sent to the Inland Revenue office closest to the taxpayer. As certain issues are dealt with at designated Inland Revenue offices, it would not be in the interests of either the taxpayer or Inland Revenue to have the documents delivered to any office other than the office where the matter is being dealt with. Having documents delivered to the office closest to the taxpayer would often necessitate the double handling of documents, create an unnecessary administrative burden and most likely delay Inland Revenue's response to the taxpayer.

## Other matters under consideration

### *The ability to remove computers to copy information*

In the discussion document *Taxpayer compliance, standards and penalties: a review,* the government proposed that section 3 of the Tax Administration Act 1994 be amended to clarify that the word "document" includes computers. This proposal was aimed at clarifying that Inland Revenue has clear authority to access or remove computers for the purpose of copying information they contain. The submissions on the discussion document raised concerns regarding the removal of computers and the impact upon businesses. The government recognises the importance of information to taxpayers and appreciates the need to minimise disruption appreciated. Officials will carry out additional research on this proposal.

***Removal of the words "necessary or relevant"***

The removal of the words "necessary or relevant" from section 17 was also proposed in the discussion document *Taxpayer compliance, standards and penalties: a review.* This issue will now be considered following the government's forthcoming review of tax and privilege.

## CAPPING THE PENALTY FOR LACK OF REASONABLE CARE

***(Clause 118)***

### Summary of proposed amendment

The Tax Administration Act will be amended to impose a monetary cap on the shortfall penalty for lack of reasonable care. The cap will be set at $50,000 per tax position and will apply to those shortfalls identified through voluntary disclosure or Inland Revenue audit within two months of the relevant return being filed. The amendment is designed to ensure that the shortfall penalty is not out of step with the offence if identified speedily.

### Application date

The amendment will apply to shortfall penalties for lack of reasonable care imposed on or after 1 April 2003.

### Key features

A new section 141JAA will be inserted to provide a $50,000 cap on the shortfall penalty for lack of reasonable care, in cases where the shortfall is identified within a two-month period through voluntary disclosure or an Inland Revenue audit.

### Background

The discussion document *Taxpayer compliance, standards and penalties: a review* recommended that a monetary cap on the shortfall penalty for lack of reasonable care be introduced. The government is concerned about the application of the lack of reasonable care penalty to very large errors that are speedily identified and corrected. The government considers that in some cases the size of the penalty may be excessive and may, in fact, discourage voluntary compliance.

Submissions on the discussion document recommended that the monetary level of the cap be reduced and that the period of time in which to identify the shortfall be extended. The government declined both these submissions as it considers that implementing them would greatly reduce the incentives on taxpayers to take reasonable care.

## PROMOTER PENALTIES

***(Clauses 72(4), 109, 113, 114, 115, 117, 120 and 121)***

### Summary of proposed amendment

The amendment will give effect to the proposal in the discussion document *Taxpayer compliance, standards and penalties: a review* that a new penalty on promoters of certain "tax arrangements" be introduced. A number of submissions on the discussion document raised concerns about the proposal. These concerns have been taken into account in developing the proposal further.

If an arrangement is offered, sold, issued or promoted to five or more people in an income year and it involves an abusive tax position, the promoter will be liable for a promoter penalty. The penalty will be 100 percent of the tax shortfalls of the investors, calculated using a 39 percent tax rate. The penalty is aimed at reducing the number of such investments by holding the people responsible for the design and sale of tax arrangements directly accountable for their actions.

The government is concerned that in many cases investors in such arrangements are not aware of the tax effects of their investment. It is also concerned that the abusive tax position shortfall penalty, which is intended to be applied to taxpayers who are not complying, is, in fact, being applied to taxpayers who thought that they were complying but were, in fact, misled by the promoters. The government has therefore proposed that if the taxpayer has less than $50,000 invested in an arrangement and has advice independent from the promoter that it does not involve an abusive tax position, the shortfall penalty on the taxpayer will be imposed at 20 percent rather than the normal 100 percent.

### Application date

The amendment will apply to arrangements entered into on or after the date of enactment.

### Key features

New sections 141EA and 141EB will be inserted to provide for the imposition of a civil penalty on promoters, in cases where investment in an arrangement leads to the investor having a shortfall penalty for an abusive tax position imposed.

Taxpayers who have less than $50,000 invested in an arrangement and independent advice that it does not involve an abusive tax position will have the shortfall penalty imposed at 20 percent, rather than the normal 100 percent.

**Background**

As noted in the discussion document *Taxpayer compliance, standards and penalties: a review*, if a taxpayer becomes a party to an arrangement that is considered by Inland Revenue to involve an abusive tax position, a shortfall penalty is imposed on the taxpayer. Although the compliance and penalties legislation penalises promoters in their capacity as taxpayers, the legislation imposes no civil sanctions on promoters in their capacity as promoters of "arrangements". The compliance and penalties legislation therefore provides no incentive for promoters to ensure that the tax effects they claim for their arrangements are correct. Furthermore, offer documents in some cases restrict taxpayers from taking legal action against the promoter.

The government considers that promoters of such arrangements should be held clearly accountable for their actions. The promoter is usually the party with the greater knowledge of the arrangement's tax effects. Often, the true tax impact of an arrangement may be determined by features that the promoter is aware of but the investor is not. These undisclosed features may place the investor at risk of significant penalties.

The discussion document recommended that the introduction of a penalty on promoters as the best way to ensure that they are held clearly accountable for their actions. The penalty was to apply to arrangements that involved breaches of an anti-avoidance provision or results in an investor having a shortfall penalty for an abusive tax position.

Submissions on the discussion document were concerned that it is often difficult to determine whether an arrangement has involved tax avoidance. The government agrees and the amendment will only apply when an arrangement involves an abusive tax position.

The discussion document also proposed that imposition of the penalty on the promoter would not depend on the successful imposition of a penalty on the investor. The government now considers that the promoter penalty should be imposed in tandem with the shortfall penalty on the taxpayer.

As noted in the discussion document, the promoter penalty will generally be imposed as one penalty – but if additional taxpayer shortfalls are detected, further penalties will be imposed. In effect, the penalty on the promoter will be based on the extent of tax shortfalls generated by the arrangement. This will ensure that the promoter faces a penalty that reflects the total tax impact of the arrangement.

To prevent disputes about the rate of tax to be used to determine the tax shortfall, a flat rate of 39 percent will be used. Investors in these arrangements are typically high-income earners, so the use of the 39 percent rate is appropriate.

