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

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Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill

Volume 2

Taxation of Maori organisations

Taxpayer compliance, standards and penalties

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Prepared by the Policy Advice Division of the Inland Revenue Department and the Treasury

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Taxation of Maori organisations

OVERVIEW

Introduction

The bill introduces legislation that modernises the tax treatment of Maori organisations that manage communally owned assets. They replace the current, specific tax rules that apply to Maori authorities. The proposed changes recognise that there is a continued need for specific tax rules for Maori organisations that manage assets held in communal ownership and face legal and economic constraints because of the nature of that ownership. They are set apart from other entities like ordinary companies and trusts by factors such as the difficulty of selling Maori 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.

The proposed Maori authority rules are aimed at updating rules which date back to the 1950s, and simplifying tax compliance and tax administration for Maori authorities, their members and Inland Revenue. The proposed measures also correct a number of problems relating to the potential for double taxation of Maori authority income and the overtaxation of member distributions.

Other key changes in the bill relate to:

- standardising the tax rules that apply to the Maori Trustee to clarify that the new Maori authority rules will apply to the Maori Trustee in its capacity of agent in administering assets under Te Ture Whenua Maori Act 1993;
- extending the current deduction available to Maori authorities for donations to Maori associations to include gifts of money to organisations with "approved donee status";
- relaxing 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; and
- clarifying the circumstances in which entities that administer marae may be eligible for charitable income tax exemption.

Twenty-four submissions commented on the proposed measures. The main issues raised in submissions are briefly discussed below.

Te Puni Kokiri were involved in the preparation of this part of the officials' report on submissions on the bill.

Proposed Maori authority rules

There is general support for the proposed Maori authority rules from Maori organisations and the tax community. The measures are viewed as a pragmatic response to addressing the current problems of the potential for double taxation of Maori authority income and the overtaxation of distributions.

Submissions also consider that the policy approach of taxing entities as a proxy for their underlying owners is appropriate and should be extended to other entities such as superannuation and investment funds.

The scope of the Maori authority rules attracted divergent views in submissions. Concerns were expressed about the restrictive nature of the "list" format of the definition of "Maori authority".

Many submissions supporting the Maori authority reforms stated that all entities that bear the hallmarks of communal ownership and restricted participation should be eligible to apply the proposed Maori authority rules. Excluding some of those entities would create "a gross inequity and evince grave and manifest disrespect for Maori custom".

Submissions also identified groups of Maori organisations that should be included, consistent with the proposed policy, which are currently excluded in the proposed legislation. These excluded organisations would need to be assessed as part of the registration process to determine whether they, in fact, fall outside the proposed definition.

A small number of submissions consider that the definition of "Maori authority" goes too far. Allowing wholly owned companies to apply a lower tax rate of 19.5%, compared with ordinary companies, who face a 33% tax rate, elicited criticism and claims that the proposed measures are unconstitutional, discriminatory and economically harmful.

The main proponents of the proposed Maori authority rules also seek to have the measures apply sooner than the 2004-05 income year, especially the lower tax rate of 19.5%.

Relaxing the public benefit requirement

There is general support for relaxing the public benefit requirement, although some submissions consider that the amendment does not go far enough. One submission considers that hapu should be charitable in their own right, a status afforded to them under the Treaty of Waitangi.

Marae charitable tax exemption

Submissions seek clarification that the proposed amendment would not preclude entities administering marae from seeking charitable status under the general exemption. They consider that the proposed exemption is too narrow – that is, the exemption should not be confined to entities administering marae on Maori reservations. They also consider that the exemption should apply in respect of funds applied to charitable purposes.

Key policy issues

The proposed definition of "Maori authority"

In considering the appropriate scope of the Maori authority rules, the government considered that if the definition of "Maori authority" was too broad there would be less justification for the lower entity tax rate and other concessions associated with the proposed rules. The proposed list of entities limits the scope of the rules to Maori organisations that manage communally owned assets whose ownership and administration is subject to certain statutory restrictions or government criteria or processes.

For example, Maori land trusts, Maori incorporations, Maori Trust Boards and the Maori Trustee are all subject to specific legislation that imposes certain restrictions or constraints on their ability to develop or trade their assets. The Crown Forestry Rental Trust and the Treaty of Waitangi Fisheries Commission were established according to specific government processes and are subject to strict governance and management requirements. Entities that receive and manage assets of the treaty settlement redress or the fisheries settlement must comply with specific government criteria relating to governance, management and accountability, to be considered appropriate recipients of settlement assets.

Companies wholly owned by a Maori authority or a group of Maori authorities were included in the definition of "Maori authority" on the basis that the underlying owners in the parent authority and the parent authority itself are subject to the restrictions or constraints that justify specific tax rules. Including these companies in the definition would reduce their tax-related compliance costs and is unlikely to result in anti-competitive behaviour (a concern expressed in some submissions). Excluding these companies could lead them to transfer their income to "parent" authorities.

All the entities that could potentially fall within the definition of "Maori authority" share the common hallmark of communal ownership, which inevitably involves restrictions on the ability of individual members or owners in these entities to transfer their property rights. However, simply holding or administering communally owned assets for the benefit of members that just happen to be Maori is insufficient in itself to claim Maori authority tax status under the proposed policy.

The proposed policy requires some form of statutory restriction or government criteria or process, such as for treaty settlements, which affects the ownership structures that are ultimately adopted by Maori organisations.

Applying broad criteria such as communal ownership per se in the definition would create uncertainty and boundary issues that could risk the integrity and sustainability of the proposed Maori authority tax rules. Officials therefore do not support extending the definition to cover Maori organisations that are not subject to statutory restrictions or government process or criteria.

Current Maori authorities may be excluded

The Committee has sought advice on whether current Maori authorities could be excluded under the proposed definition of "Maori authority" and, if they are, how Inland Revenue plans to deal with it.

Since the proposed definition of "Maori authority" applies to a more limited range of Maori organisations than does the current definition of "Maori authority, there are likely to be some current Maori authorities who would not be eligible to apply the new rules.

Where appropriate, officials have made every effort to capture organisations that meet the stated policy criteria in the proposed definition, as reflected by the recommendations contained in this report. Should there remain some organisations that are excluded but which should, in fact, be eligible to apply the Maori authority rules, they will need to approach the government individually and seek to be added to the list. This will allow the government to assess whether an organisation satisfies the policy criteria to be taxed as a Maori authority.

The proposed public benefit amendment

Proposed new section OB 3A(2) relaxes the public benefit requirement so that a trust, society or institution that meets the "charitable purpose" requirement will not be automatically excluded from qualifying for the associated income tax exemption simply because its members are connected by blood ties.

The amendment applies to Maori and non-Maori organisations, but it is especially relevant to Maori organisations as many define their beneficiary class by a personal relationship (through blood ties) to a named person.

In determining whether a trust, society or institution meets the public benefit requirement, other factors will still be relevant, 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. These factors were enumerated in the *Dingle v Turner*[1] decision.

The public benefit requirement as developed by the courts

All entities other than those established for the relief of poverty must satisfy the public benefit requirement. Although the question of whether an entity meets this requirement is considered on the facts of each case, the courts have developed a number of general tests for determining whether the benefiting group is the public or at least an "appreciably significant section" of the public.

[1] [1972] AC 601.

Through cases such as *Re Compton*[2] and *Oppenheim* v *Tobacco Securities*[3], it has been established that the number of beneficiaries must not be negligible. In addition, those beneficiaries must not be determined on the basis of a personal relationship such as blood or contractual ties. If they are, the entity will not be for the public benefit. Instead, it will be for the benefit of private individuals and therefore not "charitable".[4]

Lord Cross, delivering the court's decision in *Dingle v Turner* has questioned the *Re Compton* and *Oppenheim* tests and suggested that the existence of a personal connection such as blood ties or contract should not be determinative of whether an entity provides a public rather than a private benefit. He was of the opinion that consideration should also be given to the nature of the entity and the charitable purpose for which it was established, the number of beneficiaries, and the degree of connection between the beneficiaries.

Although the *Re Compton* and *Oppenheim* tests have continued to be applied in the English courts, Lord Cross's comments have been noted with approval in three recent New Zealand cases.[5]

Consequently, there remains a degree of uncertainty in New Zealand about whether trusts, societies or institutions that have beneficiaries determined by a blood or a contractual relationship will satisfy the public benefit requirement.

The proposed charitable exemption for marae

The proposed amendment is intended to confer an automatic "charitable" exemption on marae situated on Maori reservations that solely apply their funds to administer and maintain the marae's physical structure. However, the way in which the amendment is reflected in the bill has created confusion as to its intention and application in practice.

Firstly, it is unclear whether marae or marae-based organisations that do not qualify under the proposed amendment could seek charitable status under the general "charitable" income tax exemption (as amended by the proposed public benefit requirement).

Secondly, the amendment is unclear as to whether the marae per se is the entity subject to the exemption or whether it is the entity that administers the marae that is subject to the exemption. The policy intention is that it is the entity responsible for the marae that is subject to the exemption, not the marae per se. Marae in this context is the land set aside for the use of hapu or iwi, with buildings on it, such as a meeting house and a dining hall.

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[2] [1945] 1 All ER 198.
[3] [1951] 1 All ER 31.
[4] In Oppenheim a gift for the education of the children of the employees and former employees of the company and its subsidiaries failed to qualify as a charity because the employees of a firm were not a public class. This was in spite of the fact that at the testator's death the number of employees exceeded 110,000.
[5] *New Zealand Society of Accountants v CIR* [1986] 1 NZLR 147; *Educational Fees Protection Society Incorporated v CIR* (1991) 12 NZTC 8,203; *Latimer and Others v Commissioner of Inland Revenue*, CA215/01.

There are a wide range of entity types that may be employed to administer marae. They include:

- an entity established under the Incorporated Societies Act 1908;
- an unincorporated body of persons, for example, a marae committee;
- trustees of a trust appointed under a Maori reservation; and
- a corporate body appointed under a Maori reservation.

These entities should be eligible to apply the charitable exemption provisions as either a "trust", "society" or an "institution".

Thirdly, the amendment applies solely to entities administering marae on Maori reservations. This is because the trustees of a Maori reservation are statutorily debarred from alienating the land subject to the reservation. This presents a difficulty for trustees of Maori reservations to qualify for the "charitable" tax exemption because of the rule that property must always be applied for charitable purposes, even in winding up situations.

In practice, the usual way of avoiding this requirement while seeking exemption was to establish a separate discrete legal entity to administer the day-to-day affairs of the marae. The land remains vested in the Trustees of the Maori reservation, while a separate entity manages the affairs of the marae.

The amendment provides relief from the alienation of property requirement for trustees of Maori reservations and avoids the need for these trustees to establish another entity to administer the marae. If the trustees of a Maori reservation wish to establish a separate entity to administer the day-to-day running of the marae the specific marae exemption would still apply, since the exemption applies to marae situated on Maori reservations.

The final issue concerns the application of the general "charitable" income tax exemption. Entities administering marae that are not situated on Maori reservations must apply for exemption under the general charitable provision. Generally, such entities would not be subject to the same restrictions affecting Maori reservations, but even if they were they could still set up a separate discrete legal entity to administer the marae and apply for charitable exemption under the general provision in the same way as entities administering churches and public halls.

PROPOSED MEASURES "DISCRIMINATORY"

Issue: Bill of Rights Act and Human Rights Act – implications

Submission

(1 – The One New Zealand Party, 10 – New Zealand Retailers Association, 23 – Chen, Palmer and Partners (supported by 23A – Independent Fisheries Ltd))

Chen, Palmer and Partners consider that parliament would be acting contrary to the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993 if it introduced tax rules which give a privileged tax status to certain commercial entities because they are owned by Maori. This is "discrimination" on the grounds of race or ethnic origin.

The submission is concerned about the inclusion of wholly owned subsidiaries of Maori authorities in the proposed definition of "Maori authority". Wholly owned subsidiaries may not be subject to the "restrictions or constraints" associated with managing Maori assets in communal ownership and so allowing them to apply a 19.5% rate, compared with other similar commercial entities who face a 33% rate, would give the former a competitive advantage. The submission recommends that wholly owned subsidiaries of a Maori authority be excluded from the proposed definition of "Maori authority".

The Retailers Association is opposed to taxing entities on the basis of ethnicity.

The One New Zealand Party claims the bill gives a tax preference to one race of people, namely those who can claim Maori descendancy.

Comment

Officials do not agree with the view expressed in the Chen, Palmer and Partners submission that the proposed measures for Maori authorities are inconsistent with the Human Rights legislation.

The reason for retaining specific tax rules for Maori organisations that administer communally owned assets is that these entities have unique characteristics that set them apart from other entities such as ordinary companies and trusts. These characteristics relate to certain constraints or restrictions imposed on the administration and ownership of communally held assets by specific legislation or by government process or criteria.

Entities listed in paragraph (a) of the proposed definition of "Maori authority" clearly meet the description above.

Paragraph (b) of the proposed definition includes wholly owned entities of a Maori authority or a group of Maori authorities. Wholly owned entities will often have their own governance structures and may be unfettered by the constraints of the parent authority, so it could be argued that they should be excluded from the Maori authority tax rules.

In determining the application of the Maori authority rules, however, officials consider that regard must be had to the ultimate owners and the restrictions or constraints on the ownership structures employed to administer their assets. Furthermore, including wholly owned entities in the definition will give rise to compliance benefits.

If wholly owned companies were excluded, Maori authorities would have to carry out their commercial activities within the "parent" structure or in unincorporated bodies such as joint ventures or partnerships, or wholly owned entities could transfer income to the "parent" using a variety of methods such as deductible fees. Maori authorities could achieve the same tax result as if they had wholly owned entities undertaking the commercial activities but would incur higher transaction costs.

The justification underlying the retention of specific rules for Maori authorities recognises that their ultimate owners are subject to certain constraints or restrictions imposed by specific legislation or government process. Although these owners may share a common ethnic tie, this is not the justification for applying the specific tax rules.

Once it was clarified that there was a case for separate rules, the question of the appropriate tax rate arose. The reason for setting this rate at 19.5% is that most members of a Maori authority would be on a 19.5% tax rate. This view is based on the fact that approximately 90 percent of Maori are on incomes of less than $38,000, and 19.5% is the appropriate tax rate for this level of income.

The rationale for applying the 19.5% rate to Maori authorities is not that their owners belong to a particular race but that this is the marginal tax rate of a large majority of the owners. These lower marginal tax rates apply according to income level, not ethnicity.

For a policy measure to be unlawfully discriminatory it must make a distinction based on one of the prohibited grounds of discrimination listed in section 21 of the Human Rights Act 1993. Ownership structures and income levels are not prohibited grounds of discrimination. We consider, therefore, that the rationale for applying specific tax rules with a lower tax rate to Maori authorities should not be regarded as unlawful discrimination or inconsistent with the Human Rights legislation.

Officials also note that any widening of the proposed definition that is not based on the rationale as outlined above may run the risk of violating the Human Rights legislation.

The Attorney General is required to provide a view on whether new legislation contains proposals that are inconsistent with the New Zealand Bill of Rights Act and, if so, to issue a "section 7" report to that effect. Since no such report was issued at the time the proposed measures were introduced, it follows that the Attorney General did not consider that the proposed measures breached the New Zealand Bill of Rights or the Human Rights legislation. Consultation with the Ministry of Justice on the Human Rights implications of the proposed measures was undertaken before the legislation was introduced.

Recommendation

No recommendation is required.

DEFINITION OF "MAORI AUTHORITY"

Clause 65(12)

Issue: A "catch-all" provision should be included in the definition of "Maori authority"

Submission

(11W – Pukawa D3 Trust and Pukawa 5B Trust, 14W – Waipapa 9 Lands Trust, 15 – Te Ohu Kai Moana, 16 – PricewaterhouseCoopers, 17W – Rotohokahoka F6 Trust, 18W – Waiteti 2 Section 1A2 Trust, 19W – Waikuta 2 Trust, 20W – Fairy Springs Trust, 25 – Office of Te Runanga o Ngai Tahu)

The proposed definition should be broadened from its current "list" format to a "catch-all provision". Submissions state that the definition may exclude Maori organisations that, by their objects, rules, constitutions or other governing documents, may also face the same restrictions and constraints that justify the specific tax rules for Maori authorities.

Comment

Whether an entity outside the proposed definition satisfies the policy criteria is a question of fact which can only be determined with regard to the specific entity's founding documents or constituting legislation and the circumstances surrounding its establishment. Thus it is difficult to determine whether any given example of the classes of entities suggested by submissions should be included.

Submissions suggested the following classes of entities as potentially falling outside the proposed definition but which should be included:

- entities incorporated under the Incorporated Societies Act 1908 (for example, established to run marae);
- entities set up under the Maori Reserved Lands Act 1955 that do not have charitable status;
- a company with a Maori reservation vested in it (for example, when a body corporate operates the marae);
- iwi and runanga entities;
- trustees of trusts formed to hold or administer Maori assets; and
- entities upon which a settlement entity has itself settled assets but which are not wholly owned by the settlement entity – for example, trustees of trusts, charitable companies that are not wholly owned "subsidiaries" (as defined in the Companies Act 1993) and incorporated societies.

If it can be shown that any of these entities meet the criteria of the policy underlying the proposed definition, officials consider that they should be eligible to apply the proposed Maori authority rules.

If an entity considers that it qualifies as a Maori authority it could seek recognition by way of legislative change to the definition of "Maori authority". This approach is similar to overseas charities who seek approved "donee tax status" under section KC 5 of the Income Tax Act 1994. Officials consider that this approach is preferable to a "catch-all" provision since such a provision could include Maori organisations that do not meet the stated policy criteria.

Recommendation

That the inclusion of the "catch-all" provision be declined. Note that if a Maori organisation considers that it is a Maori authority it will need to approach the government and seek to be added to the list. This will allow the government to assess whether the organisation satisfies the policy criteria to be taxed as a Maori authority.

Issue: Commissioner of Inland Revenue should approve entities for Maori authority tax status

Submission
(16 – PricewaterhouseCoopers, 25 – Office of Te Runanga o Ngai Tahu)

If the "catch-all" provision is not adopted, the Commissioner of Inland Revenue should be given the power to determine whether certain Maori organisations are eligible to apply the proposed Maori authority rules.

Comment

In light of our previous recommendation, officials do not support this submission.

Recommendation

That the submission be declined.