# Other policy issues

## TAX AND CHARITIES

***(Clauses 6, 8 and 31)***

### Summary of proposed amendments

Late last year the government announced a number of proposed changes in relation to charities, some of which involve legislative amendments to the Income Tax Act. The changes being included in this tax bill are:

- increasing the maximum donation rebate for individual donors to $630, in line with inflation since 1990;
- setting one threshold for deductibility of corporate donations, namely, a maximum of 5 percent of net income, which simplifies the current rules by removing both the limit on donations to any one donee and the aggregate limit of $1000;
- removing the prohibition on deductions for donations made by close companies, where those companies are listed on a recognised exchange, which allows a greater range of companies to qualify for the deduction;
- clarifying that to qualify for the income tax exemption, an entity's charitable purposes has to be carried out in each year the tax exemption is claimed, thus ensuring that charitable purpose is continuous.

### Application date

The changes to the rebate and deduction provisions are to take effect from the beginning of the 2002-03 income year.

The change to verify that charitable purposes have to be continuous to qualify for the income tax exemption is to take effect from the beginning of the 2003-04 income year.

### Key features

The maximum rebate that can be claimed by an individual donor under section KC 5(3)(b) is to be changed from $500 to $630.

The section DJ 4(a) limit (of the greater of 1 percent of net income or $4000) on donations by companies to individual charities is being removed, as is the $1000 limit in section DJ 4(b)(i). This leaves just one limit – the aggregate limit of all gifts made in any one year of 5 percent of net income (current section DJ 4(b)(ii)).

The rewritten section DJ 4 also requires that for a close company to be able to deduct its donations, its shares must be quoted on the official list of a recognised exchange.

Amendments to section CB 4(1)(c) and (e) verify the requirement that charitable purpose be continuous.

**Background**

The changes in this bill were first canvassed in the government discussion document *Tax and charities*, which dealt with a range of tax issues. It was the first major review of the charities tax legislation since the Working Party on Charities and Sporting Bodies report of 1989.

One of the key issues canvassed in the discussion document was whether there should be a registration, reporting and monitoring system for charities that claim the exemption from income tax. Another significant issue was whether the definition of “charitable purpose” was still appropriate. A number of specific tax issues were also discussed, including the tax provisions that allow donors a rebate or deduction for their donations to charities.

There was significant public interest in the proposals, with over 1600 submissions being received. In response, the government proposed an initial package of changes and set up a working party comprising charitable sector representatives, to provide recommendations on a registration, reporting and monitoring system for charities.

The working party provided its recommendations earlier this year, the prime recommendation being that registration, reporting and monitoring should be carried out by a new entity, a charities commission. The government is still considering its response to those recommendations.

In the meantime, the government is proceeding with the increase in the maximum rebate level and simplification of the company deduction thresholds. It is also proceeding with the technical clarification that to qualify for the income tax exemption, an entity’s charitable purposes have to be carried out in each year the tax exemption is claimed. This change removes any argument that an entity only has to demonstrate a charitable purpose when it is established.

# CHARITABLE DONEE STATUS

***(Clause 31)***

## Summary of proposed amendment

The Open Home Foundation International Trust, the Register of Engineers for Disaster Relief New Zealand, The Hillary Himalayan Foundation and Together for Uganda are to be given charitable donee status. This will enable donors to obtain tax relief on their donations. An amendment will also be made to the name of The Save the Children Fund.

## Application date

The amendments will apply from the 2002-03 income year.

## Key features

The following organisations are being added to section KC 5 of the Income Tax Act 1994, which lists the organisations that qualify for charitable donee status:

- Open Home Foundation International Trust;
- Register of Engineers for Disaster Relief New Zealand;
- The Hillary Himalayan Foundation; and
- Together for Uganda.

The name of The Save the Children Fund, which already has donee status, will be amended to Save the Children New Zealand (and its branches) to reflect the name and structure under which this organisation now operates.

## Background

Donations to qualifying organisations entitle individual taxpayers to a rebate of 33 1/3 percent of the amount donated, to a maximum for all donations of $500 a year (to be increased to $630 a year by this bill). Donations by non-closely held companies (to be extended by this bill to a closely held company that is listed on a recognised stock exchange) qualify for a deduction from net income. The amount allowable as a deduction depends on the company's net income.

### *Open Home Foundation International Trust*

The Open Home Foundation International Trust has been established to raise educational standards in developing countries. The trust's current focus is training programmes that ensure the wellbeing and safety of children. The Open Home Foundation has operated in New Zealand since 1977.

### *Register of Engineers for Disaster Relief New Zealand*

The Register of Engineers for Disaster Relief New Zealand has been established to maintain a register of suitably qualified engineers who are available for disaster relief work in New Zealand and overseas. The register supplies information on suitably qualified engineers to relief agencies and civil defence, supply technical advice to relief agencies and civil defence, run training courses, publish literature and maintain technical information related to disaster relief.

### *The Hillary Himalayan Foundation*

The Hillary Himalayan Foundation has been established to assist people in Nepal, Sikkin, Bhutan, Tibet and those parts of India and Pakistan that are in the Himalayan and Karakoram mountains and foothills. The assistance to be provided includes the provision of medical facilities and supplies, improving agricultural methods and food production, establishing educational facilities, improving the region's infrastructure, and conserving the local environment.

### *Together for Uganda*

The Together for Uganda trust has been established to raise funds to assist underprivileged people in Uganda.

## TAX SIMPLIFICATION – TAX POOLING

***(Clauses 37, 95, 97 and 124)***

### Summary of proposed amendments

New rules that will allow taxpayers to pool their provisional tax payments are being introduced. Under the new legislation, these payments may be pooled with those of other taxpayers, with the result that underpayments may be offset by overpayments within the same pool. The amendments reduce taxpayers' exposure to use-of-money interest on underpaid tax and increase interest on overpaid tax. The proposal is a tax simplification measure canvassed in the government discussion document *More time for business*, released in May last year.

### Application date

The new rules will apply from the 2003-04 income year.

### Key features

A new subpart MBA is being inserted into the Income Tax Act 1994, and consequential amendments are being made to the Tax Administration Act 1994. They will allow businesses to pool their provisional tax payments, offsetting tax underpayments by overpayments within the same pool, thereby reducing use-of-money interest exposure. The pooling arrangement will be made through a commercial intermediary who will arrange for participating taxpayers to be charged or compensated for the offset. Participating taxpayers will pay or receive interest on their tax underpayments and overpayments respectively.

The new subpart MBA sets out rules governing the set-up and maintenance of tax pooling accounts. For example, the requirements for persons wishing to become tax pooling intermediaries are set out in section MBA 3. These include giving the Commissioner notice that:

- participating taxpayers' payments to the intermediary will be held on trust;
- the intermediary's administration and information technology systems will ensure that participating taxpayers' personal information and payment details will be kept private;
- the intermediary's record-keeping systems will allow the correct amounts to be paid back to participating taxpayers if the tax pooling account is wound up; and
- participating taxpayers will be made aware that payments to the intermediary do not satisfy their obligations to Inland Revenue.

Section MBA 4 provides that a tax pooling account will continue until it is wound up, and will not relate to a particular income year.

Section MBA 5 sets out the procedures governing intermediary deposits into a tax pooling account, including, for example, the stipulation that use-of-money interest will immediately start accruing on the amount deposited as soon as it is paid into the account by the intermediary.

Section MBA 6 sets out the procedures governing intermediary requests for transfers to be made from a tax pooling account to participating taxpayers. For example:

- An intermediary may only request transfers on a monthly basis, but may request those transfers to be made to participating taxpayers' provisional tax accounts as at any date – so long as there are, or were, sufficient funds in the tax pooling account on that particular effective date.
- Upon actioning a transfer request, Inland Revenue will provide both the intermediary and the taxpayer concerned with a statement confirming that the action has been taken.

Section MBA 7 provides for refunds from a tax pooling account to an intermediary.

Section MBA 8 provides that Inland Revenue may wind up a tax pooling account if it considers, for example, that:

- the intermediary's actions are preventing participating taxpayers from managing their use-of-money interest risks; or
- the intermediary has breached any of its obligations under the legislation.

**Background**

Taxpayers have to pay their income tax liability on their terminal tax date. Often the amount actually due is uncertain, with the amount paid during the year reflecting the taxpayer's best judgement of the law on a large number of technical issues. If taxpayers' judgement of their liability is incorrect, say as a result of an amended assessment, and they have actually overpaid or underpaid tax, Inland Revenue applies use-of-money interest.

At present, there is no administrative mechanism allowing taxpayers to reflect this uncertainty in their payment of tax. This issue is much more pointed in the area of provisional tax, where taxpayers are trying to estimate how much income they will earn in a year, with use-of-money interest applying if they are wrong. This is exacerbated by the fact that many taxpayers consider that the rate of interest the government pays on tax overpayments to be too low and the rate it charges on underpayments too high.

Under the proposed change, taxpayers will be able to approach their intermediary at any time and "borrow" from the pool, requesting that tax payments be made on their behalf to Inland Revenue whenever there are funds available at a relevant tax payment due date. The intermediary will be required, in turn, to provide the department with a schedule setting out the participating taxpayers and the amounts to be transferred to their respective tax payment accounts on the relevant date.

Pooling will provide advantages to taxpayers and commercial intermediaries, without affecting the tax base, because the intermediaries will manage underpayments and overpayments to Inland Revenue on the participating taxpayers' behalf. This means intermediaries ought to be able to pay a higher rate of interest to taxpayers who have overpaid their tax into the pool, and charge a lower rate of interest to those who have underestimated their tax and have therefore borrowed from the pool than the rates of use-of-money interest paid by the department. They will be able to do so by arbitraging the interest rate differential between the department's rates and their own financing costs. The department will continue to receive the correct amount of tax.

Tax pooling will reduce use-of-money interest costs for participating taxpayers, by ensuring that the interest charged or paid on underpaid or overpaid tax will more readily reflect the true commercial cost of borrowing or lending for the taxpayers concerned. Another advantage arising from tax pooling is that it will involve the introduction of intermediaries between taxpayers and Inland Revenue. Taxpayers who chose to participate will reduce their need to communicate with Inland Revenue about their tax payments.

# TAX SIMPLIFICATION – PAYE AND INTERMEDIARIES

***(Clauses 35, 45, 46, 47, 48, 49, 50, 51, 52, 53, 56, 57, 58, 65(7), 65(9), 65(14), 65(23), 67(2), 67(7), 76, 80, 85, 96, 106, 119, 123, 124(2), 124(4), 125, 126, 127, 131, 146, 147, 148, 149, 150, 152, 153, 154, 156, 157, 158, 159, 162, 163, 164(1), 164(2), 164(3), 164(4), 164(6), 164(8), 164(9), 164(10), 164(11) and 162(12))***

## Summary of proposed amendment

The bill introduces a proposal to give employers the option of using accredited PAYE intermediaries to meet their obligations to calculate and pay PAYE deductions and to file employer monthly schedules. The transfer of those obligations to intermediaries will mean that employers who meet requirements to provide intermediaries with basic payroll information and the gross wages of their employees in a timely manner will not face any penalties for the incorrect application of the PAYE rules.

## Application date

The amendment will come into effect from 1 April 2003.

## Key features

The main change proposed is a new subpart NBA in the Income Tax Act 1994. As well as describing the purpose of the new legislation and recognising the intermediary as an entity in the PAYE rules, that subpart will contain the rules in relation to:

- the accreditation of PAYE intermediaries by Inland Revenue;
- requirements on employers who want to transfer their PAYE obligations to an intermediary;
- obligations on PAYE intermediaries;
- the trust account in which wages and deductions are held by intermediaries before being paid to employees and Inland Revenue respectively; and
- termination of the arrangement between employers and intermediaries.

Changes also need to be made to the penalties and use-of-money interest rules in the Tax Administration Act 1994. To the extent that employers provide gross wages and the correct payroll information to the intermediary by the date specified, they will not be liable for penalties for the breach of the PAYE rules.

Currently, employers are also required to make a number of non-tax deductions from employees' gross wages, such as student loan repayments and child support deductions. When an employer engages a PAYE intermediary, the intermediary will become responsible for making these deductions.

"PAYE intermediary" becomes a defined term in section OB 1.

The current PAYE law is focused only on the actions of employers, so numerous consequential amendments are proposed to extend the scope of the rules to intermediaries. Generally, the consequential amendments add references to "PAYE intermediaries" in instances which currently refer only to "employer". It is not intended, however, to extend the references to "employer" which relate to the underlying employment relationship. For example, employees will still receive source deduction payments from the employer, regardless of the fact that it may actually be paid via a PAYE intermediary.

***Accreditation of intermediaries***

New section NBA 2 sets out the administrative process for accrediting PAYE intermediaries, the criteria to be used by the Commissioner to accredit, and the rules for removing accreditation. Employers who wish to transfer their PAYE obligations to an intermediary will be able to transfer them only to an accredited PAYE intermediary.

As outlined in *More time for business*, the government considers that accreditation of intermediaries is important to ensure the integrity of the PAYE system. This requirement was supported in the consultation process. To maximise flexibility in accreditation requirements, the detailed criteria for accreditation will be specified administratively.

Anyone applying for accreditation will generally need to be able to apply the PAYE rules correctly and pay PAYE and file returns in the format prescribed by Inland Revenue. The software to be used to calculate tax deductions will need to be certified by Inland Revenue as suitable for that purpose. Intermediaries will also have to provide an assurance to Inland Revenue and employers that gross wages paid by employers will be held in trust accounts, and personal information will be kept private. They will also need to make the employer aware that Inland Revenue is not responsible for the security of net wages.

Inland Revenue will have the power to remove accreditation if the Commissioner considers that the intermediary is not applying the PAYE rules correctly.