Issue: The definition should reflect the proposal as it was expressed in the discussion document *Taxation of Maori organisations*

Submission
(22 – New Zealand Maori Council)

The proposed definition should be extended to include:

(a) organisations for the benefit of all Maori;

(b) organisations established for the benefit of iwi or hapu provided these groups are large enough to constitute an appreciably significant section of the public;

(c) marae; and

(d) organisations established for the benefit of all Maori within a sufficiently large community.

Comment

The proposed definition is much narrower than that which appeared in the discussion document *Taxation of Maori organisations*, released in August 2001. The discussion document definition was considered too broad, especially if the entity tax rate of 19.5% were to apply Maori authorities. The discussion document was intended only as a basis for consultation.

The submission explains that proposals (a) to (c) reflect the expectation raised by last year's discussion document and proposal (d) would cater for modern service organisations. It states that the prima facie test of whether the group benefiting from an organisation established for iwi or hapu constitutes an appreciably significant section of the public should be that it has an up-to-date roll of at least 800 members (including children). Furthermore, it argues the prima facie test of whether an organisation for the benefit of all Maori covers a sufficiently large community should be a community of at least 8000 (Maori and others).

Given the government's policy underlying the definition of "Maori authority", proposals (a), (b) and (d) would not meet the requirements of that policy. In relation to proposal (c), we consider that entities administering marae should be considered under the general charitable exemption or the proposed specific marae exemption. The facts of each case will vary, but if neither of these exemptions applies, these entities are likely to be taxed as non-profit bodies on the basis that they share many of the hallmarks of such entities.

Recommendation

That the submission be declined.

Issue: Entities administering land under Te Ture Whenua Maori Act 1993

Submission

(27 – Federation of Maori Authorities,[6] 28 – The Office of the Maori Trustee)

The proposed definition should be amended to include entities administering land pursuant to an order made under Te Ture Whenua Maori Act 1993, rather than only persons established in accordance with an order made under that Act.

Comment

Clause 65(12), subparagraph (a)(i) of the proposed definition includes "a person established in accordance with an order made under Te Ture Whenua Maori Act 1993 (Maori land Act 1993)". The intention of this provision is to recognise Maori land trusts and Maori incorporations constituted under Te Ture Whenua Maori Act 1993 as Maori authorities.

The submission is concerned that the term "person" may not, in fact cover trusts and agencies established under Te Ture Whenua Maori Act 1993. The trust or agency is unlikely to be a "person" for the purposes of that Act, and the trustees and agents themselves are not established by court order.

Officials note that the tax definition of "person" covers both individuals and non-individuals such as companies, local or public authorities and unincorporated bodies of persons. The term "company" means any body corporate or other entity which 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. An unincorporated body of persons may include trustees of trusts, partnerships, joint ventures and clubs and societies.

Officials consider that the use of the term "person" is appropriate in a tax context since it can cover a Maori incorporation or a land trust established under Te Ture Whenua Maori Act 1993. However, we recognise that the term "person" may cause some confusion outside the tax context, given its ordinary, everyday meaning.

The submission refers to "entities" but this term might not be appropriate as it is questionable whether a trust could be an "entity". Given that either a trust or company could be constituted by court order, subparagraph (a)(i) should specifically refer to a trust or a company.

Thus officials accept the submission point and recommend that subparagraph (a)(i) be redrafted so that it applies to trusts and companies constituted by court order in accordance with Te Ture Whenua Maori Act 1993.

[6] The following writers of submissions indicated their support for the submissions from the Federation of Maori Authorities: 11W – Pukawa D3 Trust and Pukawa 5B Trust, 14W – Waipapa 9 Lands Trust, 15 – Te Ohu Kai Moana, 17W – Rotohokahoka F6 Trust, 18W – Waiteti 2 Section 1A2 Trust, 19W – Waikuta 2 Trust, 20W – Fairy Springs Trust.

In addition, the submission point specifically refers to "administering land", but this is too limited since Maori land trusts may also administer shares in a Maori incorporation. On this basis, we do not support the suggested reference to "administering land".

A further issue relates to those entities that administer Maori freehold land under Te Ture Whenua Maori Act 1993 but who are not constituted pursuant to a court order under that Act. Historically, such entities were created by statute to administer Maori land and other assets for the benefit of their owners. Those statutes have since been superseded by new legislation, and the entities have been reconstituted as non-statutory bodies, but they remain statutorily bound to comply with the provisions of the Maori land legislation.

Officials are aware of several entities that are established under various Maori Purposes Acts from 1926 to 1981 to administer assets that may be subject to the specific alienation provisions of Te Ture Whenua Maori Act 1993.

Officials consider that such entities should be eligible to apply the Maori authority rules as this would be consistent with the underlying policy of the proposed definition. Therefore sub-paragraph (a) of the proposed definition should be amended to include entities subject to the restrictions imposed by Te Ture Whenua Maori Act 1993.

Recommendation

That clause 65(12) be amended so that the proposed definition of "Maori authority" is more consistent with the policy intent of including entities subject to the legislative restrictions imposed by Te Ture Whenua Maori Act 1993.

Issue: Inclusion of the Maori Trustee's agencies and trusteeships

Submissions

(27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

- The proposed definition should be amended to include all agencies and trusteeships of the Maori Trustee.
- Provision should be made to capture the Maori Trustee's agencies within the Maori authority rules by deeming the Maori Trustee to have derived income processed by him in his capacity as agent.
- Each trust or agency of the Maori Trustee should be taxed separately.

Comment

Clause 65(12), subparagraph (a)(ii) of the definition of "Maori authority" includes "the Maori Trustee in the Maori Trustee's capacity as collecting and distribution agent in respect of rents, royalties or interest". The purpose of this provision is to apply the proposed Maori authority rules to the Maori Trustee when it acts as agent in the collection and distribution of rents, royalties and interest.

The submission seeks to extend the Maori authority rules to apply to all agencies and trusteeships of the Maori Trustee on the basis that a uniform tax treatment for all entities under the Maori Trustee's administration is critical to its efficiency in an environment with growing demands.

Officials do not agree that all agencies and trusteeships of the Maori Trustee should be included in the proposed definition. The reason is that the Maori Trustee may also administer property by agreement with the owners of the relevant assets, although such administrations may not be subject to the provisions of Te Ture Whenua Maori Act 1993. Furthermore, the Maori Trustee may act as trustee of a deceased person's estate. Including such trusteeships and agencies in the proposed definition would be inconsistent with the proposed policy.

Officials consider, therefore, that sub-paragraph a(ii) should be limited to situations where the Maori Trustee acts as agent in relation to assets administered under Te Ture Whenua Maori Act 1993. Sub-paragraph a(i) should cover the Maori Trustee's role as a trustee under Te Ture Whenua Maori Act 1993.

Officials accept that provision should be made to capture the Maori Trustee's agencies within the Maori authority rules by deeming the Maori Trustee to have derived income processed by him in his capacity as agent. Such a provision was contained in section HK 14, whereby the Maori Trustee was taxable on that income as if entitled to it as a beneficiary, without any individual rebates.

Officials also accept that the bill should be amended to clarify that each agency and trusteeship under the administration of the Maori Trustee should be treated separately for tax purposes.

Recommendation

That the bill clarify that each trust or agency of the Maori Trustee that falls within the proposed definition be taxed separately and that the Maori Trustee's agencies that relate to assets administered under Te Ture Whenua Maori Act 1993 can be taxed under the proposed rules.

Issue: Trusts set up to benefit Maori authorities

Submissions

(27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The proposed definition should be amended to include trusts where all persons eligible to benefit are Maori authorities.

It might be preferable to quarantine an activity in a trust rather than a wholly owned company. The ultimate ownership of the trust assets would rest with the Maori authorities subject to the restrictions and limitations justifying the tax treatment and, pragmatically, the inclusion of "wholly owned" trusts would ease compliance.

Comment

Officials do not support the suggested extension to the definition on the basis that it would be inconsistent with the proposed policy. If such a trust meets the policy criteria, it should seek recognition as a Maori authority by way of legislative change.

Recommendation

That the submission be declined.

Issue: Other entities controlled by statute

Submission

(27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The proposed definition should be amended to include other entities holding or administering assets for, or on behalf of Maori pursuant to an Act of Parliament.

The submission considers that the suggested extension to the proposed definition would include the following:

- trusts created or administered under the Maori Purposes Acts, Maori Reserved Land Act 1955, various empowering Acts, and the Maori Soldiers Trust Act 1957; and
- the Ngarimu VC and 28th (Maori) Battalion Memorial Scholarship Fund.

Comment

Officials do not support the suggested extension to the proposed definition on the basis that it is inconsistent with the proposed policy. These organisations may not necessarily be subject to any specific statutory restriction or constraint on the administration of their assets. Officials also note that some of these organisations are administered by the Maori Trustee or are subject to Te Ture Whenua Maori Act 1993 and may already be included, while others enjoy charitable status. If there is a

deserving entity it will need to approach the government and seek to be added to this list. This will allow the government to assess whether an organisation satisfies the policy criteria to be taxed as a Maori authority.

Recommendation

That the submission be declined.

Issue: Other entities with restricted transferability of property rights

Submission
(27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The proposed definition should be amended to include other entities holding or administering assets on behalf of Maori (referred to as "Other Entities") where:

- the entity is restricted in its ability to transfer assets owned by it or the right of any individual to participate in the assets of the entity are not transferable; and
- the entity exists to give effect to communal ownership in accordance with Maori custom.

Participation in these entities is determined by whakapapa and sometimes other limiting factors. However, they differ from ordinary family trusts, where the settlor or settlors make an independent choice to share assets held individually by themselves, usually with their immediate family. The trust must be wound up within a specific timeframe (not more than the duration of a life in being at the time the gift to the trust was made, plus 21 years). Upon winding up, the assets of the trust must vest beneficially and legally in particular individuals (who will be free to dispose of those assets as they see fit) or in charities. That a family trust may be settled by or have as a beneficiary a Maori should not be sufficient to draw the trust into the Maori authorities regime.

In contrast, the core assets of "Other Entities" are held for the benefit of a larger group, such as iwi or hapu, before being transferred to the entity and after it comes to an end. This form of property ownership does not readily transpose to the various property vehicles available in New Zealand's western legal system. To the extent these entities seek recognition within the broader legal system, the choice of vehicle is difficult. Non-charitable trusts cannot hold assets in perpetuity, whilst incorporated societies do not permit the distribution of pecuniary gains to members, and companies require a shareholding structure that divides entitlements to communal assets in a manner inconsistent with traditional ownership.

The most commonly chosen vehicle is a trust (charitable or otherwise) or incorporated society. Some entities, particularly those holding no significant assets, may have no specific vehicle and might, from a legal perspective, best be viewed as unincorporated societies. Others may have used (by choice or otherwise) structures imposed by statute (such as Maori Trust Boards or incorporations), or effected (as well as possible) by private legislation.

All of these entities bear the hallmarks of communal ownership and restricted participation. None can be excluded from the Maori authority rules "without creating a gross inequity and evincing grave and manifest disrespect for Maori custom and values".

It is not difficult to distinguish an iwi or hapu from a private family trust or business vehicle. In more difficult cases, the original reasons for vesting assets in the entity should resolve the issue. Any uncertainty in more difficult cases would be more than compensated by the benefits of consistency with the fundamental nature of an entity. The current list of entity types that may be accidents of colonial history skirts the hard question of their essential character. Inclusion of "Other Entities" would ensure a definition sufficiently flexible to function efficiently as the legal environment changes.

Comment

Officials do not support the suggested extension to the proposed definition. These "other entities" may not necessarily be constrained by specific legislation or subject to a specific government process or criteria. As mentioned earlier, communal ownership per se does not justify the inclusion of a Maori organisation in the definition of "Maori authority".

Recommendation

That the submission be declined.

Issue: Treaty of Waitangi Fisheries Commission

Submission
(15 – Te Ohu Kai Moana)

The proposed definition should be amended to include successor bodies to the Treaty of Waitangi Fisheries Commission.

Comment

Officials consider that this matter should be determined at the time the successor body is established. Officials understand that legislation will be required to establish the successor body.

Recommendation

That the submission be declined.

Issue: Settlement entities

Submission

(15 – Te Ohu Kai Moana, 16 – PricewaterhouseCoopers, 27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The proposed definition should be amended to include:

- existing organisations that may be suitable for the receipt of treaty settlement redress and, in fact, hold such assets but were not established for that specific purpose;
- organisations that receive and manage assets of the Treaty of Waitangi Fisheries Settlement; and
- organisations that can demonstrate that they meet the same structural requirements as settlement entities.

Comment

Clause 65 (12), sub-paragraph (a)(vi) was drafted with initial settlement entities in mind – that is, those entities established in accordance with the Treaty of Waitangi direct-negotiations process. However, the amendment does not reflect the fact that pre-existing entities that comply with the governance, structural and management requirements for settlement entities may also receive and manage assets. Officials consider the inclusion of these entities in the proposed definition would be consistent with the proposed policy.

The current wording seems wide enough to encompass settlement entities of the Treaty of Waitangi Fisheries Settlement, but some doubt has been expressed in submissions. For this reason, officials recommend that sub-paragraph (a)(vi) be clarified to reflect the fact that structures set up to receive assets of the fisheries settlement are similar to entities of the treaty settlement redress process and, therefore, should also be included in the definition of “Maori authority”.

With respect to entities that can demonstrate that they meet the same structural requirements as settlement entities, this extension of the proposed definition would be inconsistent with the proposed policy underlying the definition. Such entities might exist without having been subject to specific legislation or any government process.

The “entity” to which the sub-paragraph applies should be defined in the deed of settlement, or in the legal documentation in the case of entities receiving fisheries assets.

Recommendation

That clause 65(12), sub-paragraph (a)(vi) be amended so that an entity that receives and manages assets as part of a Treaty of Waitangi settlement redress, or as part of the Treaty of Waitangi Fisheries Settlement is included in the proposed definition. Note that the "entity" to which this provision applies should be the entity that is defined in the deed of settlement, or in the legal documentation in the case of entities receiving fisheries assets.

Issue: Wholly owned entities of a Maori authority

Submission
(15 – Te Ohu Kai Moana, 27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

Te Ohu Kai Moana submits that the proposed definition should include wholly owned *entities* of Maori authorities, rather than wholly owned *subsidiaries.* The term "subsidiary" implies that only where the entities involved are companies will clause 65(12), paragraph (b) of the proposed definition apply. Many Maori authorities are not companies.

In a similar submission, the Federation of Maori Authorities and the Office of the Maori Trustee submits that clause 65(12), paragraph (b) of the proposed definition should be amended to include "a company wholly owned by a Maori authority or a group of Maori authorities".

Comment

Officials acknowledge that the current wording of clause 65(12), paragraph (b) does not achieve its purpose. The reference to "wholly owned subsidiaries" restricts the provision to corporate structures and precludes Maori authorities that are trusts who have wholly owned companies. However, the reference to "wholly owned entities" is imprecise since it is not possible for a Maori authority to wholly own any entity other than a company.

Officials consider that the word "company" would more accurately reflect the intended meaning.

Recommendation

That clause 65(12), paragraph (b) be amended to apply to a company rather than a subsidiary.

Issue: Current Maori authorities should be included

Submission
(29 – New Zealand Law Society)

The proposed definition should be amended to include entities which are currently treated as a Maori authority.

Comment

Including all current Maori authorities in the proposed definition could mean including many entities that are not consistent with the policy underlying the proposed definition.

Recommendation

That the submission be declined.

Issue: Companies wholly owned by Maori authorities should be excluded from the proposed definition

Submissions
(4 – C Gibbons and Holdings Ltd, 10 – New Zealand Retailers Association, 13 – Business New Zealand, 23 – Chen, Palmer and Partners[7] (supported by 23A – Independent Fisheries Ltd))

Several submissions argued that businesses owned by Maori authorities should be taxed as ordinary companies. Any concessions for such businesses should apply to all companies and trusts. Beneficiaries of such organisations were like shareholders of a private company, and much of their profit was reinvested. The New Zealand Retailers Association and Chen Palmer and Partners submitted that the lower tax rate applying to businesses owned by Maori authorities as a result of their inclusion would give them an unfair and distortionary competitive advantage.

Chen, Palmer and Partners submitted that the new rules should achieve competitive neutrality for all companies, and limit the benefits of the proposed policy to distributions to authority members (the real beneficiaries). There would be incentives to structure businesses and assets to take advantage of the favourable tax rate. The argument that including wholly owned subsidiaries in the definition of "Maori authority" would allow parent authorities to apply a single tax framework, reducing tax compliance costs while quarantining commercial risk, failed because the benefits did not justify the resulting economic distortions. A non-Maori authority company setting up a business must bear the risks, and Maori authorities are likely to receive some income through non-Maori authorities, preventing the application of a single tax

[7] Chen Palmer and Partners provided their submission on behalf of their clients Sanford Limited, Amaltal Corporation Limited, Vela Fishing Limited, Solander Group, Simunovich Fisheries Limited, Talleys Fisheries Limited, United Fisheries Limited, and Independent Fisheries Limited.

framework. The flow of imputation credits among grouped or related Maori authority companies would exacerbate the economic impact of the regime.

Comment

Companies wholly owned by Maori authorities are included in the proposed definition of "Maori authority" in order to promote the efficient commercial structuring of Maori authority assets, including quarantining commercial risk in separate companies. If these companies were excluded from the Maori authority rules, Maori authorities would be encouraged to carry on their commercial activities within the parent Maori authority. It would not be administratively feasible to differentiate streams of income from different kinds of assets held within the parent entity. Although Maori authorities are likely to have some income taxed under other rules – for example, dividends from ordinary companies, including companies owned entirely by Maori authorities in the definition is expected to reduce compliance costs relative to exclusion.

Including these entities in the definition is also consistent with the grouping of ordinary, wholly owned companies for tax purposes, which offers certain tax advantages but encourages the efficient structuring of wholly owned commercial activities.

Economic analysis suggests that the lower tax rate on Maori authority companies would not give them a significant competitive advantage and that Maori authority investment strategies will be distorted by tax considerations, whether or not their companies are included in the definition (refer "Issue: Maori authorities should face the same tax rate as other companies"). Indeed, if they are excluded, it will be possible for companies wholly owned by Maori authorities to transfer profits to a "parent" by way of management fees that are deductible from the company's income and included in the "parent's" income.

Ordinary companies that share predominantly the same ownership are able to group and consolidate, reflecting the view that since the owners are the same, the income of the group as a whole should be considered, not the income of the individual companies. This avoids biasing Maori authorities towards carrying on all of their commercial activities within a single, parent Maori authority that may be inappropriate for the purpose. Allowing companies wholly owned by Maori authorities to be taxed either as Maori authorities or as ordinary companies allows them to choose the most efficient commercial structure. For example, they will be able to choose whether to group with other Maori authority companies, group with ordinary companies (which would, if officials' recommendations are adopted, require them to elect out of the Maori authorities rules), or not to group at all.

Officials consider that, on balance, including wholly owned companies in the definition of "Maori authority" will reduce compliance costs and will be less distortionary than excluding them.

Recommendation

That the submissions be declined.

APPLICATION OF THE PROPOSED MAORI AUTHORITY RULES

Issue: Clarifying the application of the Maori authority rules – new registration and election process

Clause 24

Submission
(15 – Te Ohu Kai Moana)

The bill should clarify that a wholly owned entity of a Maori authority that otherwise qualifies to be taxed under the general tax rules should be taxed as a Maori authority only if it elects to do so. Entities should not be required to apply the Maori authority rules if they qualify under another set of tax rules.

Comment

Proposed new subpart HI provides entities that meet the proposed definition of "Maori authority" with the option of applying the general tax rules, if they meet the requirements of those rules. It is intended that Maori authorities would make this decision by filing the appropriate tax return at the end of the year. This approach would not require Maori authorities to provide any formal notification to the Commissioner of Inland Revenue.

Officials have since revised this approach and consider that it would be more expedient and efficient if there were a formal registration and election process. Such a process would clarify the operation of the new subpart HI and rationalise the transitional measures for Maori authorities moving in and out of the new rules.

The proposed new registration and election process is set out below.

New registration requirement

All entities meeting the proposed definition of "Maori authority" would need to register their tax status with the Commissioner of Inland Revenue in the income year the proposed changes take effect – 2004-05.

The intention of registration is to ensure that the proposed new rules are confined to the entities that meet the proposed definition of "Maori authority". There could be some entities that are currently taxed as a Maori authority but might not meet the proposed definition of "Maori authority". These entities would be identified as part of the registration process.

New election requirements

In the post-reform period, a Maori authority could make a formal election to cease to be treated as a Maori authority. The Maori authority would cease to be a Maori authority for the purposes of the Income Tax Act and would no longer be eligible to apply the provisions that relate specifically to Maori authorities. Its applicable tax treatment would then depend on whether it is a trust or a company under the general tax rules – this is because, with the exception of the Maori Trustee in its capacity as agent, the listed entities in the definition are either trusts or companies.

Timing of election rules

Any election would take effect on the first day of the income year of the company or trust that succeeds the income year in which the notice is received by the Commissioner. However, in the case where a later income year has been specified, the election would take effect on the first day of the specified income year. The advanced notification of a change in status means that the change can take place in respect of an income year.

Specific rules would be required for part-year cessation, especially in relation to entities that cease to qualify for Maori authority status part-way through an income year, or that wish to exit the rules (such as a Maori authority company that amalgamates with an ordinary company).

Specific rule for the first year

A Maori authority would also be permitted to elect out of the new rules in respect of the 2004-05 income year. For example, an entity is taxed as a company before the reforms and wants to continue to be treated as a company in the post-reform period. In this case the entity would have to make a formal election not to apply the Maori authority rules. This would occur as part of the registration requirement. To support this measure, a specific timing provision is required as an exception to the general timing rule mentioned above.

Revocation rule

The election to cease to be a Maori authority would remain effective until revoked by the company or trust. An election may only be revoked if appropriate notification in writing has been provided to the Commissioner. The revocation would take effect on the later of the beginning of the income year in which the notice of revocation is received by the Commissioner, or the beginning of the income year as may be specified in the notice.

An automatic revocation would occur if an entity ceased to satisfy the definition of "Maori authority".

Recommendation

That the submission be accepted and the bill be amended to reflect the new registration and election process.

Issue: Clarifying the tax consequences for movements in and out of the Maori authority rules

Clause 24

Submission
(Matter raised by officials)

New section HI 6 and its table should be amended to reflect the new registration and election process outlined in the previous submission.

Comment

Proposed new section HI 6 and its table set out the specific tax consequences for companies and trusts moving in or out of the Maori authority rules. In order to accommodate the new election process consequential changes are required to new section HI 6 and the table.

Recommendation

That the submission be accepted.

Issue: Clarifying the consequences of re-entering the Maori authority rules and applying market value calculations

Clause 24

Submission
(Matter raised by officials)

The proposed new registration and election process requires consequential changes to section HI 7 and the table.

Comment

Rules governing the tax consequences for Maori authorities that re-enter the Maori authority rules are provided for in the proposed new section HI 7. These rules apply in situations where, under the proposed Maori authority rules, a Maori authority is taxed as a Maori authority, then taxed as a company or trust and then reverts to being taxed as a Maori authority again.

A Maori authority re-entering the Maori authority rules would be subject to the same tax consequences that would have arisen had it wound up and disposed of its property at market value. The purpose of these rules is to minimise the risk of Maori authorities moving in and out of the Maori authority rules to obtain tax advantages.

New section HI 7 requires consequential drafting changes to accommodate the new election process. In particular, the provision should require that where a Maori authority has made an election to cease to be a Maori authority, and then subsequently revokes that election and reverts to being a Maori authority, market value calculations must be made.

A problem exists, however, for companies and trusts that have made an election to cease to be a Maori authority in relation to the 2004-05 income year (that is, they continue to be taxed as a company or trust in the post-reform period) but in a subsequent year revert to being a Maori authority. Technically, these entities have "re-entered" the Maori authority rules, so market value calculations would be required to be made. Such calculations should not be required of entities applying the proposed rules for the first time.

Recommendation

That the bill be amended so that if a Maori authority that is a company or a trust makes an election in relation to the 2004-05 income year and subsequently reverts to being a Maori authority, market value calculations should not be required to be undertaken. If that company or trust subsequently makes an election and then revokes that election, the market value calculations should apply.

Issue: Section HI 6 and HI 7 should also apply to individuals

Clause 24

Submission
(26W – Ernst & Young)

The submission makes two points in relation to the transitional provisions:

- The transitional provisions should be extended to provide for Maori authorities that are individuals.
- The table in clause 24(1) should be given a brief title or included as a separate schedule to the Income Tax Act 1994, and references to the table in section HI 6 should be amended accordingly.

Comment

We disagree with both submission points.

The proposed definition of "Maori authority" lists entities that either have a legal form of a company or a trust, so there is no need for transitional rules for individuals.

The table forms part of sections HI 6 and HI 7 and must be read concurrently with those sections. We consider that there is a sufficient relationship between the table and its relevant sections.

Recommendation

That the submission be declined.

Issue: Clarifying the application of the company rules to Maori authorities

Submission
(Matter raised by officials)

The rules should be clarified to ensure that a company that is a Maori authority cannot maintain an imputation credit account and that its distributions are not dividends.

Comment

It is intended that a Maori authority not maintain an imputation credit account. Ensuring this requires a specific provision in the Maori authority rules. It is also necessary to ensure that distributions by a Maori authority are not treated as dividends.

Recommendation

That the bill be amended to ensure that a Maori authority cannot maintain an imputation credit account and that its distributions are not treated as dividends.

Issue: Trusts as Maori authorities should retain exclusion from beneficiary gross income and trustee income rules

Clauses 21 and 23

Submission
(26W – Ernst & Young)

Maori authorities and their members should retain their exclusion from sections HH 3 and HH 4 – the rules relating to the taxation of income from trusts.

Comment

Officials agree with this submission. Current sections HH 3(6) and HH 4(8) should remain to clarify that a Maori authority and its members will be taxed according to the proposed Maori authority rules and would not be subject to the trust rules. The trust rules would apply only if the Maori authority has made a formal election to cease to be a Maori authority and meets the requirements to apply the trust rules.

Recommendation

That clauses 21 and 23 be amended to make clear that Maori authorities will not be subject to the trust rules unless they make a formal election and also meet the requirements of the trust rules.

MAORI AUTHORITY TAX RATE OF 19.5%

Clauses 68 and 78

Issue: Specification of the basic tax rate and resident withholding rate for Maori authorities

Submission

(27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The basic rate of income tax and the resident withholding tax rate for Maori authorities should refer to the lowest rates already prescribed in the schedules to the Act. This would achieve the policy objective of applying the rate that most closely reflects the marginal tax rate of members of Maori authorities, while avoiding the need to amend the Maori authority rate if the lowest rates were to change.

Comment

Officials consider that the basic rates of income tax and resident withholding tax for Maori authorities should be separately defined in the Act, as currently proposed in the bill. Any future change in the rates applying to Maori authorities should be given separate consideration. Parliament will have an opportunity to review the Maori authority tax rates annually when it confirms all other statutory tax rates. Some reasons for which the appropriate Maori authority rate in the future could be different from the lowest basic tax rate include a change in tax rate thresholds, a change in the income distribution of members of Maori authorities, or a change in government policy on Maori authorities.

In terms of a process for reviewing the Maori authority tax rate, officials propose, as part of reporting on the confirmation of the annual tax rate, to review the data on the income distribution of Maori. If there is a significant change in the distribution, officials will undertake further analysis as to whether the tax rate should be amended. Other factors that may need to be taken into account include whether any weighting should be applied to the amount of the distribution.

Recommendation

That the submission be declined.

Issue: Extend tax rate to superannuation schemes and investment funds

Submission

(13 – Business New Zealand)

The tax rates in New Zealand are too high and, as a step towards reducing them, the proposed 19.5% tax rate for Maori authorities should apply to superannuation schemes and investment funds.

Comment

The submission notes that savers in superannuation schemes and investment funds with marginal tax rates of 19.5% currently overtaxed by the 33% tax on the income of a superannuation fund or life insurance policyholders' funds.[8] It should be noted that savers with a marginal tax rate of 39% are undertaxed. However, there are a number of problems with lowering the tax rate on these funds.

Firstly, based on 1997 figures and adjusting for inflation, officials estimate that a little under half of those saving in life insurance and superannuation funds have marginal tax rates of less than 33%. Therefore a statutory tax rate of 19.5% on fund income would undertax at least as many investors as are currently overtaxed.

Secondly, unlike the tax on Maori authority income, the tax on superannuation and life insurance income is a final tax, with no "square-up" mechanism such as the attachment of tax credits to distributions. Such a mechanism would be complicated by the imperfect match between the contributions made by investors and the income they (or their estate) finally receive. Possible square-up mechanisms have so far not been adopted, largely because of concerns about the complexity they would add and therefore the costs they would impose on taxpayers and Inland Revenue.

In 1998 Parliament rejected legislation to deal with the overtaxation of savers in superannuation funds because of the industry's concern about compliance costs associated with administering the mechanism to deal with the overtaxation.

Recommendation

That the submission be declined.

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[8] The government is developing options for matching the tax rate on employer contributions to employment-related superannuation funds to employees' tax rates.

Issue: Maori authorities should face the same tax rate as other companies

Submissions

(4 – C Gibbons and Holdings Ltd, 10 – New Zealand Retailers Association, 13 – Business New Zealand, 23 – Chen, Palmer and Partners (supported by 23A – Independent Fisheries Ltd))

Maori authorities, or at least businesses owned by Maori authorities, should be taxed at the same rate as other businesses and do not need a 19.5% tax rate. If adopted, this rate should apply to all companies and trusts. Beneficiaries of such organisations are like shareholders of a private company, and much of their profit was reinvested. Beneficiaries on higher tax rates would face a terminal tax liability, generating compliance and administration costs.

The New Zealand Retailers Association submitted that commercial ventures not using inalienable property would be unfairly advantaged by being taxed at a higher rate (33%) than similar ventures owned by Maori authorities (19.5%). Maori authorities could reinvest 80.5 percent of retained income instead of 67 percent – a constant advantage of 13.5 percent. This would reduce their cost of capital and, all else being equal, allow a Maori authority to under-cut competitors.

Chen, Palmer and Partners submitted that the new rules should achieve competitive neutrality for all companies. A 19.5% tax rate for Maori authority companies would be economically detrimental, giving Maori authority companies a competitive advantage by increasing their after-tax cash flow, distorting market share and cost of capital at the expense of competitors. The proposals set up incentives to structure businesses and assets to take advantage of the favourable tax rate. Efficient commercial structures do not depend on a tax rate of 19.5%. Moreover, Maori authorities are likely to receive some income through non-Maori authorities, so the vision of a single tax framework is an illusion. The flow of imputation credits among grouped or related Maori authorities would exacerbate the economic impact of the proposed regime.

Comment

The proposed tax rate for Maori authorities has been set at 19.5% because this is the statutory marginal tax rate applying to most of their members. Matching the tax rate applied to the entity to that of members brings savings in compliance and administration costs, avoids distorting the ratio of entity distributions to retained earnings, and is consistent with the view that, where practicable, an entity should be seen as a proxy for its members. (Practical considerations include the need to minimise compliance costs and to identify a rate that is likely to continue to be the appropriate one for a clear majority of members.)

About 90 percent of Maori have an income tax rate of 19.5%. It is reasonable to assume that, as submitted by the Federation of Maori Authorities, members of Maori authorities have a similar income distribution to that of Maori generally, since membership is unrelated to income. In contrast, most company shares belong to shareholders with a statutory marginal tax rate of 33% or higher. Furthermore, from the point of view of equity, shareholders who are overtaxed on their company income can sell their interest at relatively low transaction costs and invest where they will be

taxed at a lower rate (for example, in their own homes), but this cannot be said of members of Maori authorities.

Economic analysis suggests that the differential between the tax rate to be paid by Maori authority companies and ordinary companies would not bestow a significant competitive advantage. The considerations here are very similar to those applying to businesses enjoying a charitable income tax exemption, except that the differential is much smaller and the restrictions on the use of income are less stringent.

Some submissions imply that Maori authorities are likely to indulge in anti-competitive pricing and production behaviour. Such behaviour is generally not sustainable, and would be subject to the scrutiny of the Commerce Commission.

Profit-maximizing levels of price and output are not affected by the rate of income tax on a firm. (They are affected by the rate of a tax on gross revenue or output.) Price and output are set at the point where marginal cost and marginal revenue are equal: since costs are deductible from revenue when calculating taxable income, a change in the rate of income tax does not affect this calculation. Marginal cost and marginal revenue before and after tax intersect at the same level of output and the pre-tax price remains unchanged. Even though a Maori authority's after-tax return on an investment may be higher than the return a normal business could obtain, its return on any other investment would also be higher. Therefore there is no incentive to "beat the market" on price.

Maori authority companies may have greater access to debt finance than if they were taxed at 33%, but their overall access to capital may be no greater than that of other companies. Maori authority companies tend to be somewhat dependent on debt finance, and the "parent" faces unique problems in raising it. The "parent" cannot sell shares in itself, and financers are more reluctant to lend to them because of the restrictions on their ability to alienate assets such as land.

The proposed difference between the Maori authority and company tax rates may favour Maori authority investment in enterprises wholly owned by themselves and other Maori authorities. The alternative of taxing companies wholly owned by Maori authorities at a higher rate than their "parents" would create a different distortion, encouraging Maori authorities to carry out their commercial activities within parent structures or to use tax planning mechanisms (such as using management fees to transfer profits from wholly owned companies to the parent, which would be deductible from the company's income and included in the parent's income).

Although Maori authorities are likely to receive some income taxed at a higher rate, a common tax rate applied to its "hands-on" commercial activities will have compliance cost benefits. (Refer Issue: Companies wholly owned by Maori authorities).

Recommendation

That the submissions be declined.

Issue: Maori authority credits and imputation credits – the same rules should apply

Clause 44

Submission
(4 – C Gibbons and Holdings Ltd, 10 – The New Zealand Retailers Association, 23 – Chen, Palmer and Partners)

Maori authority credits and imputation credits should be treated the same for tax purposes.

Chen, Palmer and Partners considered that the existing company imputation credit system should apply to Maori authorities, rather than the proposed Maori authority credit system. The proposed system parallels the imputation credit system in allowing shareholders to offset their tax liabilities using imputation credits attached to dividends. The application of the imputation rules to distributions to members of Maori authorities can achieve the underlying policy goal of the bill – taxing members at their marginal tax rates.

Comment

Officials acknowledge that the Maori authority credit system is based on the company imputation credit system. However, the Maori authority credit system will apply to trust structures as well as company structures, whereas the imputation credit system applies only to companies.

Maori authority tax credits are an integral feature of the proposed tax rules, combining aspects of imputation and withholding taxes such as the operation of a memorandum account and the refundability of credits. They interlink with other features of the proposed tax rules such as the 19.5% tax rate and distributions. Incorporating these other features into the existing company imputation system and limiting them to Maori authorities would have increased the complexity of the current imputation credit account rules and increased compliance for companies in accessing and understanding how the tax rules apply to them. Officials consider it appropriate to apply separate tax rules in respect of the Maori authority credit account in order to ensure ease of use of the tax legislation.

Recommendation

That the submission be declined.

Issue: Imputation credits should be refundable

Clause 44

Submission

(10 – New Zealand Retailers Association, 12 – Institute of Chartered Accountants of New Zealand, 29 – The New Zealand Law Society)

The Law Society and the Retailers Association consider that if Maori authority credits are refundable, imputation credits should also be refundable.

The Law Society argues that non-refundability of imputation credits disadvantages charities, other tax-exempt entities or an investor whose marginal tax rate is less than 33 percent, since they are unlikely to be in a position to use imputation credits to offset other income tax or provisional tax.

The Institute of Chartered Accountants submits that the government should consider allowing refundability of excess imputation credits.

Comment

Government policy is that excess imputation credits should not be refundable. This is primarily for reasons of fiscal cost and risk, particularly in relation to non-residents. If refundability were made available to residents but not to non-residents, New Zealand could be in breach of its non-discrimination provisions in its double tax agreements. The treatment of non-residents is consistent with the general treatment of resident shareholders.

Under the previous rules that applied before the introduction of the current imputation credit system, non-resident investors were subject to company tax and non-resident withholding tax when dividends were paid. The non-refundability of imputation credits maintained the status quo treatment of non residents.