***Arrangements between employers and intermediaries***

New section NBA 3 and NBA 4 outline the responsibilities of the employers who wish to transfer their PAYE obligations to an intermediary. In order to administer the new system and verify that the proposed intermediary is accredited, Inland Revenue will need to know, in advance of the arrangement, the identity of the proposed intermediary, and into which accounts the gross wages will be deposited. The arrangement will need to apply to all of the employers' employees.

Participating employers will be required to pay the gross wages of their employees into the intermediary's trust account. The discussion document proposed an alternative model where employers do not have to transfer the gross wages to the intermediary, instead holding the wages until the tax on them has to be paid to Inland Revenue. The government has decided not to legislate for this alternative model because it did not receive sufficient support in consultation. Employers will still be required to keep records of gross wages paid so that Inland Revenue can verify that intermediaries have appropriately distributed all the gross wages received from

employers. Basic payroll information from employers to intermediaries will need to be provided within the timeframe set by the intermediary. To provide the greatest flexibility in the arrangements between employers and intermediaries, no general timeframe is being legislated for. Intermediaries will bear the responsibility for making calculations and payments on time, so they are best placed to communicate their information needs to employers.

***Duties of payroll intermediaries***

New section NBA 5 sets out the main obligations on intermediaries. These are to calculate and pay PAYE, meet filing requirements, provide remittance certificates and keep records as though they were the employer for whom they are acting.

Other than the obligations described above, it is not proposed to legislate for the services that intermediaries provide to employers or the charges for those services. This is intended to facilitate the most flexible commercial agreement possible between employers and intermediaries about what information they provide to each other and how they provide it. It is envisaged that employers will make arrangements to provide information required by staff such as payslips and general records so that they can audit their payroll expenses and have sufficient information to allow them to move their custom to another intermediary if need be.

***Wages and deductions to be held on trust***

New section NBA 6 sets out the requirements for setting up and operating the trust accounts into which employers must deposit gross wages. An intermediary will be allowed to hold multiple trust accounts, but will be required to provide information relating to all such accounts to the Commissioner at the time of accreditation. The new section will ensure that:

- Only gross wages are allowed to paid be into an intermediary's trust account – that is, an intermediary's fees for example cannot be deposited into the trust account.
- Withdrawals from the account are limited to employees' net wages and the payment of the relevant deductions to the Commissioner.

***Termination of arrangement***

The proposed section NBA 7 sets out the rules for the termination of an arrangement between employers and intermediaries. Either party to the arrangement can terminate it by notice to the other party and Inland Revenue. To ensure certainty in the arrangement the termination must be prospective. Any proceeds in the trust account at the time the arrangement ceases must be dealt with as if the arrangement was still in effect. This is important given the possible time lag between the deposit of gross wages and dates when payment of wages and deductions should occur.

No rules are proposed to deal with deposits mistakenly made by employers into the trust account once the arrangement has ceased. The government considers it best for the parties to come to their own arrangement in such situations.

### *Penalties and interest*

Various changes are proposed to Part IX of the Tax Administration Act 1994 to reflect the liability of intermediaries for applying the PAYE rules. For example, under the proposed section 141JB, intermediaries will be liable for late filing, late payment and shortfall penalties to the extent that employers have provided gross wages and the correct payroll information to the intermediary within the time agreed by the parties. Changes to section 139AA will mean that PAYE intermediaries will also be subject to the non-electronic filing penalty.

A new section 120OA is being added to Part VII of the Tax Administration Act 1994 with respect of the application of use-of-money interest. That section will impose interest on PAYE intermediaries who fail to make the appropriate payment of PAYE deductions by the due date.

Associated changes are required to the tax and penalty recovery provisions in Part X of the Tax Administration Act 1994. For example, changes to sections 167 to 169 ensure that if a PAYE intermediary receives gross wages and the relevant information from an employer but fails to make the appropriate deductions, these amounts can be recovered from the intermediary. Similarly, changes to sections 156 and 157 of the Tax Administration Act allow the Commissioner to recover penalties from intermediaries when a penalty is so imposed.

Finally, Part XI of the Tax Administration Act is being changed to allow the Commissioner to remit penalties imposed on PAYE intermediaries, for example, if there is reasonable cause. Section 183A currently allows for remission of a late filing, late payment and non-electronic filing penalty if the penalty arose as a result of an event beyond the control of a taxpayer. Similarly, provisions dealing with the cancellation of interest and the payment of refunds, when tax is overpaid, are being amended so that they apply equally to PAYE intermediaries.

### *Non-tax deductions required to be made from gross wages*

Employers are also required to make a number of non-tax deductions from employees' gross wages and remit them as part of PAYE. If an employer engages an intermediary to take over PAYE obligations, the intermediary will also be responsible for making these additional, non-tax, deductions.

The deductions include the earner account (or employee) levy, student loan repayment deductions and child support. The Injury Prevention, Rehabilitation and Compensation Act 2001, the Student Loan Scheme Act 1992 and the Child Support Act 1991 govern the collection of these deductions along with tax. In the case of the earner levy and student loan repayment deductions, the respective Acts treat these deductions as a tax deduction for the purposes of the PAYE rules.

A number of consequential amendments are also required. For example, section 221 of the Injury Prevention, Rehabilitation and Compensation Act 2001 is being amended to ensure that a PAYE intermediary is able to collect levies by deduction from employee earnings. In the case of student loan repayment deductions, section 25 of the Student Loan Scheme Act 1992 is being changed to allow a borrower to inform a PAYE intermediary of a student loan repayment obligation. Minimal changes are

required to the Child Support Act 1991 to ensure that a PAYE intermediary is able to make the appropriate deductions when notified of a liability.

Consequential amendments are therefore required to the respective legislation to ensure that intermediaries are responsible for making the relevant deductions and are also liable for penalties if these obligations are not met.

**Background**

This simplification initiative was outlined in the government discussion document *More time for business*, released in May last year.

It was developed in response to employers' concerns about the time they spend keeping up to date with the PAYE rules, calculating and paying deductions, and filing returns. In addition they face the risk of penalties if mistakes have been made. The new legislation is intended to reduce the obstacles to payroll firms acting as intermediaries between employers and Inland Revenue, and therefore the barriers that discourage employers from using intermediaries to do this work. Consequently, employers' resources should be freed up to be used more productively elsewhere in their businesses. It is also intended to reduce the worry and stress associated with penalties.

This initiative was also designed to support employers who already use intermediaries to help meet PAYE obligations. Although these employers currently benefit from using PAYE specialists to meet their obligations, they are statutorily responsible for penalties that arise from mistakes made by the intermediary. Therefore they still face the residual risk that a mistake has been made and this creates unnecessary worry and stress for them. The legislation will reduce that risk.

## INCOME TAX RATES

***(Clause 3)***

### Summary of proposed amendments

The bill confirms the annual income tax rates that will apply for the 2002-2003 income year.

The annual rates to be confirmed are the same rates that applied for the 2001-2002 income year.