In relation to the issue of non-refundability of imputation tax credits for tax-exempt entities such as charities, the government has indicated that it will review the current position once the planned charities commission is established and information from charities is provided. This will give the government a better indication of the likely fiscal cost of refunding imputation tax credits to charities.

Recommendation

That the submission be declined.

Issue: Claiming refunds of excess Maori authority credits

Clause 36

Submission
(12 – Institute of Chartered Accountants of New Zealand)

Inland Revenue's systems should ensure that refunds of excess Maori authority credits can be accessed at minimum compliance cost to Inland Revenue and taxpayers.

Comment

Officials consider it appropriate that general rules apply to members seeking tax refunds in relation to Maori authority distributions. If a member has excess Maori authority credits he or she would need to request a summary of earnings, a pro forma tax calculation and, if it is to his or her advantage, a personal tax summary. Clause 78 of the bill provides for this in relation to charitable entities receiving a taxable Maori authority distribution.

In developing its system to administer the Maori Authority tax rules, Inland Revenue will ensure that compliance cost implications for taxpayers are minimised.

Recommendation

No recommendation is required.

Issue: Excess imputation credits should be refundable to Maori authorities

Clause 34

Submission
(15 – Te Ohu Kai Moana)

Excess imputation credits should be refundable to Maori authorities. Many Maori authorities would not be able to use all of their imputation credits and so their effective tax rate on dividend income, after offsetting losses, would be higher than 19.5%. This result could provide a disincentive for Maori authorities to invest in companies taxed under the company rules.

Comments

Allowing imputation credits to be refundable to Maori authorities would be contrary to current policy on imputation credits. This is consistent with the current tax treatment afforded to other taxpayers who cannot utilise all their imputation credits.

Recommendation

That the submission be declined.

Issue: Maori authority credits on transition

Clause 24

Submission
(25 – The Office of Te Runanga o Ngai Tahu)

New section HI 6 should ensure that Maori authority credits arise when a company that has paid tax on undistributed income reverts to being a Maori authority.

Comments

The proposed rules for transitions are intended to ensure that a transition between tax rules does not give rise to additional tax advantages (for example, in relation to income earned under the ordinary company rules). When a company enters the Maori authority rules, any remaining credits in its imputation credit account would be extinguished and any undistributed tax-paid income would be able to be distributed tax free.

Recommendation

That the submission be declined.

Issue: Clarify that Maori authority credits are to be refundable to exempt entities

Clause 36

Submission
(15 – Te Ohu Kai Moana, 16 – PricewaterhouseCoopers)

The bill should be amended to enable exempt entities such as charities who receive Maori authority credits to obtain a refund of any excess credits. This would be consistent with the intention expressed in the commentary on the bill.

Comment

It is the intention of the proposed legislation that Maori authority credits should be refundable to entities earning exempt income as well as entities earning gross income.

As this clause is currently drafted, a refund of credits would only be available to persons receiving gross income. However, exempt entities such as charities do not receive "gross income", as defined in the Income Tax Act 1994, they receive "exempt income".

Recommendation

That the submission be accepted.

Issue: Clarifying the application of new section HI 3

Clause 24

Submission
(16 – PricewaterhouseCoopers, 26W – Ernst & Young)

New section HI 3 should be clarified so that amounts distributed which do not represent gross income derived by a Maori authority or a non-taxable distribution would not be taxable to members who receive those distributions.

Comment

The purpose of new section HI 3 is to establish which distributions are taxable to members who receive them. The section applies to taxable distributions to which Maori authority credits may be attached under new section MK 6, or from which resident withholding tax may be deducted under new section NF 1(2)(c).

Section HI 3(1) deems amounts distributed by a Maori authority to have been distributed from gross income of the authority and to be gross income derived by the member who receives that distribution. Section HI 3(2) stipulates that section HI 3(1) does not apply to amounts distributed that do not represent gross income derived by the Maori authority. If section HI 3(1) applies, then all amounts distributed are from gross income of the authority, and section HI 3(2) may never apply. This means all distributions would be gross income and taxable in the hands of the members, with the possible exception of non-taxable distributions. Officials acknowledge that this result was not intended and should be corrected.

Furthermore, proposed section HI 3(3) has the unintended effect of narrowing the meaning of "non-taxable distribution" specifically for the purposes of section HI 3. However, new section HI 6 also contains a reference to a "non-taxable distribution" which should also come within section HI 3.

Recommendation

That new section HI 3 be amended to clarify that section HI 3 does not apply to a distribution that is not sourced from gross income derived by the Maori authority or a non-taxable distribution. The amendment should also clarify that a non-taxable distribution includes a non-taxable distribution under new section HI 6 and a distribution of taxable income derived by the Maori authority in the 2003-04 or a prior income year.

Issue: Resident withholding tax and Maori authority distributions

Clause 59

Submission
(26W – Ernst & Young)

New section NF 1(2)(c) should be amended to clarify that it applies to "taxable Maori authority distributions" only.

Comment

Officials consider that the suggested change is not necessary. New section NF 1(2)(c) is intended to apply resident withholding tax to taxable Maori authority distributions. This is achieved by the current wording of clause 59, which reads: "distributions to which section HI 3 applies from a Maori authority". As mentioned in the previous comment, section HI 3 establishes which distributions are taxable to members who receive them.

Recommendation

That the submission be declined.

Issue: Distributions and discretionary grants

Clause 24

Submission
(22 – New Zealand Maori Council)

When a person receives a discretionary grant from a Maori authority, the person's expenditure in relation to that grant should be deductible under section BD 2(b)(i).

Comment

Officials consider that the general deductibility rules contained in section BD 2(b) should apply to determine whether an amount of expenditure is deductible for tax purposes. Expenditure relating to discretionary grants made by a Maori authority would be deductible if it meets the criteria for deductibility in section BD 2(b). Thus, a member that receives a discretionary grant from a Maori authority would be able to deduct any related expenditure that the member incurred in deriving that grant.

Recommendation

That the submission be declined.

Issue: Education grants should be excluded from the definition of "distribution"

Clause 24

Submission
(22 – New Zealand Maori Council)

The proposed definition of "distribution" in new section HI 2 should exclude educational scholarships to which section CB 9(d) applies.

Comment

New section HI 2 treats certain amounts distributed from a Maori authority to a member as a "distribution" for the purposes of the Maori authority rules. The meaning of "distribution" includes both cash amounts and non-cash amounts such as property transfers for inadequate consideration. This is necessary to deal with the wide range of financial and non-financial benefits that Maori authorities provide to their members.

New section HI 2 includes payments made to members under an educational scholarship. Whether such a payment is taxable to the member under the Maori authority rules would depend on whether the payment is made from tax-paid income sources or non-taxable income sources. If the payment is sourced from exempt income, pre-reform income or is a non-taxable distribution under section HI 6, then the payment would not be taxed in the hands of the member. However, if the payment is sourced from Maori authority tax-paid income, Maori authority credits or resident withholding tax would apply – in other words, the payment would constitute a taxable Maori authority distribution.

The tax treatment of distributions would also depend on the nature of the payment in the hands of the recipient members. Certain types of distributions would be exempt from tax in the hands of the members if certain criteria are met, such as an amount to which section CB 9(d) applies. Under this section, an amount paid as a scholarship or a bursary to attend an educational institution is treated as exempt income.

If the payment meets the criteria under section CB 9(d) the recipient member would be able to claim a full refund of any Maori authority tax credits attached to their payment or any resident withholding tax deducted by filing a tax return or requesting an income statement at the end of the year.

We consider that there is no reason to specifically exclude payments to which section CB 9(d) applies from the definition of "distribution".

Recommendation

That the submission be declined.

NON-TAXABLE DISTRIBUTIONS

Clause 24(1)

Issue: Non-taxable distributions: overtaxation and double taxation

Submission
(27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The definition of "non-taxable distribution" should be amended to include any distribution or part thereof that has not been fully credited with Maori authority credits.

Under the proposed Maori authority rules, some overtaxation and double taxation could still occur if funds are distributed before they are taxed at the Maori authority level, or if there is insufficient tax paid in relation to those funds to allow the whole distribution to be fully credited.

For example, a Maori authority distributes an amount of gross income that has not been taxed at the authority level because of an equivalent deduction, such as depreciation, which does not correspond to cash outlay in the income year. Another example is when a Maori authority distributes amounts that are recognised as gross income according to accounting principles earlier than they are recognised for tax purposes. In both cases there would be insufficient tax credits to attach to the distribution to avoid further tax on the distribution in the hands of the recipient member. These situations could also lead to the generation of surplus Maori authority credits that are not able to be attached to distributions.

This proposed amendment would be consistent with the qualifying company rules under section HG 13. The rationale behind these rules is that a qualifying company's ownership is so small that it is appropriate to look through the company to its shareholders. This is consistent with the taxation of Maori authorities as surrogates for the underlying members.

Comment

Officials acknowledge that the suggested change would greatly simplify the operation of the Maori authority credit account and thereby lower overall compliance costs for Maori authorities, and simplify the payment of distributions and the attribution of Maori authority credits. In addition, allowing Maori authorities to treat distributions as non-taxable to the extent that there are not adequate credits to fully credit them would:

- eliminate overtaxation and undertaxation of the Maori authority's income;
- avoid having the timing of distributions distort the timing of income recognition under the general provisions;

- emphasise that the amount of tax paid by the Maori authority will determine the amount of income that will be taxable to the member, thereby avoiding the need for the Maori authority to pay additional tax or deduct resident withholding tax to fully credit the distribution; and
- avoid the need to track income from its source to distributions.

However, officials have a number of concerns about the suggested change.

As noted by the submission, the suggested change is based on the qualifying company rules under section HG 13 of the Income Tax Act. Maori authorities generally do not share the same tax characteristics as qualifying companies and so, as a matter of principle, it would be inappropriate to apply the rules for qualifying companies to Maori authorities. There are strict requirements applying to qualifying company rules. For example, a qualifying company must have five or fewer shareholders and the directors and shareholders must elect to be a qualifying company, and the shareholder's election must also involve electing to be personally liable for the relevant share of tax liability imposed on the qualifying company. In addition, a qualifying company cannot receive more than $10,000 of foreign non-dividend income in an income year. None of these tax characteristics applies to Maori authorities.

Officials consider that relying on the quantum of tax credits in the Maori authority credit account and attributing these to distributions could have the unintended effect of taxing distributions sourced from exempt income such as Treaty settlement assets. One of the key features of the proposed rules preserves a current tax preference which permits Maori authorities to distribute non-taxable receipts tax-free to members. Although in theory the source of the distribution would not, in fact, be taxed, the potential for such distributions to be attributed with tax credits would indicate otherwise and this would be inconsistent with the proposed policy.

On balance, we do not support the suggested change.

Recommendation

That the submission be declined.

GROUPING OF MAORI AUTHORITIES

Issue: Grouping of Maori authority companies based on ordinary rules

Clauses 24 and 65

Submission
(15 – Te Ohu Kai Moana, 16 – PricewaterhouseCoopers, 23 – Chen, Palmer and Partners (under instruction from Sanford Limited, Amaltal Corporation Limited, Vela Fishing Limited, Solander Group, Simunovich Fisheries Limited, Talleys Fisheries Limited, United Fisheries Limited, and Independent Fisheries Limited), 25 – Office of Te Runanga o Ngai Tahu, 27 – Federation of Maori Authorities (supported by 11W – Pukawa D3 Trust and Pukawa 5B Trust, 14W – Waipapa 9 Lands Trust, 17W – Rotohokahoka F6 Trust, 18W – Waiteti 2 Section 1A2 Trust, 19W – Waikuta 2 Trust, and 20W – Fairy Springs Trust), 27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

A number of submissions considered that wholly owned Maori authorities should be able to group in the same manner as groups of companies. The structure and operation of groups of Maori authorities will be similar to those of groups of companies, so the same rights should exist. Rights that should apply include:

- exempt distributions between 100 percent owned Maori authorities (equivalent to section CB 10(2)) *(Te Ohu Kai Moana, PricewaterhouseCoopers)*;
- offsetting of losses between Maori authorities within a group *(Te Ohu Kai Moana, PricewaterhouseCoopers, The Office of the Maori Trustee, The Federation of Maori Authorities and (supported by Pukawa D3 Trust and Pukawa 5B Trust; Waipapa 9 Lands Trust; Rotohokahoka F6 Trust; Waiteti 2 Section 1A2 Trust; Waikuta 2 Trust; and Fairy Springs Trust)*; and
- transferability of Maori authority tax credits between group members *Te Ohu Kai Moana (PricewaterhouseCoopers*).

Te Ohu Kai Moana and PricewaterhouseCoopers argue that without these rights, companies that would have applied the Maori authority rules may apply the general rules, defeating the purpose of changing the Maori authority rules. PricewaterhouseCoopers note that the possibility of permitting Maori authorities in a group to offset losses is mentioned in pages 13-14 of the Commentary.

PricewaterhouseCoopers also submitted that imputation credits should be able to be transferred between Maori authorities within a consolidated group structure, and that, like dividends passed between companies in a 100 percent wholly owned group, distributions between Maori authority companies within a 100 percent wholly owned group should be tax exempt.

The Office of the Maori Trustee and the Federation of Maori Authorities, with the support of various other writers of submissions, argued that a wholly owned group of Maori authority companies should retain the ability to offset losses between companies in the group, and that this could be achieved by:

- amending clause 24(1) so that the proposed section HI 1(2) stipulates that the Maori authority is still a company for the purposes of part IG; and
- amending clause 65(6) so that the proposed definition of "continuity provisions" in section OB 1 reads:

  "(b) in relation to a Maori authority that is a company, means sections GC 2, GC 4, IE 1, IF 1, IG 2(1*),* and MK 5(1)(d)"

Subpart IG allows companies within a wholly owned group to offset taxable income using losses in other companies in the group. The rationale for grouping – that owners should be taxed on the income of the group as a whole – applies equally to Maori authority companies.

The Office of Te Runanga o Ngai Tahu submitted that the proposed rules relating to the ability of a group of Maori authorities to offset losses may need clarification.

Chen, Palmer and Partners submitted that the normal company rules for grouping and consolidation should apply to companies wholly owned by Maori authorities, rather than specific rules. The parent entity does not need to belong to the group, the existing rules were readily understood, and applying them (or transparently parallel concepts) to Maori authorities would:

- preserve competitive neutrality;
- preserve the benefits of the new policy at the point of distribution to Maori authority members – the real beneficiaries; and
- preserve the principle that Maori and other New Zealanders should enjoy the same benefits and opportunities under the law.

However, Chen, Palmer and Partners also considered that if the 19.5% tax rate for Maori authorities were adopted, its harmful effects, for example on how Maori authorities structured their commercial operations, would be exacerbated by the flow of imputation credits among grouped or related Maori authorities.

Comment

The bill does not currently provide for the application or non-application of the grouping and consolidation rules to Maori authority companies. After further analysis, officials consider that without amendment to the bill, these rules could apply, permitting these companies (if they meet the necessary conditions) to group with each other or with ordinary companies.

Officials, in general, accept that the grouping and consolidation provisions of the Income Tax Act should apply to Maori authority companies. However, to limit the opportunity for Maori authority companies and other companies to use the grouping or consolidation rules to gain potential tax advantages, officials consider that the grouping and consolidation rules should apply only where companies share the same tax characteristics. Maori authority companies should not be able to group or consolidate with ordinary companies for tax purposes.

For a Maori authority company to group with an ordinary company, the ordinary company would have to come under the Maori authority rules (which would require its purchase by Maori authorities, if it were not already wholly owned by the Maori authority). Otherwise the Maori authority company would have to revoke its Maori authority status.

Furthermore, officials consider that inter-company distributions between wholly owned Maori authority companies (those that have elected to be taxed as Maori authorities) should be non-taxable in the same manner as inter-corporate dividends. If Maori authority tax credits are attached to such distributions, the recipient company will not be able to offset those tax credits against it own tax liability. The tax credits will be credited to the recipient's Maori authority tax credit account. Similar rules apply in respect of ordinary companies.

Recommendation

That the grouping and consolidation rules in the Income Tax Act apply to Maori authority companies, but not to combinations of Maori authority companies and ordinary companies.

That inter-company distributions between wholly owned Maori authority companies be non-taxable in the same manner as inter-corporate dividends.

Issue: Wholly owned Maori authority companies: provisional tax offsets

Clauses 24 and 44

Submission
(27 – The Federation of Maori Authorities (FoMA) (supported by Pukawa D3 Trust and Pukawa 5B Trust, Waipapa 9 Lands Trust, Rotohokahoka F6 Trust, Waiteti 2 Section 1A2 Trust, Waikuta 2 Trust and Fairy Springs Trust), 28 – The Office of the Maori Trustee)

The bill should be amended to allow companies applying the Maori authority rules to continue to offset provisional tax payments between wholly owned group companies. This would be achieved by:

- amending clause 24(1) so that the proposed section HI 1(2) stipulates that the Maori authority is still a company for the purposes of Part IG and section MB 9; and

- amending clause 44(1) so that equivalent provisions to sections ME 4(1)(b) and ME 5(1)(d) with their equivalent timing provisions are included in the proposed sections MK 4 and MK 5 respectively.

Section MB 9 allows companies within a wholly owned group to offset any overpayments and underpayments of provisional tax. The rationale for grouping is that the same owners derive the income of the grouped companies and bear the cost of any resulting taxes. Taxing parts of a wholly owned group when the group as a whole has paid the right amount of tax would be inequitable. This rationale applies equally to wholly owned groups of Maori authority companies.

Sections ME 4(1)(b) and ME 5(1)(d) deal with the crediting and debiting of imputation credits in relation to offsets of provisional tax by wholly owned groups of companies.

Comments

Officials agree that provisional tax offsets within a wholly owned group of Maori authority companies should be permitted. As suggested in the submission, this requires amendment to sections MB 9, and to the proposed sections MK 4 and MK 5.

Recommendation

That provision be made for Maori authority companies within a wholly owned group to offset provisional tax payments.

MAORI AUTHORITY COMPANIES – AMALGAMATIONS AND CO-OPERATIVE COMPANIES

Issue: Application of the amalgamation provisions

Submission

(27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The amalgamation provisions in the Income Tax Act should apply to Maori authority companies.

Comment

The bill does not provide for the tax consequences of amalgamations of Maori authority companies, even though these companies, if they meet the necessary conditions, might be entitled to amalgamate with each other or with ordinary companies under the Companies Act 1993. Officials acknowledge that companies incorporated under the Companies Act that are taxed as a Maori authority would continue to be subject to the provisions of the Companies Act.