### Application date

The amendment will apply for the 2002-2003 income year.

### Key features

The rates listed in Schedule 1 of the Income Tax Act 1994 will be confirmed for the 2002-2003 income year.

### Background

The Income Tax Act 1994 provides for the rates of income tax specified in the First Schedule of the Act to be confirmed each year.

## GST AND TELECOMMUNICATIONS SERVICES

***(Clauses 133, 134, 135, 136, 137, 138, 139, 140, 141 and 142)***

### Summary of proposed amendments

The amendments will clarify the GST treatment of cross-border supplies of telecommunications services by inserting a new place of supply rule, zero-rating provisions and definitions.

Although in policy terms it is clear that supplies of telecommunications services should be subject to GST in New Zealand when they are consumed in New Zealand, the general place of supply rule and zero-rating provisions in the Goods and Services Tax Act 1985 are not easily applied to cross-border supplies of telecommunications services. This leads to uncertainty as to when supplies of telecommunications services are subject to GST in New Zealand, and when they are not.

The amendments will reduce this uncertainty by inserting provisions dealing specifically with cross-border supplies of telecommunications services.

### Application date

The amendments will apply from 1 July 2003.

### Key features

Provisions will be inserted into the GST Act to determine to whom a supply of telecommunications services is made and the circumstances in which it will be subject to GST in New Zealand. These rules will be in addition to the general place of supply rule in section 8(2), which is based on the residence of the supplier. They will, however, override the proviso to section 8(2), which deems there to be a supply in New Zealand in certain instances when a service is physically performed in New Zealand.

The amendments to section 8 will:

- Deem there to be a supply of services in New Zealand when a person physically in New Zealand (other than a telecommunications supplier) initiates (including on behalf of another person) a supply of telecommunications services from a telecommunications supplier outside New Zealand (the “physical location” test). This will require an offshore telecommunications supplier who makes more than $40,000 of supplies to persons in New Zealand (other than telecommunications suppliers) to register for GST here.

- When use of the physical location test is impractical for a class of customer or service, deem there to be a supply of services in New Zealand when a person with a billing address in New Zealand initiates (including on behalf of another person) a supply of telecommunications services from a telecommunications supplier outside New Zealand (the "billing address" test).
- Require the billing address test, if used for a member of a class of customer or service, to be used consistently for all members of that class of customer or service.
- Clarify which party initiates collect calls and conference calls.
- Allow the Commissioner to clarify in other situations where a call is initiated.

Section 51 will be amended to provide that non-resident telecommunications suppliers do not have to register for GST solely as a result of making supplies that section 8(5) or 8A treats as being made in New Zealand to persons who are not resident, but who are physically in New Zealand. This will ensure that non-resident cellular phone companies do not have to register for GST in New Zealand solely because they make supplies of telecommunications services to non-resident customers "roaming" in New Zealand.

New provisions will zero-rate supplies of telecommunications services made:

- by New Zealand telecommunications suppliers to non-resident telecommunications suppliers when a telecommunications service is initiated outside New Zealand; and
- to non-resident persons, other than telecommunications suppliers, when a telecommunications service is initiated outside New Zealand.

For purposes of clarification, a definition of "telecommunications services" is proposed. This will extend the application of the amendments to the provision of access to global information networks (the Internet).

**Background**

The nature of telecommunications services means that it can be difficult to state with certainty where the services are performed. Determining where services are performed is of particular importance as in many instances the rules in the GST Act (for instance, section 8(2)(a) and section 11A(1)(j)) look to where a service is physically performed to determine its treatment.

The concept of physical performance does not fit well with the nature of telecommunications services. Overseas case law suggests that the physical performance of telecommunications services takes place where the telecommunications equipment (such as satellite dishes and exchanges) used to provide the service is situated.[6]

---

[6] *British Sky Broadcasting* [1996] BVC 1107.

The physical performance test can be particularly difficult to apply in cases where cross-border telecommunications services are supplied, as in many instances the suppliers of the services will have equipment located in both countries (such as a satellite station) to complete the "circuit" needed for a telephone call.

There can also be uncertainty as to who is receiving the supply of telecommunications services. For example, in an international call between two consumers, either fixed line or mobile, there will be component supplies of telecommunications ("connection" services) between telecommunications companies to link the two consumers in different jurisdictions combining to make the "whole" of the call between the consumers.

Certain provisions of the GST Act are, therefore, difficult to apply to supplies of telecommunications services, including:

- section 8(2)(a)(ii): the taxation of services physically performed in New Zealand;
- section 11A(1)(j): the zero-rating of services physically performed outside New Zealand; and
- section 11A(1)(k): the exclusion from zero-rating where services are provided directly in connection with movable personal property in New Zealand.

The provisions in this bill will reduce these uncertainties by enacting specific provisions in relation to cross-border telecommunications services.

## GOODS AND SERVICES TAX ON DOMESTIC LEGS OF INTERNATIONAL PASSENGER CRUISES

*(Clause 137)*

### Summary of proposed amendment

The amendment will allow the zero-rating of the domestic leg of international passenger cruises if either the first place of departure or the final place of destination of the cruise is outside New Zealand. An international voyage remains international in character even when the voyage includes stops at more than one New Zealand port. The amendment clarifies the GST treatment of these cruises.

### Application date

The amendment will apply from the date of enactment.

### Key features

Section 11A(1) of the Goods and Services Tax Act (GST Act) is being amended to provide that an international cruise that visits a number of New Zealand ports, and in respect of which the first place of departure or the final place of destination is outside New Zealand, is zero-rated for the purposes of GST.

### Background

At present, the legislation is not clear as to whether an international cruise that visits a number of New Zealand ports should be considered as one supply, or as a series of individual supplies between ports. Two typical international cruises of this kind are shown in figures 1 and 2.

To make a distinction between the international and domestic aspects of the one sea voyage may often be impractical, regardless of how many New Zealand ports are visited. To require an apportionment of the fee charged for the cruise would require overseas cruise operators to determine the portion of the cruise that is consumed in New Zealand.

Because of the compliance and administrative costs associated with apportioning the domestic and international legs of an international cruise the legislation should zero-rate the domestic portion of an international journey. This recognises that the supply of the voyage is in general predominantly international and is consumed overseas.

Other types of cruises not illustrated in figures 1 or 2 which may visit a number of New Zealand ports but which either leave from or depart to a destination offshore require similar clarification in the legislation. The practical effect of this amendment is that since these types of cruises are not easily distinguished from other international cruises, they will be zero-rated in the same manner.

FIGURE 1

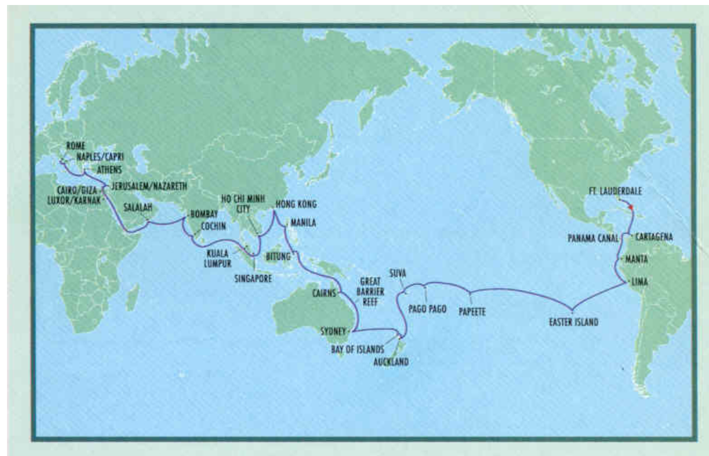
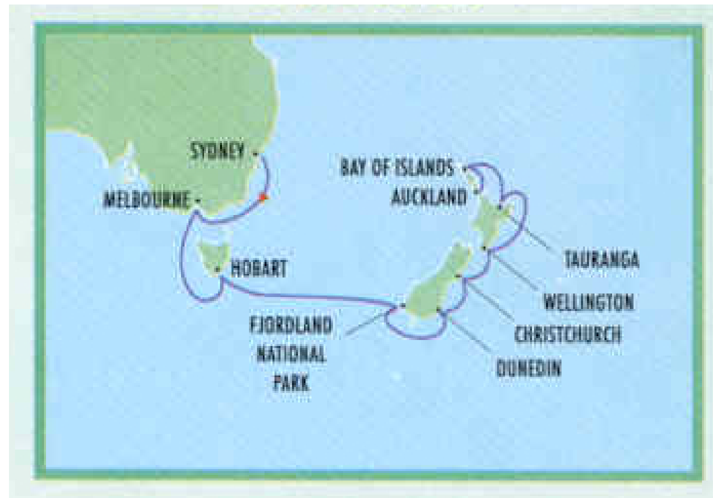



FIGURE 2



# Remedial amendments

## DEPRECIATION RULES ON AMALGAMATION

***(Clauses 9, 14, 15 and 144)***

### Summary of proposed amendments

A proposed amendment will make it clear that an anti-avoidance rule in the depreciation provisions applies on the transfer of depreciable property on a non-qualifying amalgamation.

Another amendment corrects an oversight in the rules that govern depreciation on a qualifying amalgamation. It will allow companies that amalgamate in a qualifying amalgamation to claim depreciation deductions in the year of amalgamation for the period up to the date of amalgamation.

### Application date

The amendment that clarifies the application of the anti-avoidance provision on a non-qualifying amalgamation applies in relation to property acquired on or after the date of introduction of the bill into Parliament.

The amendment relating to depreciation deductions on a qualifying amalgamation has retrospective application. It applies from the introduction of the amalgamation provisions in 1994, unless a taxpayer has filed a return before the date of introduction of the bill into Parliament in which a deduction was not claimed.

### Key features

Sections EG 17 and FE 5 of the Income Tax Act 1994 are being amended to make it clear that the rules in section FE 5 for determining the cost of assets acquired in non-qualifying amalgamations are subject to the anti-avoidance rule in section EG 17. That rule limits the cost base of a depreciable asset acquired from an associate to the original cost of the asset to the associate.

A new section FE 6A is being introduced so that the ban on claiming a depreciation deduction in the year of disposal is lifted where the disposal occurs on a qualifying amalgamation.

### Background

Tax rules governing the amalgamation of companies were introduced following reforms to company law in 1993. The interaction of these rules with the depreciation provisions has given rise to two problems. The first relates to the anti-avoidance rule in section EG 17, the second to the basic depreciation rule in section EG 1.

*__Anti-avoidance rule and non-qualifying amalgamations__*

The amalgamation provisions provide concessionary tax treatment for the transfer of property on a qualifying amalgamation (essentially one between resident companies). Property is deemed to be acquired by the amalgamated company at tax book value, rather than at market value.

Because the provisions are concessionary, taxpayers can elect that they do not apply. The amalgamation is then non-qualifying, and property is deemed to be acquired by the amalgamated company at market value, following section FE 5.

Section EG 17 prevents taxpayers who are associated from increasing depreciation deductions by transferring a depreciable asset between them at a price above its original cost. The base value of the asset to the new owner is limited to the cost of the asset to the old owner.

The restriction in section EG 17 should apply to property transfers between associated companies in an amalgamation. Otherwise, a company which holds depreciable assets with a market value above their original cost could obtain increased depreciation deductions simply by amalgamating with another company under the same ownership and electing for the amalgamation to be non-qualifying, so that the assets are treated as transferred at market value. It was never the intention of the amalgamation provisions that associated companies should be able to avoid section EG 17 in this way.

It is not entirely clear that the rule in section EG 17 takes priority over the rule in section FE 5. An amendment is being made to section EG 17 to put this beyond doubt. An amendment is also made to section FE 5 to counter an argument that section EG 17 cannot apply on a non-qualifying amalgamation because there is no acquisition from an associate, the amalgamating company having ceased to exist at the time the acquisition is deemed to occur under section FE 5.

*__Basic depreciation rule__*

Under section EG 1(2), no depreciation deduction is allowed for most classes of depreciable property in the year in which the property is disposed of. In the year of disposal there is a square-up of depreciation deductions so that in total, over the period of ownership, the taxpayer deducts only the difference between the purchase and the sale price.

When depreciable property passes between companies on a qualifying amalgamation, however, it passes at tax book value. In effect, this means that there is no square-up. Because of section EG 1(2) the old owner cannot claim a depreciation deduction for the period up to the amalgamation. The new owner can only claim in respect of the period following amalgamation. The effect is that depreciation for the period of the year up until the date of amalgamation remains locked away until the asset is finally disposed of.

It is therefore proposed to amend the amalgamation rules so that depreciation can be deducted for the period up to amalgamation.

The amendment is retrospective because some amalgamating companies have claimed the depreciation deduction for the period up to amalgamation, either because they were unaware of the technical defect in the legislation or because they assumed that this was intended. However, some taxpayers may have chosen to take advantage of the opportunity to defer the deduction until the amalgamated company disposed of the asset. Their position is protected.

## Future proposals

This bill puts beyond doubt the relationship between sections FE 5 and EG 17. There may well be other provisions where the relationship is not absolutely clear, and these will be considered separately. In the meantime, it is not intended that the current amendment cast an adverse inference on the interaction between sections FE 5 and other provisions in the Income Tax Act.

## INTEREST COMPONENT OF REIMBURSEMENT FOR FILM PRODUCTION EXPENDITURE

***(Clause 13)***

### Summary of proposed amendment

An amendment corrects a technical problem regarding the inter-relationship between the interest rules enacted last year and the rules applying to the reimbursement of film production expenditure. It clarifies that the reimbursement of interest expense can qualify as film expenditure.