Officials accept, in principle, that the amalgamation provisions contained in the Income Tax Act should apply to companies that are able to amalgamate under the Companies Act. However, officials are concerned about the potential for the amalgamation rules to be used to gain tax advantages, and so the application of these rules should apply in certain circumstances:

- when all the companies subject to the amalgamation are taxed as Maori authorities; or
- when all the companies subject to the amalgamation are subject to the normal company tax rules.

This could mean that a Maori authority company would need to make an election to cease to be a Maori authority before it can amalgamate. In doing so, the Maori authority would be subject to the tax consequences under new section HI 6. The amalgamated company could be treated as a Maori authority if it satisfies the definition of "Maori authority". Furthermore, officials consider that the amalgamated company in this situation would be treated as re-entering the Maori authority rules and, therefore, must face the tax consequences in new section HI 7.

Recommendation

That the amalgamation rules contained in the Income Tax Act apply to Maori authority companies provided that:

- all the companies subject to the amalgamation are taxed as Maori authorities; or
- all the companies subject to the amalgamation are subject to the normal company tax rules; and

- if the Maori authority company has elected out of the rules to amalgamate and the amalgamated company elects to be taxed as a Maori authority, it would be treated as re-entering the Maori authority rules and must apply new section HI 7.

Issue: Co-operative companies wholly owned by a Maori authority

Submission

(27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

Consideration should be given to extending the co-operative company provisions to allow a Maori authority to attach Maori authority tax credits to a cash distribution or to a notional Maori authority distribution.

Comment

Under the co-operative company tax rules, a co-operative company can make a cash distribution to its shareholders based on the shareholder's produce transactions[9] with it, rather than pay a rebate.[10] Imputation tax credits can be attached to the cash distribution. In addition, a co-operative company can make a notional distribution (similar to a taxable bonus issue) to its shareholders based on the shareholder's produce transactions with it. Again, imputation tax credits can be attached to that notional distribution. Any actual distribution by the co-operative which represents a distribution of an amount previously treated as a notional dividend is not treated as a dividend.

Officials acknowledge that a co-operative company could be eligible to be taxed as a Maori authority if all its shareholders are Maori authorities – that is, if the co-operative company is a wholly owned company of a group of Maori authorities. Given this, officials consider that similar rules to those that currently apply to co-operative companies that allow them to attach imputation credits to cash distributions and notional distributions should be included in the Maori authority tax rules. This would allow a co-operative company that is taxed as a Maori authority to attach Maori authority tax credits to such distributions.

Recommendation

That the submission be accepted.

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[9] A shareholder's produce transactions is the supply or acceptance of produce or goods, such as milk, between a co-operative company and its shareholders.

[10] A co-operative company is able to pay a rebate of the profits arising from its shareholders' transactions to its shareholders. The amount of the rebate is deductible to the co-operative company and may be taxable to the shareholder if the shareholder transactions were taken into account in determining the taxable income of the shareholder.

APPLICATION DATES

Issue: Earlier enactment date for proposed rules

Submission
(22 – New Zealand Maori Council)

The proposed Maori authority rules should apply from the 2003-04 income year, rather than the 2004-2005 income year.

Comment

Officials consider that an earlier application date would not be appropriate. Maori authorities need sufficient time to inform themselves of the proposed changes and to make the necessary adjustments to their administrative and accounting systems. Likewise, Inland Revenue also requires sufficient time to develop and test appropriate systems and to undertake a comprehensive information campaign with Maori authorities and their tax advisers before the proposed changes take effect.

If the application date was brought forward as suggested, systems changes and information initiatives would have been required by 1 October 2002 – being the earliest commencement date of the 2003-04 income year for Maori authorities with early balance dates. In addition, the proposed new election process would mean that Maori authority entities would need to have made elections as early as October 2002.

Recommendation

That the submission be declined.

Issue: Income tax rate and resident withholding tax rate of 19.5%

Clause 68(6), 68(7) and 70(3)

Submission
(11W – Pukawa D3 Trust and Pukawa 5B Trust, 14W – Waipapa 9 Lands Trust, 17W – Rotohokahoka F6 Trust, 18W – Waiteti 2 Section 1A2 Trust, 19W – Waikuta 2 Trust, 20W – Fairy Springs Trust, 27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The proposed income tax rate and resident withholding tax rate for Maori authorities should apply from the 2003-04 income year, rather than the 2004-05 income year. These components of the proposed measures should be implemented without delay, mitigating the inequities of the current rules until they are replaced in the 2004-2005 income year.

Comment

Officials do not agree that the tax rate of 19.5% should apply from the 2003-04 income year.

In reviewing the tax laws for Maori authorities, the definition of a Maori authority is being refined and clarified. This means that a number of entities that are currently Maori authorities will cease to be Maori authorities for the financial year 2004-05. Modifying the tax rate now would be inconsistent and incur a revenue cost, and it would be more efficient to bring all the changes in concurrently.

Recommendation

That the submission be declined.

COMPLEXITY OF THE MAORI AUTHORITY CHANGES

Issue: Maori authority credits: transition may be too complex

Submission

(13 – Business New Zealand)

The Finance and Expenditure Committee should consider whether the proposed imputation system for Maori authorities would be too complex, and consider how the likely traps in the transition to it could be avoided.

Comment

Indications from some submissions is that maintaining a Maori authority credit account would be relatively simple and that completing an annual return for this account would be one of the simplest parts of the income tax return process. Although it is accepted that the compliance requirements associated with these changes may not be well understood in the broader Maori community, this problem could be addressed as part of the implementation phase through an appropriate information programme.

Recommendation

No recommendation required.

APPLY GENERAL TAX RULES TO MAORI AUTHORITIES

Issue: Maori authorities should be taxed according to their legal form

Submission
(10 – The New Zealand Retailers Association)

The proposed rules for Maori authorities should not be enacted and Maori authorities should be taxed according to their legal form.

Comment

Tax rules are intended to tax entities in the most appropriate way, taking into account an entity's specific characteristics, structures, conditions, and activities. This usually means applying tax rules that are consistent with an entity's legal form, because legal form closely determines an entity's specific characteristics.

However, the proposed measures relating to Maori authorities recognise that certain Maori organisations have unique characteristics that set them apart from ordinary companies and trusts. These characteristics include the difficulty of selling Maori 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.

Officials consider it inappropriate to apply the trust or company rules to Maori authorities without recognising the restrictions or constraints under which they must operate or the underlying marginal tax rates of the members.

If income of a Maori authority were taxed at the company rate of 33%, members of a Maori authority would be over-taxed. They would need to file a tax return or request an income statement in order to claim back the overpaid tax. If the income of a Maori authority were taxed as a trust, members of a Maori authority would need to file a tax return as required under the return filing requirements for beneficiaries that derive income from a trust. Thus applying general tax rules may involve higher compliance costs for Maori authorities and their members and administration costs for Inland Revenue.

Recommendation

That the submission be declined.

MISCELLANEOUS TECHNICAL ISSUES RELATING TO THE MAORI AUTHORITIES RULES

Issue: Dividend withholding payments in the Maori Authority Credit Account

Clause 44

Submission
(26W – Ernst &Young)

New subpart MK, which deals with the operation of the Maori Authority Credit Account, should be amended so that foreign dividend withholding payments (FDWP) can be credited and debited in this account.

Comment

FDWP is payable by a company that receives overseas dividends that are exempt under section CB 10 of the Income Tax Act. Like imputation credits, FDWP credits can be attached to dividends paid by a company. Officials agree that a Maori authority should be entitled to recognise FDWP credits and debits in its Maori Authority Credit Account and should also be able to attach FDWP to distributions in the same way as an imputation credit account company.

Recommendation

That new sections MK 4 and MK 5 be amended to provide for the crediting and debiting of FDWP in the Maori Authority Credit Account, in the same way as FDWP is credited and debited to an imputation credit account.

Issue: A Maori authority company should be able to maintain a FDWP account

Submission
(Matter raised by officials)

The bill should clarify that a company that is taxed as a Maori authority (a Maori authority company) can maintain a FDWP account.

Comment

Subpart MG of the Income Tax Act allows a resident company to elect to maintain a dividend withholding payment account (FDWP account) for an imputation year. A FDWP account operates in a similar way to an imputation credit account. The credits to a FDWP account usually arise owing to FDWP credits attached to dividends received from other resident companies or FDWP payable by the company on certain

exempt dividends that it receives from overseas. A FDWP account company is able to attach FDWP credits to the dividends it pays in the same way as imputation credits.

Officials consider that a company that operates a FDWP account should be able to continue to maintain that account when it opts to be taxed under the Maori authority rules. Unlike the imputation credit account, the FDWP account should not be subsumed into the Maori Authority Credit Account. The reason for this is that should the Maori authority company subsequently elect out of the Maori authority rules, any FDWP credit should be maintained.

Under the proposed Maori authority rules, when a company that is taxed as a Maori authority opts out of those rules, any credit balance in its Maori Authority Credit Account is carried through to its imputation credit account. Because excess imputation credits are not refundable, whereas excess FDWP credits are, the conversion of FDWP credits to imputation credits on exiting the Maori authority tax rules would be penal. The ability to continue to maintain a FDWP account avoids the compliance costs associated with tracing FDWP credits and debits in a Maori Authority Credit Account to allow for the crediting or debiting of the FDWP account when the company exits the Maori authority rules.

Furthermore, a Maori authority company should be able to elect to be a FDWP account company at any time.

Recommendation

That the submission be accepted.

Issue: Dividend withholding payment deductions at 19.5%

Submission

(Matter raised by officials)

The rate applied to calculate an amount of dividend withholding payment to be deducted from a dividend received by a Maori authority company should be 19.5%.

Comment

Under the current rules, certain foreign-sourced dividends received by a resident company are subject to a dividend withholding payment deduction at the rate of 33%. This rate is linked to the company tax rate of 33%. Since a Maori authority company would be subject to a 19.5% tax rate, officials consider that the rate applied to calculate dividend withholding payment should be 19.5%. This would ensure that the amount of dividend withholding payment to be deducted and credited to distributions (dividends) by the Maori authority company would be based on the same rate and thereby avoid the accumulation of excess dividend withholding payment credits which might not be able to be utilised.

Recommendation

That the submission be accepted.

Issue: Calculation of branch equivalent tax credits for Maori authorities when New Zealand losses are used

Submission
(Matter raised by officials)

For companies that are taxed as Maori authorities, the provisions that allow a branch equivalent tax account credit to be created when New Zealand losses are offset against attributed foreign income should be based on the Maori authority tax rate rather than the company tax rate.

Comment

The international tax rules provide that attributed foreign income from a controlled foreign company is subject to tax in New Zealand, and foreign dividends received by a New Zealand company are subject to foreign dividend withholding payment.

To prevent double taxation of the same underlying income when it is attributed and also when it is distributed as a dividend, the branch equivalent tax account mechanism was designed. The 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 and so no liability to income tax arises.

When losses from New Zealand sources are used, the calculation of the branch equivalent tax account credit is based on the company tax rate. For companies taxed as Maori authorities this is inappropriate as any subsequent dividend withholding payment liability, if a previous officials' submission is accepted, would be based on a 19.5% rate.

Officials consider that for companies taxed as Maori authorities, the branch equivalent tax account credit calculated when New Zealand losses are offset against attributed foreign income should be based on the Maori authority tax rate rather than the company tax rate. This would require amendments to sections MF 4 and MF 8 of the Income Tax Act 1994.

Recommendation

That the submission be accepted.

Issue: Treatment of foreign tax credits

Submission
(27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

Maori authorities should be able to pass foreign tax credits received in respect of foreign-sourced income to their underlying owners (members).

Comment

When overseas income is treated as gross income derived in New Zealand, a credit for income tax paid overseas is allowed against the New Zealand income tax applicable to the overseas income. In most cases the credit is limited to the lesser of the actual overseas tax paid on the overseas income and the New Zealand tax applicable to the overseas income.

Under current rules, there is no pass-through of foreign tax credits to the underlying owners, except when overseas income is derived by a trust and is paid out as beneficiary income. In terms of the exception, overseas income is not derived by the trust, but by the beneficiaries and so it is appropriate that the beneficiary is able to claim a credit for the foreign tax paid. In all other cases, the person (including a company) who derives the overseas income is the only person who can claim a credit for overseas tax paid.

Officials consider that allowing Maori authorities to pass through foreign tax credits would be inconsistent with current tax policy.

Recommendation

That the submission be declined.

Issue: Record-keeping requirements of Maori authorities

Submission
(Matter raised by officials)

Under the record-keeping provision, a company that operates an imputation credit account, a dividend withholding payment account or a branch equivalent tax account is required to keep sufficient records to allow for the ascertainment of every credit and debit balance to these various accounts and the amount of any imputation credits or dividend withholding payment credits attached to dividends paid. Similar rules

should apply in respect of a Maori authority that operates a Maori Authority Credit Account.

Comment

As a Maori authority will operate a Maori Authority Credit Account, which is similar to an imputation tax credit account, the same record-keeping requirements that apply to a company in relation to an imputation credit account should apply to a Maori authority in relation to its Maori Authority Credit Account.

Recommendation

That the submission be accepted.

Issue: Annual returns of income not required to be filed by members of a Maori authority

Clause 79

Submission
(Matter raised by officials)

An individual is generally not required to file an income tax return if he or she earns employment income subject to the PAYE rules, interest or dividends subject to the resident withholding tax rules or interest or dividends from overseas that have been subject to withholding tax. Other non-return filing requirements must also be met.

The current non-filing rules apply to a distribution from a Maori authority because that distribution is deemed to be a dividend subject to the resident withholding tax rules. However, this would not be the case under the proposed Maori authority rules, since distributions from a Maori authority are not specifically defined as a dividend.

Comment

The omission outlined above was not intended. Officials consider that the non-return filing criteria should be amended to specifically cover distributions from a Maori authority that have been credited with Maori authority tax credits or have had resident withholding tax deducted.

The effect of this proposal is that under clause 79 of the bill, an individual whose total income exceeds $38,000 would be required to request an income statement or file a tax return if he or she also received a taxable Maori authority distribution greater than $200. A "taxable Maori authority distribution" is defined in clause 65(19) to mean a distribution to which a Maori authority credit has been attached or is treated as being attached under new section NF 8A.

Recommendation

That the submission be accepted.

Issue: Provision of members' names and IRD numbers

Clause 87

Submission
(Matter raised by the Committee)

The Committee asked officials whether Maori authorities would be required to provide Inland Revenue with names and IRD numbers of all members who are on higher marginal tax rates than the Maori authority tax rate.

Comments

New section 68B in the Tax Administration Act 1994 requires Maori authorities to furnish a distribution statement to Inland Revenue for an income year. The statement shows the details on distributions and Maori authority credits in aggregate form. While there is no specific requirement for Maori authorities to provide the names and IRD numbers of members who received distributions during the income year, Inland Revenue may request further information of this kind under its information-gathering powers (section 17 of the Tax Administration Act 1994). Under the new section 31 of the Tax Administration Act, a Maori authority will be required to provide members with a notice of the amount distributed, and a copy of this notice could be requested.

This proposed provision is consistent with the current requirement for companies to provide a company dividend statement. It is likely that if Inland Revenue suspected that a member of a Maori authority with a 33% or 39% marginal tax rate was not complying with his or her return filing obligations, it would require the Maori authority to provide details of any distributions to that member. Furthermore, trustees are not required to advise the department of the names and IRD numbers of beneficiaries who have received distributions from trusts.

Recommendation

No recommendation required.

Issue: Continuity rules: succession to interests in Maori authorities

Clauses 24 and 65(6)

Submission
(22 – New Zealand Maori Council)

The inherited interests in Maori authorities whose legal form is that of a company should be deemed to have been held by the inheritor from the time his or her predecessor in title held those interests. The submission seeks express recognition that succession following the death of a registered owner does not of itself breach the continuity rules.

Comment

Officials consider that the current continuity rules provide adequately for succession to interests in Maori authorities, so no amendment is required.

New section HI 1(2) provides that a Maori authority that is a company is subject to the continuity provisions in the Income Tax Act. One of these provisions is section OD 5(2), which provides relief in situations where changes in ownership occur when a person inherits an interest in a company on the death of a registered shareholder. The person who inherits the interest is deemed to have held that share from the time the deceased person acquired that interest – so there is no breach in continuity of ownership.

Officials consider that section OD 5(2) should address the submission's concern in respect of inherited interests in Maori authorities, and would be particularly relevant to changes in the underlying ownership of Maori incorporations.

Recommendation

That the submission be declined.

Issue: Maori authority trusts should retain exclusion from income assessable to beneficiaries

Clause 17

Submission
(26W – Ernst & Young)

Maori authorities and their members should retain their exclusion from section GC 14(1). Clause 17 should be amended so that section GC 14(2) is not repealed, but is amended so that the exclusion applies to a Maori authority or a member of a Maori authority.

Comment

The submission claims that since participation in Maori authorities is restricted, they would be regarded as an unsuitable vehicle to use in any scheme for the purpose of defeating the intent and application of section HH 3. It is therefore unlikely that any effect of defeating section HH 3 would be intentional and, if such an effect were to arise it would have been unavoidable. For this reason subsection GC 14(2) should be retained and expanded to include all Maori authorities, regardless of whether or not they have elected to apply Part HI.

Officials agree with this submission but consider that the exclusion should apply only to Maori authorities and their members and not to trusts that have elected to cease to be a Maori authority. This position is consistent with the policy that when a Maori authority elects to apply the general rules it should be subject to all relevant provisions under the general rules.

Recommendation

That clause 17 be amended so that section GC 14(2) is not repealed but is amended so that the exclusion applies to a Maori authority or a member of a Maori authority.

Issue: Definition of "tax advantage" and "tax credit advantage"

Clause 18

Submission
(16 – PricewaterhouseCoopers)

The definitions of "tax advantage" and "tax credit advantage" in section OB1 of the Income Tax Act should be consequentially amended to reflect the insertion of the new section GC 27A. The new section is an anti-avoidance provision which applies to arrangements to obtain a tax advantage in relation to Maori authority credits.

Comment

Officials agree that the definitions of "tax advantage" and "tax credit advantage" should be amended to reflect the new section GC 27A, which is modelled on the existing imputation tax credit anti-avoidance provision. The current definitions of "tax advantage" and "tax credit advantage" refer back to the imputation tax credit anti-avoidance provision and should also cater for the new Maori authority tax credit anti-avoidance provision.

Officials also recommend that the definition of "account advantage" in section OB 1 be amended to include a reference to the new Maori authority tax credit anti-avoidance provision. The new provision includes a definition of "account advantage".

Recommendation

That the submission be accepted, and that the definition of "account advantage" be amended to include a reference to the new Maori authority tax credit anti-avoidance provision.

Issue: Transitional provisions: market value calculations

Clause 24

Submission

(26W – Ernst & Young)

- The reference to "market value" in new section HI 7(6)(a) should be clarified so that it refers to the market value of the property that is deemed to be acquired under section HI 7.
- The reference in new section HI 7(6)(b) to "cost price" should be amended to "cost" to ensure that depreciation can be claimed on the property that has no "cost price", such as property that was settled on a trust.

Comment

The proposed new section HI 7 deals with situations where a company or a trust re-enters the Maori authority rules. The purpose of new section HI 7 is to treat the trust or company as realising its assets at market value and subsequently re-acquiring them at market value. This is to ensure that before an entity re-enters the Maori authority rules, any tax liabilities on property such as trading stock is crystallised at the company or the trust tax rate.

For depreciation purposes, however, the cost of the property would be the lower of the market value of the property on the deemed acquisition date or the original cost of the property to the company or the trust. This rule ensures that the Maori authority does not receive an uplift in the base price of the property for depreciation purposes.

Officials agree that new section HI 7(6)(a) should be amended to refer to the market value at which the property is deemed to be acquired under the new section HI 7.

In the depreciation rules, the term "cost of the property to the taxpayer" is used for the purposes of determining base value for depreciation purposes. Officials agree that the term "cost price" in new section HI 7(6)(b) is not consistent with the depreciation rules and should be amended to "cost".

Recommendation

That the submissions be accepted.

Issue: Retrospective credit provisions, non-cash dividends and transfer pricing adjustments

Clause 44(1)

Submission
(26W – Ernst and Young)

The imputation rules allow for imputation credits to be attached retrospectively to a non-cash dividend that arises as a result of the transfer pricing rules. A similar provision should apply to Maori authorities in relation to non-cash distributions.

Comment

Officials acknowledge that a non-cash distribution could arise in a transfer pricing context, albeit in very limited circumstances. This could occur if a Maori authority disposes of property, such as trading stock, for inadequate consideration in a cross-border arrangement to a member who is treated as an associated person under the international tax rules. Given this potential, officials consider that Maori authorities should have the ability to attach Maori authority tax credits retrospectively to a non-cash distribution in the same way as a company can do so in relation to imputation credits.

Recommendation

That new subpart MK be amended to allow Maori authority credits to be attached retrospectively to a non-cash distribution that arises as a result of the transfer pricing rules.

Issue: Further tax payable – references to non-existing subsection

Clause 44(1)

Submission
(26W – Ernst & Young)

Clause 44(1) should be amended so that the references to the non-existent "subsection (7)" in the proposed section MK 8(1) and section MK 8(3) are removed.

Comment

Officials agree with the submission.

Recommendation

That section MK 8(1) and section MK 8(3) be amended to remove redundant references.

Issue: References to dividend withholding payment credits

Clause 33

Submission
(16 – PricewaterhouseCoopers)

Section LB 1(3) should be amended after the second reference to dividend withholding payment credits and not just the first, as in the current draft of the bill.

Comment

Section LB 1(3) deals with the calculation of imputation credits or dividend withholding payment credits in relation to a beneficiary of a trust who derives dividends with an imputation credit or a dividend withholding payment credit attached. The bill amends the section to deal with the proposed Maori authority credits in the same manner.

Clause 33(4)(b) inserts the words ", or distributions with a Maori authority credit attached," after the word "attached", which follows the second reference to dividend withholding payment credits. The submission appears to have overlooked this.

Recommendation

That the submission be declined.

Issue: Payments not resident withholding income – grammatical error

Clause 60(4)

Submission
(16 – PricewaterhouseCoopers)

The extra and first "or" that will remain after the insertion of the words ", or a distribution from a Maori authority" by clause 60(4) should be removed by that clause. If left unchanged, the clause would result in the wording:

> "…in the case of a payment of either interest <u>or</u> dividends <u>or</u> a distribution from a Maori authority."

Comment

As argued by the submission, the first occurrence of the word "or" would be superfluous. For section NF 2(7) to be grammatically correct it will also be necessary to remove the word "either", which cannot refer to more than two alternatives.

Recommendation

That the necessary corrections be made.

Issue: Definition of "member" of a Maori authority

Clause 65(13)

Submission
(27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The definition of "member" should be amended to reflect the fact that membership of a Maori authority could take any of a number of forms such as owner, shareholder or beneficiary.

A further amendment should be made to clarify that trusts and other Maori authorities can be a person or group of persons for the purposes of the term "member" in the Maori authority rules.

Comment

We agree that the definition of "member" should include a reference to owners, members, shareholders or beneficiaries to reflect the fact that membership of a Maori authority can take any of a number of forms.

We also agree with that the phrase "group of persons" may be required to cover a number of trustees in a trust or an unincorporated group of persons.

Recommendation

That the submission be accepted.

Issue: Definition of "member" to remove reference to "distribution"

Clause 65(13)

Submission
(27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The definition of "member" in clause 65(13) should be amended to remove reference to "distribution" in the definition of members.

Comment

Officials agree with this submission. The proposed definition of "member" and "distribution" should be redrafted to avoid this circularity.

Recommendation

That the definitions be clarified.

EXTENDING THE DONATION DEDUCTION FOR MAORI AUTHORITIES

Clause 7

Issue: Extension of the deductible donations available under section DI 2

Submission
(22 – New Zealand Maori Council)

The level of deductible donations should be increased to 20 percent for Maori authorities in recognition of their "... Special status..., close relationship to their people, and their present depressed status (arising from breaches of the Treaty)."

The new section DI 2, proposed in clause 7 of the bill, would allow Maori authorities to deduct up to 5 percent of net income in donations to charities or Maori associations from 2004-2005. The cap should be raised because the definition of "Maori authority" is narrowly defined, and because Maori authorities are likely to direct their charitable giving to Maori who "are at a significant disadvantage in socio-economic terms compared with the rest of New Zealand...."

Comment

Under the current provision, the deduction for donations paid to Maori associations is capped at 5 percent of the Maori authority's net income. The bill extends the provision to allow a Maori authority to claim a deduction for donations paid to organisations that have donee status. A similar provision in the bill for donations paid by companies has a cap of 5 percent. For consistency purposes, officials consider that the cap should be aligned.

Recommendation

That the submission be declined.

Issue: Application date

Submission
(22 – New Zealand Maori Council, 27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

Clause 7(2) should be amended to provide that the proposed section DI 2 apply from the 2003-2004 income year rather than the 2004-2005 income year. These provisions will not be part of the proposed Maori authorities rules, so there is no reason to defer their application.

Comment

Officials agree with the submission point. There is no reason that the amendment cannot apply from the 2003-04 income year.

Recommendation

That the submission be accepted and the amendment apply from the 2003-04 income year.

RELAXING THE PUBLIC BENEFIT REQUIREMENT

Clause 66

Issue: The amendment does not go far enough

Submission
(7 – Dunedin Community Law Centre)

New section OB 3A should be amended so that Maori groups are not prevented from obtaining a "charitable" income tax exemption because of their cultural foundation of whakapapa (genealogy) and whanaungatanga (family ties). Even with the removal of the "blood ties" barrier, some iwi or hapu groups might fail the public benefit requirement owing to their small numbers or the degree of relationship between the beneficiaries.

The suggested change would be consistent with the Court of Appeal's comments in *Latimer and Others v Commissioner of Inland Revenue*,[11] in particular that "in the New Zealand context it is, we think, impossible not to regard the Maori beneficiaries of the trust, both together and in their separate iwi or hapu groupings, as a section of the public."

Comment

Officials do not support the suggested change on the basis that it is inconsistent with the policy underlying the proposed amendment. The suggested change contemplates specific exemption for iwi and hapu-based entities from the public benefit requirement, whereas the proposed amendment is intended to apply to all trusts, societies or institutions whose beneficiary class is defined by reference to blood ties.

Recommendation

That the submission be declined.

Issue: Hapu should be recognised as charitable as of right

Submission
(22 – New Zealand Maori Council)

Given the historic and constitutional position of hapu, hapu should be capable of being charitable in their own right, if they meet the following requirements:

[11] CA215/01.

(a) they have 800 members (including children) on their rolls (circumventing the vagueness of the public benefit requirement and limiting dispute over the definition of hapu);

(b) they have altruistic objectives (replacing the charitable purposes requirement, and going to the heart of the term "charity");

(c) their activities are not carried out for the private pecuniary benefit of any individual (as required under the present tax rules for charitable societies and institutions); and

(d) they are accountable to their members (reinforcing (b)).

Comment

Questions of the constitutional status of hapu are outside the scope of this tax review. The question of whether hapu should be "charitable" in their own right extends beyond mere consideration of the public benefit requirement.

Recommendation

That the submission be declined.

Issue: The "public benefit" provision should avoid implying a law change

Submission
(22 – New Zealand Maori Council, 27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The provision that deals with the blood ties component of the public benefit test should be seen as a clarification rather than a law change. However, it could be read as implying that the blood-ties component of the public benefit test is to be considered when determining the tax status of trusts, societies or institutions established before its application date of 1 April 2003. This implication should be avoided. The New Zealand Maori Council considers that the amendment should apply immediately, with no stated commencement date, and should be declared to be for the avoidance of doubt.

Comment

Officials do not consider that the suggested change is necessary. The intention of the proposed amendment is to negate the view expressed in *Oppenheim v Tobacco Securities*[12] that a beneficiary class connected by blood ties cannot meet the public benefit requirement. The amendment applies from the 2003-04 income year. This means that in determining whether an entity meets the public benefit requirement before the proposed amendment is enacted, regard must be had to how the courts have determined the public benefit requirement.

[12] [1951] 1 All ER31.

Recommendation

That the submission be declined.

Issue: Clarify that Maori collective entities come within the terms "society" or "institution"

Submission

(27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The bill should clarify that Maori collective entities other than trusts will come within the meaning of "society" or "institution" for the purposes of the charitable exemptions in section CB 4(1)(c) and (e) and the proposed section OB 3A(2). Entities such as unincorporated marae committees should not be excluded from these provisions simply because they may not satisfy the definitions of "society" or "institution".

Comment

Neither the terms "society" nor "institution" are defined in the Income Tax Act 1994, but based on ordinary, dictionary definitions, both terms have a wide meaning:

> *Society ... an association of persons united by a common aim or interest or principle…*
>
> *Institution ... an organisation…*
>
> *(Both from the Concise Oxford Dictionary of the English Language)*

Bodies that are registered under the Incorporated Societies Act 1908 should fall within the meaning of "society". In addition, on the basis of the very wide meaning ascribed to the term as set out above, virtually any body calling itself a society should qualify. In relation to companies, Justice Thorp in *CIR v NTN Bearing Saeco (NZ) Ltd* [13] found that a company would likely be considered to be an institution for the purposes of the "charitable" income tax exemption. He was not required to consider the issue in the case before him, but he did refer to the definition in the *Shorter Oxford Dictionary* and state that he considered that there were a number of parts of the definition which could apply to a company. On this basis there are reasonable grounds for maintaining that a company is an institution.

Given the wide meaning of the terms "society" and "institution", it seems reasonable that Maori collective entities should fall within either of the terms. Thus entities such as unincorporated marae committees should also meet the requirements of a "society" or "institution".

Recommendation

That the submission be declined.

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[13] (1986) 8 NZTC 5,039.

Issue: Definition of "charitable purpose" should be more important than the public benefit requirement

Submission
(7 – Dunedin Community Law Centre)

The purpose of an organisation seeking charitable tax status should be more important than the public benefit requirement, thus removing a significant impediment to Maori groups seeking tax exemption.

Comment

The key requirement for a "charitable" income tax exemption is that an entity must have a charitable purpose.

"Charitable purpose" is defined in section OB 1 of the Income Tax Act 1994 as including:

> *… every charitable purpose, whether it relates to the relief of poverty, the advancement of education or religion, or any other matter beneficial to the community".*

The categories of relief of poverty, education, religion or other community benefits are known as the four "heads" of charity, and are based on the Charitable Uses Act 1601 (sometimes also known as the Statute of Elizabeth). They are not defined in legislation. Instead, their meaning is to be found in court decisions in New Zealand, the United Kingdom, and elsewhere.

Officials note, however, that the public benefit requirement and its relevance varies for different categories of charitable purpose. For example, the public benefit requirement is not a pre-requisite for charities for the relief of poverty.

Recommendation

That the submission be declined.

Issue: The public benefit changes should apply in general law

Submission
(22 – New Zealand Maori Council, 29 – New Zealand Law Society)

The changes to "charitable purposes" should apply immediately for all purposes at law, rather than just income tax law. The proposed amendment would only clarify tax law, but the "blood ties" issue remains – for example, for the purposes of registration under the Charitable Trusts Act 1957. This may cause confusion for some entities.

The Courts may not consider the proposed change to the public benefit requirement when determining charitable status under the Charitable Trusts Act 1957. The reverse applied in the past, when the definition of "charitable" in tax law was narrower than the general law definition.[14]

The New Zealand Maori Council also considered that the suggested change would be consistent with section 4 of the Ngati Rarua-Atiawa Iwi Trust Empowering Act 1993, and clause 5 of the Te Whanau-a-Taupara Trust Empowering Bill, which declare the relevant trusts to be charitable for all purposes at law.

Comment

Officials acknowledge that the submission raises a valid point that the government should consider. However, the submission seeks a change that goes beyond the scope of this bill.

Recommendation

That the submission be declined.

Issue: The amendment should not be adopted until the likely effects have been clarified

Submission
(31W – Minter Ellison Rudd Watts)

Further analysis should be conducted and made available on the likely effects of the proposed amendment before it is enacted.

The amendment should not be adopted until the following questions have been answered:

- whether the intended result is that substantially all Maori entities are now intended to be tax-exempt under the charitable exemption, as compared to a prior position where that was not the case;
- whether the effect of the amendment is to increase the level of assets or income held by Maori entities that are tax-exempt charities from a certain dollar level existing prior to the change to a new higher dollar level; and
- whether essentially the same level of charitable exemption as existed before the amendment is passed is expected to exist after the amendment is passed and the intention is just to achieve greater clarity.

[14] See *Halsbury's Laws of New Zealand*, paras 287-288.

Comment

The amendment is intended to remove the blood ties barrier of the public benefit requirement for all trusts, societies or institutions seeking “charitable” tax exemption. However, such entities must still meet the other requirements of a charity – that is, they must have a “charitable purpose”, that purpose must be for the benefit of the public or an appreciably significant section of the public, and the entity must not be carried on for the private pecuniary profit of any individual. It is not intended that substantially all Maori entities would automatically secure “charitable” tax exemption.

The amendment is more relevant to those entities that define their membership by reference to whakapapa to a named person. Those Maori entities that have secured “charitable” tax exemption have been eligible because their beneficiary class is not defined strictly by reference to whakapapa to a named person. For example, the beneficiary class may encompass all Maori residing in the particular locality or include a number of hapu.

Some entities that would not have been eligible for charitable status might become so as a result of the proposed change, and their assets may grow as a result. However, the intention of the amendment is not to target a specific level of growth in charitable assets or income.

Any analysis of the additional revenue cost of the proposed clarification would be speculative, but with the continuing application of the other requirements of charitable tax exemption, officials expect that the cost would be modest.

Recommendation

That the submission be declined.

Issue: The proposed amendment should not be adopted

Submission
(4 – C Gibbons and Holdings Ltd)

The rules for obtaining charitable status should not be changed. To give credibility to the status of charities, the “public good” test must apply in order to avoid damaging the viability of private companies.

Comments

The amendment is limited to relaxing the blood ties component of the public benefit requirement. To qualify for a “charitable” tax exemption, an entity must still have a charitable purpose and must satisfy the other requirements of a charity, such as the charity must not be carried on for the private pecuniary gain of any individual.

The submission is concerned about the impact of charitable businesses on other businesses. In general, an income tax exemption would not alter such decisions as how much a business should produce, what prices it should charge, what price it should pay for assets, or what proportion of its income it should invest or consume, so long as the exemption applies to all income of the business. For example, there is no reason why an income tax exemption would encourage a business to pay a higher price for property than other bidders would. Even though its after-tax return on such an investment may be higher than the return that non-exempt businesses could obtain, its return on any other investment – for example, making a loan to a finance company – would also be higher. Therefore there is no incentive to "beat the market" on price.

A charitable business is able to retain more income in an absolute sense and therefore grow its retained capital faster than other businesses. This advantage needs to be balanced against other constraints charitable businesses face. They do not have access to equity from other investors because paying out a dividend to a non-charitable owner would violate the requirements of charitable status. Furthermore, charitable businesses are not commercially driven in the manner of private businesses, in which the strong incentive of increased personal wealth encourages growth. The ability of privately owned businesses to compete with charitable businesses is borne out by the co-existence of charitable and non-charitable businesses in many industries in New Zealand.

Recommendation

That the submission be declined.

Issue: Definition of "member" for the purposes of new section OB 3A

Submission
(31W – Minter Ellison Rudd Watts)

The definition of "member" in section OB 1 of the Income Tax Act 1994 should be amended so that it applies to beneficiaries of a trust.

Comment

The proposed section OB 3A(2) is intended to deal with blood-ties among beneficiaries of trusts, but as noted by the submission, beneficiaries of trusts are not "members" per se under general law. Officials agree with the submission and recommend that a consequential amendment should be made to ensure that beneficiaries of a trust are reflected in the new section OB 3A.

Recommendation

That the submission be accepted.

MARAE CHARITABLE EXEMPTION

Clause 66

Issue: The amendment should be removed

Submission
(7 – Dunedin Community Law Centre)

The proposed exemption should be removed. They are too restrictive in terms of the location of marae and their ability to develop, are potentially discriminatory compared with the way churches and public halls are treated, and may preclude marae-based organisations from obtaining charitable exemption under the general rules. The proposed changes to the public benefit requirement and the changes to "charitable purposes" requirement proposed by the Charities Working Party mean that marae-based organisations could secure exemption without the proposed changes.