### Application date

Because the amendment verifying that the timing of interest deductions is determined by the accrual rules applied from the 1997-98 income year, the amendment to section EO 4 is also to be backdated to apply from the 1997-98 income year.

### Key features

A new section EO 4(2A) indicates that for the purposes of subsection EO 4(1), the reimbursement of interest expense can qualify as film production expenditure.

### Background

Last year the Income Tax Act was amended to allow certain types of companies to deduct interest expenses more simply. The amendments included verification that the timing of interest deductions is determined by the accrual rules rather than other timing rules in the Act. Transitional exceptions were provided for taxpayers that had been applying the other timing rules.

Under section EO 4(1) of the Act, when a person reimburses another party for film production expenditure, that person can deduct that reimbursement as if it were film production expenditure they had incurred themselves. Conceivably, the amount reimbursed could cover interest as well as other more direct film production expenses.

An inadvertent result of clarifying that interest deductions have to be timed under the accrual rules is that it seems that section EO 4(1) cannot apply to any reimbursement of interest expenses. Consequently, while the rest of the reimbursement would be deductible either in the year it is incurred or the year the film is completed, whichever is later, under the timing rule applying to the costs of producing a film, the reimbursement of interest expenses would probably not be deductible until the film was sold, under another timing rule.

The amendment rectifies the problem.

## INTERNATIONAL TAX – REMEDIAL ISSUES

*(Clauses 16, 42, 43 and 65)*

### Summary of proposed amendments

Amendments are being made to the conduit, branch equivalent tax account and provisional tax rules to clarify that:

- The non-resident shareholding percentage used when receiving conduit relief is the same percentage used in the conduit excess interest allocation rules.
- Only one branch equivalent tax account credit can be created when a company uses losses to offset its income tax liability and also pays income tax.
- The definition of "residual income tax" excludes transfers from a branch equivalent tax account.

Although these amendments are primarily remedial in nature, they also involve base maintenance as the law currently allows interpretations contrary to the original policy intent.

### Application dates

The clarification to:

- the conduit rules will apply from the 1998-99 income year except when a taxpayer has a filed an income tax return based on the current law before the date of introduction of the bill, when it will apply from the next income year or 2002-03, whichever is earlier;
- branch equivalent tax account credits will apply from 1 April 1995 except when a taxpayer has filed an income tax return based on the current law before the date of introduction of the bill, when it will apply from the next income year;
- the definition of "residual income tax" will apply from the 1995-96 income year except when a taxpayer has a filed an income tax return based on the current law before the date of introduction of the bill, when it will apply from the next income year or 2002-03, whichever is earlier.

### Key features

- Section FH 3(3) of the Income Tax Act 1994, within the conduit excess interest allocation rules, is being amended to ensure that the non-resident shareholding percentage is either the same as the one used to calculate conduit relief either under section KH 1 or is the average of the percentages used to receive conduit relief under section NH 7.

- New sections MF 4(1A) and MF 8(2A) are being added to limit the branch equivalent tax account credits that arise under sections MF 4(1)(a) and (b) and MF 8(2)(a) and (b) respectively. When a company pays income tax as well as uses losses from New Zealand operations to reduce its taxable income, the credits will be limited to attributed foreign income multiplied by the company tax rate.
- Paragraph (ka) is being added to the definition of "residual income tax" in section OB 1 to clarify that it does not include debit transfers from the branch equivalent tax account made under sections MF 5(4) or MF 10(3).

**Background**

***Conduit rules***

The conduit rules aim to relieve New Zealand tax on foreign sourced income of New Zealand resident companies to the extent they have non-resident shareholders. These rules are buttressed by interest allocation rules to prevent excessive interest deductions being taken against New Zealand income, while the foreign income has tax relieved from it.

The conduit excess interest allocation rules initially compare the company's group debt to asset ratio with a safe harbour threshold of 66 percent. Before making this comparison the foreign assets of the company that receive conduit relief are reduced by the non-resident shareholding percentage in order to measure the debt that generates New Zealand tax deductions against the assets that generate taxable income.

To ease compliance costs, there are a number of dates that a company receiving conduit relief may choose to calculate its non-resident shareholding percentage in a year. Additionally, a listed company may choose any date in a year, if for commercial reasons it would normally calculate its non-resident shareholding percentage on that date.

It was always the policy intention that the non-resident shareholding percentage that applied to the calculation of conduit relief would be the same one that applied to reducing the assets when calculating whether the conduit excess interest allocation rules applied. An amendment is being made to clarify this intent.

***Branch equivalent tax accounts***

The branch equivalent tax account rules aim to prevent double taxation of foreign income that is subject to income tax under controlled foreign company or foreign investment fund rules, as well as subject to foreign dividend withholding payment on foreign dividends received. The intention is that regardless of which income stream occurs first, tax will only be paid once.

The branch equivalent tax account mechanism provides that if income tax has been paid first, a branch equivalent tax account credit arises which offsets the liability to foreign dividend withholding payment. Alternatively, if a dividend had been paid in advance of the income being earned in the controlled foreign company, with foreign

dividend withholding payment being paid first, a branch equivalent tax account debit arises which offsets the liability to income tax.

A branch equivalent tax account credit can also be created when losses from New Zealand sources have been offset against attributed foreign income, so no liability to income tax arises.

It was never the intention that when a company paid income tax and also used losses from New Zealand sources that the credits created would exceed the value of the tax rate multiplied by the attributed foreign income for the year, which the law currently allows. An amendment is being made to limit the credits accordingly.

***Residual income tax***

The provisional tax rules aim to tax income that has not had tax deducted from or credited to it in any form in the year it is earned. Its calculation is based around "residual income tax", which is the tax liability on income in the previous year that did not have tax paid or deducted from it.

As noted in the discussion of branch equivalent tax accounts, the payment of foreign dividend withholding payment generates a branch equivalent tax account debit that can be used to offset a liability to income tax.

Although a company may transfer a branch equivalent tax account debit to meet its income tax liability on attributed foreign income, the current definition of residual income tax does not take into account branch equivalent tax account debit transfers. This means the law as it stands requires that a company would have to pay provisional tax on income from which foreign dividend withholding payment had already been deducted contrary to the aim of the provisional tax rules.

The proposed amendment clarifies that transfers of a branch equivalent tax account debit by a company are excluded from the definition of "residual income tax" within the provisional tax rules.

## RATIONALISATION OF TERMINAL TAX PAYMENT DATE PROVISIONS

***(Clauses 38, 54, 55, 65, 69, 90, 91, 92, 93, 99, 102, 122, 150, 151, 161 and 164)***

### Summary of proposed amendments

The terminal tax payment date provisions for income tax are being rationalised by reducing the three such provisions to a single provision. A number of consequential amendments will be made to the tax Acts and other legislation. These amendments will not result in a policy change to terminal tax payment dates.