Comment

Officials consider that a specific exemption for marae would still be required for entities that administer marae situated on Maori reservations. The amendment would obviate the need for entities that administer the Maori reservation to establish a separate body for the specific purpose of administering the marae in order to avoid breaching the alienation rule associated with the reservation.

Recommendation

That the submission be declined.

Issue: Marae funds should be able to be applied to charitable purposes

Submission
(11W – Pukawa D3 Trust and Pukawa 5B Trust, 14W – Waipapa 9 Lands Trust, 17W – Rotohokahoka F6 Trust, 18W – Waiteti 2 Section 1A2 Trust, 19W – Waikuta 2 Trust, 20W – Fairy Springs Trust, 22 – New Zealand Maori Council, 27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The proposed exemption should be broadened to include marae applying their funds towards cultural activities, such as traditional tangi, and to wider social objectives such as the health, education, and welfare of its community.

The Federation and Maori Authorities and the Office of the Maori Trustee consider that the proposed amendment would benefit very few marae, and involves culturally inappropriate restrictions. The proposed amendment would require separate entities for the administration and physical maintenance of marae and for the activities that take place there. Restrictions on the ability of marae to claim charitable status should

be directed at the elimination of the ability of individuals to derive private pecuniary profit – as currently provided in the charitable exemptions in CB 4(1)(c) and (e).

The New Zealand Maori Council submitted that if the bill is not amended to allow hapu and iwi to be "charitable" in their own right, marae should be permitted to apply their funds to charitable purposes.

Comment

The government discussion document *Taxation of Maori organisations*, published in 2001, proposed that marae should be permitted to apply their funds to purposes that supported the activities traditionally carried out on the marae. Submissions received on the discussion document strongly opposed any move that would allow the courts to interpret the meaning of "supporting activities traditionally carried out on the marae" as this would be seen as the court determining the tikanga of the marae. Such a move would have been considered totally inappropriate. For this reason, the exemption proposed in this bill did not include marae activities.

Restricting the amendment to apply to marae funds solely applied to the maintenance of the physical structures of the marae would mean that very few marae would benefit from it. Officials consider that denying a charitable income tax exemption on the grounds that some of a marae's funds are applied to recognised charitable purposes other than the maintenance and administration of its physical structures would make the new provision less relevant and would be inconsistent with the general policy on charitable exemptions. In determining whether a marae is applying its funds for charitable purposes (other than to administer and maintain the marae's physical structure), the current rules as to what is a charitable purpose would apply.

Recommendation

That the submission be declined, but note that officials recommend that new section OB 3A(1)(b) be amended to clarify that marae funds can be applied to charitable purposes.

Issue: The exemption for marae should be extended

Submission
(22 – New Zealand Maori Council)

If the bill is not amended to allow hapu and iwi to be charitable in their own right, the proposed exemption should be extended to cover marae that adhere to customary Maori practices, serve a significant number of Maori and are recognised by other marae in the area. Most urban marae are not on Maori reservations and some new marae, such as university marae and Kokiri marae, may have difficulty becoming reservations as they may not be on Maori freehold land.

Comment

The specific marae exemption is intended to apply to marae situated on Maori reservations only. However, it was never intended that entities not meeting the specific exemption would be precluded from seeking charitable status under the general exemption.

Recommendation

That the submission be declined, but note that officials recommend that the new section OB 3A (1) be amended to clarify that it does not prevent marae from qualifying for general "charitable" tax exemption.

Issue: Marae should be included in the definition of "charitable purposes"

Submission
(27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The proposed exemption should be amended to "include" marae in the definition of "charitable purpose".

Comment

Including marae in the definition of "charitable purpose" would mean that entities administering marae would be "charitable" under the general exemption provision. Such an inclusion would go further than the proposed policy permits.

Recommendation

That the submission be declined.

Issue: The amendment should not be limited to marae on Maori reservations

Submission
(27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The proposed exemption should be amended so that it does not require marae to be situated on a Maori reservation for the exemption to apply. This requirement is unduly restrictive and is likely to prejudice urban marae.

Comment

As mentioned earlier, the proposed amendment applies to entities that administer marae situated on Maori reservations and is intended to provide relief for such entities from the requirement that assets must be applied for charitable purposes in perpetuity. Consistent with the proposed policy, entities that do not meet the specific requirements of the proposed amendment can apply for charitable status under the general exemption provision.

Recommendation

That the submission be declined.

Issue: The amendment should apply from the 2003-04 income year

Submission
(22 – New Zealand Maori Council, 27 – Federation of Maori Authorities, 28 – The Office of the Maori Trustee)

The proposed exemption for marae should apply from the 2003-04 income year, and not the 2004-05 income year, as currently proposed.

Comment

Since the amendment is not linked to the proposed Maori authority rules there is no reason the amendment should not apply from the 2003-04 income year.

Recommendation

That the amendment apply from the 2003-04 income year.

Issue: Alienation of Maori land

Submission
(7 – Dunedin Community Law Centre)

New section OB 3A should be amended to include a specific clause that prohibits the alienation of Maori land on the winding up of a charitable trust, and that any issue relating to the winding up of a trust involving Maori land must be referred to the Maori Land Court. This is in recognition of the impacts of the alienation of Maori land in the past.

Comment

The proposed exemption is intended to provide relief for trustees that administered marae on Maori reservations from the requirement to alienate land subject to the reservation. Officials consider that the submission's concern should be addressed as part of clarifying the intention of the amendment.

Recommendation

That the submission be declined.

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. The discussion document *Taxpayer compliance, standards and penalties: a review*, released in August 2001, represented the findings of the first stage of the review. This bill contains most of the proposals relating to shortfall penalties. The key ones are:

- The penalties for lack of reasonable care and unacceptable tax position are being reduced to 10 percent if the breach is the taxpayer's first breach of a required standard of behaviour. If the taxpayer does not take reasonable care in his or her tax affairs for the following four years, the shortfall penalty for any subsequent breach will be imposed at 20 percent.
- The legislation is being amended to provide that a shortfall penalty can be imposed in cases where a tax position taken is unacceptable but the taxpayer has not "interpreted" the law.
- The lowest threshold for the application of the penalty for having taken an unacceptable tax position is being increased from $10,000 to $20,000.
- A $50,000 cap is being introduced 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.

Submissions were generally opposed to replacing the unacceptable interpretation penalty with an unacceptable tax position penalty, and generally considered that the measures relating to reducing penalties for good behaviour and the $50,000 cap on penalties need extending in various ways.

In response, officials propose minor amendments in relation to most of the measures, extending the scope of the measures which are taxpayer-friendly, but not as far as requested in submissions. The main recommendations by officials to the Committee following submissions are that amendments be made to the bill to:

- extend the good behaviour provisions to include all shortfall penalties; and
- amend the proposal to ensure that a shortfall penalty for an unacceptable tax position is not imposed on calculation or processing errors.

Clauses 109-113

Issue: Application date

Submission
(12 – Institute of Chartered Accountants of New Zealand)

The legislation should be made clear as to whether it applies to penalties charged on or after 1 April 2003, or shortfalls incurred after that date.

It is preferred that the new regime apply to penalties charged on or after 1 April 2003.

Comment

As currently drafted, the proposals relating to shortfall penalties generally apply on and after 1 April 2003. Officials agree with the submission that it could be uncertain as to whether the proposed amendments apply to penalties charged on or after 1 April 2003, or shortfalls incurred after that date.

In relation to the good behaviour proposal, officials recommend that the proposal apply to tax positions taken on or after 1 April 2000, apart from those instances where a shortfall penalty has already been imposed, in which case the higher penalty rate will stand. This will ensure that tax shortfalls identified after the date of enactment but relating to tax periods starting after 1 April 2000 benefit from the "good behaviour" provisions. It ensures that the reduced penalty rates take effect as soon as possible and is consistent with the submissions.

We also propose that the application date make it clear that if a taxpayer has had a shortfall penalty imposed under the old rates, that penalty would not be taken into account in determining the rate of penalty to be charged on a subsequent breach. In other words, for the purposes of the "good behaviour" proposals, taxpayers start with a "clean slate".

In relation to the change allowing a penalty to be imposed in cases where the taxpayer has not taken an acceptable tax position, officials consider that it would be fairer if the proposed amendments applied to tax shortfalls incurred on or after 1 April 2003. If the proposal were to apply to penalties imposed after 1 April 2003, taxpayers who had tax shortfalls in similar periods might be treated differently, depending on whether the penalty was imposed before or after 1 April 2003.

Recommendation

That the submission be accepted to the extent that:

- the proposed amendment taking into account taxpayers' good behaviour apply to tax positions taken on or after 1 April 2000, apart from those instances where a shortfall penalty has already been imposed, and that taxpayers will start with a "clean slate"; and
- the amendment to allow an unacceptable tax position penalty to be imposed in cases where no interpretation was made apply to tax shortfalls incurred on or after 1 April 2003.

GOOD BEHAVIOUR

Clause 111

Issue: Period too long

Submission

(10 – New Zealand Retailers Association, 12 – Institute of Chartered Accountants of New Zealand, 13 – Business New Zealand)

A more equitable approach is to reduce the clean period to less than four years and remove the proposal to apply the discount separately in respect of each tax type. (*New Zealand Retailers Association)*

A four-year period is too long, and a two-year period would be more realistic in today's environment. *(Institute of Chartered Accountants of New Zealand)*

The four-year "probationary" period of "good behaviour" for lack of reasonable care and unacceptable interpretation should be reduced to two years. *(Business New Zealand)*

Comment

The discussion document *Taxpayer compliance, standards and penalties: a review* recommended a seven-year period. Following the consideration of submissions on the discussion document, this period was reduced to four years.

The proposal that the amendment apply separately to each type of tax was added after receiving the submissions on the discussion document. For example, the rate of the shortfall penalty imposed on a taxpayer for not taking reasonable care in relation to income tax will not be affected by a previous breach of the reasonable care test in relation to another tax type such as GST.

The period needs to be sufficiently long to indicate that the taxpayer's behaviour has changed, but short enough to be not overly burdensome on the taxpayer. Officials consider that for income tax, a two-year period is not long enough to demonstrate that a taxpayer's behaviour has changed. A four-year period, we judge, gives a better guide as to a taxpayer truly having improved his or her behaviour. We consider that in the case of GST, PAYE and fringe benefit tax, a two-year period would be sufficiently long for a taxpayer to demonstrate improved compliance behaviour.

Recommendation

That the submissions be accepted in part, in that the "good behaviour" period be reduced to two years for GST, PAYE and fringe benefit tax.

Issue: Mental element to be taken into account

Submission
(10 – New Zealand Retailers Association)

A mental element should be taken into account if culpability is to be used to determine whether a shortfall penalty can be discounted on account of previous good behaviour. The line should be drawn at the point where the taxpayer is cognisant that the position taken is probably wrong in law or constitutes tax avoidance. This test would, quite rightly, preclude the discount being available in respect of evasion. But in cases of gross carelessness and avoidance, which are measured on an objective basis, it would mean that some taxpayers would be eligible for the discount.

Comment

It many cases it would be difficult for Inland Revenue to determine whether the taxpayer was cognisant or not. One of the purposes of the compliance and penalties legislation is to ensure that penalties for breaches of tax obligations are imposed impartially and consistently; drawing the line at the point where the taxpayer is cognisant would make the legislation more difficult for Inland Revenue to impose impartially and consistently.

Recommendation

That the submission be declined.

Issue: Proposal should apply to all penalties

Submission
(12 – Institute of Chartered Accountants of New Zealand, 13 – Business New Zealand, 21W – KPMG)

A past record of good behaviour should be taken into account for all penalties imposed under the Revenue Acts. If the primary submission is not accepted, past behaviour should be taken into account for those shortfalls that do not incorporate an element of deliberate action – for example, gross carelessness. *(Institute of Chartered Accountants of New Zealand)*

The "good behaviour" approach for lack of reasonable care and unacceptable interpretation contained in this bill should be extended more strategically across all penalties, with the exception of those for the worst behaviour. *(Business New Zealand)*

Consideration should be given to extending this approach to other penalties, not just lack of reasonable care. *(KPMG)*

Comment

Officials agree with the submission's concerns in relation to shortfall penalties. We consider that good behaviour can be expanded to cover all shortfall penalties along the following lines:

- The rate of all shortfall penalties can be halved if within the previous four-year period the taxpayer has not been liable for a shortfall penalty imposed as the result of an audit.
- An exception to this general rule should be made in relation to shortfall penalties for evasion where it is considered that there should be no "good behaviour" period. In other words, having evaded once, a taxpayer will have the evasion shortfall penalty imposed at the rate of 150 percent on any subsequent shortfalls arising as the result of evasion.
- The proposal will apply separately for each type of tax, such as PAYE, income tax and GST. This means a penalty imposed in relation to one tax does not prevent "good behaviour" being considered for another tax.
- Tax shortfalls will be grouped and effectively counted as one offence. For example, if a taxpayer who has never had a tax shortfall is audited, and several breaches of the lack of reasonable care standard are ascertained, all of those tax shortfalls would be treated as the first offence. The reason for this is that we were concerned that there could be disagreement as to which shortfall was the "first", and we wanted to ensure that where a taxpayer had made the same mistake in several periods, all were penalised at the same rate.
- Breaches of the lack of reasonable care and unacceptable tax position standards will not count as first offences for gross carelessness, abusive tax position and evasion. But a first offence for these higher penalties will count as a breach of good behaviour in relation to the lower penalties. We consider that the higher penalties require some form of intent or significant non-compliance and that it would be unfair for a small error by way of lack of care to effectively expose the taxpayer to the full extent of these more significant penalties.
- Voluntary disclosure will not count against "good behaviour". It will only be when the taxpayer has been audited and a shortfall penalty is imposed that the "probation" period will begin. We are concerned that if this were not the case taxpayers could be discouraged from voluntarily disclosing tax shortfalls, as once they had made a voluntary disclosure they would face higher penalties on any other shortfalls for a period of four years.

This proposal will mean that:

- The shortfall penalty rate for first time evasion is aligned with the rate for evasion in Australia and Canada.
- Taxpayers and Inland Revenue staff see that those taxpayers who repeatedly offend are more harshly penalised, reflecting their failure to begin complying voluntarily.

- The general concern that the shortfall penalty rates are excessive is addressed. (This is particularly the cases with voluntary disclosures where the rules are seen as penalising taxpayers who are attempting to comply.)

One concern about this proposal is that the measure reduces the penalty applying to evasion from 150 percent to 75 percent for a “first offence” and therefore this measure could be seen as softening the seriousness of this offence. Our response is that the penalty for evasion when halved is now equal to the penalty imposed in Australia and Canada. We also consider that a 75 percent penalty is still substantial, and the legislation will now provide that increased penalties apply to those who re-offend. Further, we do not propose that the four-year good behaviour period apply in the case of evasion.

The submission requested that good behaviour be extended to other penalties. The next stage of the compliance and penalties review will consider this issue.

Recommendation

That the submissions be accepted, in part, and that the rates of shortfall penalties for first offences be reduced.

Issue: More strategic approach required

Submission
(21W – KPMG)

There needs to be a more strategic approach to encouraging voluntary compliance. What is needed is an approach that does more than just penalise certain behaviour, but has the twin objectives of both rewarding and penalising.

Comment

The current proposal reflects a strategic approach to ensuring compliance, with penalties reflecting culpability and with thresholds established to minimise compliance costs. The legislation does not expect, or require, that taxpayers get everything right when taking tax positions. The legislation requires that taxpayers take reasonable care, and where there is a significant amount of tax at stake that taxpayers take extra care to ensure that the tax positions they take are likely to be correct.

Officials consider that it is not feasible to reward taxpayers simply for meeting their legal requirements other than in the sense that has been proposed, to take a taxpayer’s good behaviour into account by reducing the level of shortfall penalties.

Officials considered the option of not penalising taxpayers for their first breach but, on reflection, consider that such a proposal would be unfair to those taxpayers who never breach the standard. Also, such an approach could reduce the incentives on taxpayers to comply voluntarily, as first-time non-compliance is penalty-free.

Recommendation

That the submission be declined because the proposals already reflect a strategic approach to encouraging voluntary compliance.

UNACCEPTABLE TAX POSITIONS

Clause 111

Issue: General disagreement with the proposal

Submission
(12 – Institute of Chartered Accountants of New Zealand, 16 – PricewaterhouseCoopers, 21W – KPMG, 29 – New Zealand Law Society)

The Institute of Chartered Accountants strongly disagrees with this proposal. *(Institute of Chartered Accountants of New Zealand)*

Extending the penalty as proposed is inappropriate and unwarranted. *(PricewaterhouseCoopers)*

These changes are an unwarranted extension of the considerable penal powers that the Inland Revenue already has. *(New Zealand Law Society)*

This proposal should not proceed. *(KPMG)*

Comment

The new shortfall penalty for unacceptable tax position 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 proposed amendment addresses this concern. It ensures that taxpayers cannot choose to avoid interpreting the legislation on a complex tax issue, as a means of avoiding possible shortfall penalties. The current interpretation 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.

Recommendation

That the submissions be declined.

Issue: Current legislation does reflect the original intent

Submission
(24W – Andrew Gibbin)

The original intent of the legislation is not to impose penalties regardless of the behaviour of a taxpayer and whether or not the taxpayer has interpreted the legislation.

Comment

Officials consider that, as the proposed legislation is currently drafted, there is opportunity for taxpayers to take steps to ensure that a shortfall penalty is not imposed if the position they have taken fails to meet the "standard of being, viewed objectively, about as likely as not to be the correct tax position test". Officials therefore consider an amendment is necessary.

The submission's concern is that this reform was not originally intended and should therefore not proceed. Officials consider that the original intent of the legislation was to impose a shortfall penalty regardless of whether or not the taxpayer had interpreted the legislation. We also consider, however, the fundamental issue is one of whether the unacceptable interpretation penalty has appropriate coverage, regardless of the intent of the original policy as it might or might not have been amended.