### Application date

The amendments rationalising the terminal tax payment date provisions will apply from the 2002-03 income year.

### Key features

The three separate terminal tax payment date provisions in the Income Tax Act 1994 are to be combined into one provision. This will make it easier for taxpayers to determine their terminal tax payment dates. It will also allow other provisions that refer to terminal tax payment dates to be made significantly more concise.

The rationalisation of the terminal tax payment date provisions will be mainly achieved by repealing the specific payment date provisions in sections NC 17 and MC 1 of the Income Tax Act 1994, applying to employees and provisional taxpayers. The following related amendments will also be made:

- Minor amendments will be made to the general terminal tax payment date provision in section MC 2 (to be re-enacted as new section MC 1) so that it can apply to all persons.
- The definition of "terminal tax date" in section OB 1 will be amended so that it refers to the date determined under new section MC 1 for payment of terminal tax for an income year by a person. If a person does not have to pay terminal tax for an income year, new section MC 1 will apply as if the person does have terminal tax for the year. This ensures that all persons can be treated as having a terminal tax date – for example, persons whose tax credits equal or exceed their income tax liability. This amendment will allow the definition to be used more widely in other provisions, thereby making them more concise.
- Part A of Schedule 13, which specifies the months for payment of provisional tax and terminal tax, will be amended to clarify that persons (such as employees) who do not have the Commissioner's permission to use a non-standard balance date have a March balance date. A non-resident company that does not have a fixed establishment in New Zealand will also be treated as having a March balance date for the purpose of determining its provisional tax

or terminal tax payment dates. (This continues the treatment of such companies under current section MC 2(1).)

- Section MC 3, which authorises regulations to be made to allow taxpayers with outstanding tax liabilities to make instalment payments, will be repealed because it is redundant. There are no such regulations in existence and the function of allowing taxpayers in arrears to make instalment payments is covered by the taxpayer relief provisions in the Tax Administration Act 1994.
- A number of consequential amendments will be made to the tax Acts and other legislation to cater for the combining of the three current terminal tax date payment provisions into one provision.

The following provisions in current sections MC 1 and NC 17 will not be re-enacted as part of the single terminal tax payment date provision in new section MC 1 because they are unnecessary:

- Sections MC 1(3) and NC 17(2)(c), which allow the Commissioner to specify an earlier terminal tax date for a particular taxpayer. Although these provisions have a revenue protection purpose, they are unnecessary because there are other provisions with a similar function that are more effective, in particular, section 44 of the Tax Administration Act 1994, which allows tax to be assessed and payable on demand in high-risk situations such as when a person is about to leave New Zealand.
- Section NC 17(1), which contains a separate assessment provision for employees. The general income tax assessment provision in section 92 of the Tax Administration Act 1994 can apply to all taxpayers, and there is no reason for having a separate assessment provision for employees. (The separate assessment provision for provisional taxpayers was repealed in 1996.)
- Section NC 17(3), which provides that income tax payable under an income statement (that is treated as an assessment under section 92 of the Tax Administration Act 1994) is due on the dates specified in section NC 17(2). This provision was originally enacted because section NC 17(2) applies only to income tax payable under an assessment made under section NC 17(1). Because the separate assessment provision in section NC 17(1) is not being retained, section NC 17(3) will also become unnecessary.

**Background**

Terminal tax is the difference between a taxpayer's tax credits (such as provisional tax, PAYE and imputation credits) and the taxpayer's income tax liability for an income year. There are currently three separate provisions in the Income Tax Act 1994 covering the payment dates for terminal tax: section NC 17, applying to employees (other than non-filing taxpayers); section MC 1, applying to provisional taxpayers; and section MC 2, applying to persons generally.

The existence of separate terminal tax payment date provisions for employees and provisional taxpayers in sections NC 17 and MC 1 is for historical reasons only. PAYE and provisional tax were implemented in 1958 as self-contained legislative codes with their own recovery, penalty, assessment and payment date provisions.

Many of these separate provisions have been replaced by more generic provisions in the Tax Administration Act 1994 and the Income Tax Act 1994 (for example, the penalty provisions). The separate terminal tax payment date provisions for employees and provisional taxpayers are, therefore, an unnecessary residue of the original separate legislative codes for PAYE and provisional tax.

## THE INCLUSION OF MATERIAL FACTS IN PRIVATE OR PRODUCT RULINGS

***(Clause 72)***

### Summary of proposed amendment

The definition of "arrangement" in the Tax Administration Act 1994 is being altered to clarify that the Commissioner of Inland Revenue can include in private and product rulings facts that the Commissioner considers to be material, or relevant as background or context to any of the matters on which the private or product ruling is sought. Under the amendment, such facts will form part of the "arrangement" that is the subject of a ruling. Consequently, they will become subject to the provisions that determine that a ruling ceases to apply if the arrangement is materially different from the arrangement identified in the ruling. The amendment prevents private and product rulings having a wider application than intended.

### Application date

The amendment applies from the date of enactment.

### Key features

The definition of "arrangement" in section 3(1) of the Tax Administration Act 1994 will be amended to duplicate the definition of "arrangement" contained in section OB 1 of the Income Tax Act 1994, and to include, for the purposes of the private and product rulings legislation, facts that are material, or relevant as background or context to any of the matters on which a private or product ruling is sought.

The amendment will allow the Commissioner to include facts that may not technically be part of the "arrangement" (as currently defined in section OB 1) that is the subject of a ruling, but nevertheless are important as background or as context to the transaction proposed.

Such facts will become subject to the ruling non-application tests contained in sections 91EB(2)(a) and 91FB(2)(a) of the Tax Administration Act 1994. The tests provide that if the arrangement is, in reality, materially different from the arrangement identified in the ruling, then the ruling does not apply.

The amendment will not affect the Commissioner's existing ability to include facts in private and product rulings that are, under the existing definition of "arrangement", unambiguously part of the arrangement that is the subject of the ruling.

**Background**

Private and product binding rulings are made in respect of an “arrangement”. The word “arrangement” is defined as “any contract, agreement, plan, or understanding (whether enforceable or unenforceable), including all steps by which it is carried into effect”.

The legislation prescribes that when a private or product ruling is issued, the particular arrangement to which the ruling applies must be specified as part of the ruling. It also provides that if the actual arrangement subsequently proves to be materially different from that specified in the ruling, then the ruling will not apply.

Inland Revenue often includes in a ruling numerous facts describing an arrangement that are considered to be relevant as background or as context to the transaction proposed. However, it is possible that, on a strict interpretation, while the facts are highly relevant, they do not form part of the “arrangement” as such. Excluding these facts potentially makes the ruling of more general application than intended.

It is therefore important that Inland Revenue can set out these facts in rulings without giving rise to the technical issue of whether the facts are part of the “arrangement” identified in the ruling.