The discussion document *Taxpayer compliance, standards and penalties 2: Detailed proposals and draft legislation* notes:

> The earlier discussion document proposed that when the tax at stake was large, taxpayers would need to have a "reasonably arguable position" in support of the way they had applied the law. Failure to have a reasonably arguable position would result in a penalty. The fact that this would apply only where the tax involved was substantial meant that ordinary taxpayers would generally not be affected.[15]

That discussion document makes it clear that the original intent was that taxpayers have tax arguments for the positions they take in a tax return. The introduction of the concept of interpretation was not intended to change this position. When it reported to Parliament on the 1995 Taxpayer Compliance, Penalties and Disputes Resolution Bill, the Finance and Expenditure Committee noted that it considered there was a conflict between the term "reasonably arguable position" and its definition in the bill. The Committee concluded that:

> … the ordinary meaning of "reasonably arguable position" does not equate with "about as likely as not to be correct". Therefore, we recommend that the bill be amended by changing the name of this penalty to "unacceptable interpretation", and that this be defined as one that "fails to meet the standard of being, viewed objectively, about as likely as not to be the correct tax position".[16]

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[15] *Taxpayer compliance, standards and penalties 2: Detailed proposals and draft legislation,* April 1995, paragraph 6.1.

[16] *Taxpayer Compliance, Penalties, and Disputes Resolution Bill as reported from the Finance and Expenditure Committee Commentary*, page v.

Recommendation

That the submission be declined.

Issue: The lack of reasonable care penalty should apply

Submission
(10 – New Zealand Retailers Association, 21W – KPMG)

The proposed extension is unwarranted as cases where the taxpayer has not interpreted the law should be dealt with under the lack of reasonable care provision (which also carries a 20 percent shortfall penalty).

The commentary states that "taxpayers could choose not to interpret the legislation on a complex tax issue as a means of avoiding the shortfall penalties", but surely a taxpayer in that position would be guilty of not taking reasonable care, if not gross carelessness, in any event? *(New Zealand Retailers Association)*

The correct penalty for taking a tax position without interpreting the law is the lack of reasonable care penalty. *(KPMG)*

Comment

Officials agree in some cases that the lack of reasonable care penalty can apply. There is a concern that there could be cases where a penalty cannot be imposed even though it is appropriate that the taxpayer be penalised. 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.

In effect, the current legislation allows taxpayers to avoid making reasonable efforts to determine what the law is. The proposed amendment ensures that taxpayers are accountable for all of their tax positions. Officials recommend that the original intent of the legislation be made clear and that the legislation provide that a shortfall penalty could be imposed if the tax position taken is not as likely as not to be correct, including where the taxpayer has not interpreted the law.

As stated earlier, the requirement for interpretation of legislation before a shortfall penalty could be imposed was unintentional. When the 1995 bill containing the compliance and penalties legislation was introduced this penalty was known as the penalty for lack of a "reasonably arguable position". That bill commentary notes that a tax shortfall in this category must be the result of a taxpayer having taken an incorrect position on a question of interpretation. The standard requires the interpretation to be "about as likely as not correct".

The Finance and Expenditure Committee recommended that for the purpose of clarity the name of the penalty be changed to "unacceptable interpretation" and that this be defined as one that "fails to meet the standard of being, viewed objectively, about as likely as not to be the correct tax position".

Recommendation

That the submissions be declined.

Issue: Contrary to the Finance and Expenditure Committee's recommendation

Submission
(10 – New Zealand Retailers Association, 13 – Business New Zealand)

This measure is quite inconsistent with the thrust of the Finance and Expenditure Committee and Committee of Experts recommendations. *(New Zealand Retailers Association)*

The provisions regarding penalties for unacceptable tax positions should not proceed and instead the rules should be clarified, as recommended by the Finance and Expenditure Committee in its 1999 report. *(Business New Zealand)*

Comment

Officials note that the proposal conflicts with the Finance and Expenditure Committee's recommendation in relation to its 1999 inquiry into the powers and operations of the Inland Revenue Department. That conflict was made clear in the most recent discussion document.

As stated earlier, however, the proposed amendment addresses the concern that current legislation allows taxpayers to avoid making reasonable efforts to determine what the law is on more complex tax matters.

Recommendation

That the submissions be declined.

Issue: Proposal should not apply to calculation and processing errors

Submission
(12 – Institute of Chartered Accountants of New Zealand, 29 – New Zealand Law Society)

The legislation needs to exclude calculation and processing errors which do not involve interpretations being taken. *(Institute of Chartered Accountants of New Zealand)*

The New Zealand Law Society is concerned that if the amendments are enacted, the Inland Revenue Department will wield section 141B each time a major taxpayer, even if inadvertently or with the best care possible, gets it wrong. It will be too easy for the Inland Revenue to impose shortfall penalties on significant taxpayers who are, for instance, late in complying with filing and paying obligations or who transpose figures in their returns or who, through the confusing and unclear nature of certain tax forms, simply complete them incorrectly. *(New Zealand Law Society)*

Comment

Officials agree with the submission. It was never intended that this penalty apply to calculation or processing errors. This penalty applies to shortfalls that arise because a tax position taken is not likely to be correct, whether or not the taxpayer actually interpreted the law. If a calculation or processing error is of such a magnitude that the error breaches the reasonable care standard, that shortfall penalty should apply.

Recommendation

That the submission be accepted.

Issue: Definition of "tax position"

Submission
(16 – PricewaterhouseCoopers)

Clarification is required as to what is intended by amending the definition of "tax position".

Comment

Officials have re-examined the amendment and now consider that the amendment is unnecessary. Instead, a minor clarifying amendment should be made to the current definition. We therefore recommend that the current amendment to the definition of "tax position" be replaced with an amendment clarifying the current definition.

Recommendation

That the amendment to the definition of “tax position” be replaced with a minor amendment clarifying the current definition.

CAPPING SHORTFALL PENALTIES

Clause 118

Issue: Proposal should be extended to apply to other penalties

Submission
(10 – New Zealand Retailers Association)

The cap should apply in respect of other penalties. If culpability is the key, it should at least apply to the unacceptable tax position penalty as, by carrying the same 20 percent tariff that applies to the lack of reasonable care penalty, the two of them can be taken to involve the equivalent degrees of culpability.

Comment

This proposal is aimed at ensuring that those breaches of the reasonable care standard that are large in dollar terms which are speedily identified and corrected are not excessively penalised. Generally, the cap should not apply to the unacceptable tax position standard because at the time taxpayers take their position in their return they will be aware whether or not their interpretation meets the standard of being as likely as not to be correct. However, as that penalty will now apply in cases where no interpretation has been made, it is possible that at the time taxpayers took the position they were not aware that the position did not meet the standard of being as likely as not to be correct. Officials therefore agree that the cap should apply to the unacceptable tax position penalty.

Recommendation

That the submission be accepted and the cap apply to the unacceptable tax position penalty.

Issue: Time limit

(10 – New Zealand Retailers Association, 12 – Institute of Chartered Accountants of New Zealand, 16 – PricewaterhouseCoopers, 21W–- KPMG)

The cap should not be subject to the two-month cut-off period. *(New Zealand Retailers Association)*

At a minimum the proposed cap should apply to shortfalls identified through voluntary disclosure or Inland Revenue audit within the period within which the next annual income tax return is due to be filed. *(Institute of Chartered Accountants of New Zealand)*

In most cases the two-month time limit does not provide an adequate timeframe for taxpayers to determine whether a tax shortfall has occurred. *(PricewaterhouseCoopers)*

KPMG agrees that the penalty for lack of reasonable care can give incongruous results when the error is quickly identified and rectified. However, the situations when the cap applies should be extended to cover a period of time prior to notification of an audit. *(KPMG)*

Comment

The government proposed capping shortfall penalties for lack of reasonable care because it was concerned that if the tax shortfall was identified quickly, the imposition of a shortfall penalty might be out of step with other penalties imposed under the Tax Administration Act.

The cap is meant to apply only to those shortfalls identified in a short period of time. If the length of time were longer, for example, a year for annual income tax returns, the incentives for taxpayers to take care would be significantly reduced.

If the taxpayer is notified of an audit within the two-month period and the shortfall is ascertained within that period then the cap will apply. To extend the time period to apply to all notifications of audit, regardless of when the tax shortfall arose, reduces greatly the incentives for taxpayers to comply voluntarily. Some taxpayers would be more prepared to risk that they will not be audited or, alternatively, that they will not be audited within a certain amount of time, and therefore would not take as much care when they file returns.

Officials can, however, see the benefit of increasing the period of time to three months, which is the period between fringe benefit tax returns. This would provide an opportunity for taxpayers preparing a fringe benefit tax return to identify an error in the previous return and disclose that error, with the cap therefore applying.

Recommendation

That the submissions be accepted in part and in that the time period be extended to three months.

Issue: The value of the cap should be reduced

Submission
(12 – Institute of Chartered Accountants of New Zealand, 16 – PricewaterhouseCoopers)

While the Institute of Chartered Accountants agrees with the proposal to introduce a monetary cap, it should be $10,000 per tax position. *(Institute of Chartered Accountants of New Zealand)*

It is incorrect to state that lowering the cap from the proposed $50,000 level would remove an incentive to take reasonable care. *(PricewaterhouseCoopers)*

Comment

A cap of $50,000 was proposed because that amount equates to the maximum criminal evasion penalty. It seems inappropriate that penalties for lack of reasonable care should exceed this amount, regardless of the amount of shortfall involved, in cases where the shortfall is identified promptly.

One concern with the cap is that when the cap is breached, as the amount of the tax shortfall increases the shortfall penalty proportionally reduces. Officials consider that a $50,000 cap appropriately balances the need for a proportionate, but not excessive, penalty.

While the appropriate level of a cap is a matter of judgement, concerns about adopting a lower cap include that the penalty may end up being only a small percentage of the tax involved. For example, for a large shortfall the $10,000 cap may only be 1 percent of the underlying tax, while taxpayers with similar errors but smaller discrepancies or discrepancies not detected within the four month window will face a 20 percent penalty.

With a smaller cap, the resulting maximum penalty would be a small percentage of the tax shortfall. Therefore officials do not recommend any change in the level of the cap.

Recommendation

That the submissions be declined.

Issue: Penalties on voluntary disclosures

Submission
(10 – New Zealand Retailers Association, 12 – Institute of Chartered Accountants of New Zealand)

Voluntary disclosures should not be subject to shortfall penalties (it is appreciated that abusive tax position and evasion disclosures may need to be treated differently), as this would increase voluntary compliance without adversely affecting the revenue. *(New Zealand Retailers Association)*

Shortfalls that are voluntarily disclosed should not be penalised, except through use-of-money interest. *(Institute of Chartered Accountants of New Zealand)*

Comment

At the core of the compliance and penalties legislation is a standard of reasonable care. This means that each taxpayer's actions in meeting their obligations should be at the standard expected of a reasonable person. In addition, for interpretative matters which involve significant amounts of tax, taxpayers must ensure that they have interpreted the law in a reasonable way.

If no penalties were imposed for voluntary disclosures then there would be no reason for taxpayers to take care when complying with their tax obligations. For example, taxpayers could omit income from a particular source when they file their return and then, six months later, make a voluntarily disclosure that they had omitted the income. The concern with this position is that the tax return potentially ceases to be a taxpayer's best attempt at assessing their tax liability as error in the return will not be penalised if disclosed at a later date.

While use-of-money interest compensates the Crown for not having the use of its money, if taxpayers decided not to take reasonable care at the time they completed their tax return and then voluntarily disclosed shortfalls at a later date, the government would face a temporary loss of revenue.

The next stage of the compliance and penalties review will consider whether the current level of penalty in the case of voluntary disclosure is appropriate. The submissions will be considered further as part of that work.

Recommendation

That the submissions be considered further as part of the second stage of the post-implementation review of the compliance and penalties legislation.

PROMOTER PENALTIES

Clause 114

Issue: Generally disagree with proposal

Submission
(12 – Institute of Chartered Accountants of New Zealand, 13 – Business New Zealand)

The Institute of Chartered Accountants remains strongly opposed to this proposal. *(Institute of Chartered Accountants of New Zealand)*

The provisions on promoter penalties should be deleted. *(Business New Zealand)*

Comment

The government is concerned about the number of taxpayers investing in tax arrangements involving abusive tax positions where the arrangement has been promoted to the taxpayer. The compliance and penalties legislation currently imposes no penalty on the promoter and therefore provides no incentive for promoters to ensure that the tax effects that they claim for their arrangements are correct. The government is concerned that in many cases investors in such arrangements are not aware of the tax effects of their investment, while the promoter is.

The proposed promoter penalty is aimed at reducing both the marketing of and investment in such arrangements involving abusive tax positions.

Recommendation

That the submission be declined.

Issue: Proposal should be delayed

Submission
(12 – Institute of Chartered Accountants of New Zealand)

This issue should be held over until the review of the proposals on closely related mass marketed schemes is complete.

Comment

While the proposals attack a similar concern, they are fundamentally different. The issues raised in the officials' paper on mass-marketed tax schemes include the registration of certain types of investments, and place limits on deductions attributable to some investments. The proposal in this bill is aimed at penalising promoters of

investments where the investment results in the taxpayer taking an abusive tax position. The promoter penalty proposal and the mass-marketed schemes suggestions would operate independently of each other.

Recommendation

That the submission be declined.

Issue: Clarification that deduction be of the same type and quantum

Submission
(12 – Institute of Chartered Accountants of New Zealand)

The wording of section 141EA(2) should be clarified so that the deduction taken by the five or more persons (or the loss offset) must be of the same type and quantum as the deduction taken which leads to the abusive tax position.

Comment

Officials disagree with the submission. We are concerned that the effect of the investment may not necessarily be of the same type and quantum as the deduction taken which leads to the abusive tax position. For example, a taxpayer may have a loss arising from a decline in the value of shares, which are held on revenue account, which arises because of the decline in value of substantially overvalued fixed life intangible property owned by the company. In this case the loss is not of the same type as the decline in the value of the fixed life intangible property.

Recommendation

That the submission be declined.

Issue: Threshold should be increased

Submission
(29 – New Zealand Law Society)

The threshold of five or more persons in any income year is too low. Offering an arrangement to five people, particularly if they are related to the offeror, or are the offeror's business associates, would hardly constitute "mass-marketing". If the legislation is genuinely meant to attack mass-marketed schemes, then a more realistic threshold, such as 20 or more people, should be chosen.

Comment

Officials agree with the submission. However, we consider extending the threshold to 20 or more people unduly broadens the scope, possibly allowing some promoters to avoid imposition of the penalty. We therefore recommend as a compromise that an arrangement must be promoted to ten or more people. Determining an appropriate threshold is a matter of judgement requiring a balance between including arrangements which are not widely promoted and excluding some arrangements that we do consider the promoter should be penalised for.

Recommendation

That the threshold be increased to ten or more people.

Issue: Concerns relating to the definition of "promoter"

Submission
(29 – New Zealand Law Society, 31W – Minter Ellison Rudd Watts)

The definition of "promoter" includes any person who "is involved in formulating a plan or programme from which an arrangement is offered". It will literally catch any person who happens, somewhere along the way, to have input into an idea that sometime in the future materialises in a mass-marketed scheme. The definition will catch persons who, after legal advice, abandon an inchoate scheme but find the exact arrangement marketed by someone else. It is conceivable that the definition could catch the Inland Revenue officer in the Adjudication and Rulings Division, who provides a binding ruling on the arrangement that eventually, after a number of iterations, becomes a mass-marketed scheme. *(New Zealand Law Society)*

Virtually everyone who gives legal/accounting advice in connection with a public offering, and which is used for purposes of the public offering, comes within the definition of "promoter". Because section 141EA applies a "no fault" liability standard on all promoters, the section creates a severe impediment to the provision of any tax advice for use in a public offering. This itself is a severe impediment to capital rising through capital markets. *(Minter Ellison Rudd Watts)*

Comment

The definition of "promoter" is deliberately broad to ensure that those who do promote arrangements involving an abusive tax position are not able to structure their affairs so that they are not exposed to the potential application of the promoter penalty. Given that the goal of the penalty is to hold promoters accountable for their actions, and the penalty is based on the tax impact of the arrangement, which can be significant, they have strong incentives to try to structure themselves outside the definition. However, we do accept the submission's concerns that people who are peripherally involved may be covered by the definition. We therefore recommend that the definition be amended to include only those who have a significant involvement.

Recommendation

That the submission be accepted and the definition of "promoter" in section 141EB be amended to include only those who have a significant involvement.

Issue: Clarification of the meaning of "invests"

Submission
(12 – Institute of Chartered Accountants of New Zealand)

Section 141EA(1) needs to clarify the meaning of "invests" so that it cannot apply to amounts paid in fees.

Comment

Officials agree with the submission. We are also concerned that the concept of "invest" could be manipulated by promoters so that taxpayers who invest more than $50,000 would still qualify for the reduction in penalties.

Officials consider that rather than referring to the amount invested, a better approach would be to consider the effect of the arrangement, that is, whether the tax deductions, tax losses, input tax credits or deferred output tax from the arrangement are less than a certain amount. We recommend that the threshold be set at $50,000.

In order to capture multiple investments through intermediaries, officials recommend that for the purpose of determining whether the threshold is breached, interests be aggregated.

Recommendation

That the submission be accepted in that the reference to "invests" be removed and the threshold be changed to one where the tax effect of the arrangement is less than $50,000.

Issue: Promoters' right to dispute penalty and assessment

Submission
(12 – Institute of Chartered Accountants of New Zealand, 31W – Minter Ellison Rudd Watts)

"Promoters" who may be liable to such a penalty should have clear and unambiguous rights to dispute both the penalty and the assessment. (*Institute of Chartered Accountants of New Zealand)*

Proposed section 141EA does not address the situation where a taxpayer settles, and pays a penalty or portion of a penalty, for an abusive tax position without actually being found liable for such a penalty by the High Court or otherwise. The difficulty is that a taxpayer may settle and accept the Commissioner's view for reasons relating to litigation risk/costs of litigation and other factors that do not involve an express finding or acceptance that there is an abusive tax position. The concern is that such a settlement by the taxpayer results in automatic satisfaction of the standard in section 141EA(1)(a) (penalty "imposed on" the taxpayer) without any ability of the promoter to challenge whether or not there is in fact an abusive tax position. (*Minter Ellison Rudd Watts)*

Comment

Officials agree with the concerns expressed in both submissions. We recommend that promoters have a legislated right to dispute whether the arrangement involves an abusive tax position and also to dispute the imposition of the promoter penalty itself, including whether they are a promoter and the amount of the promoter penalty.

Recommendation

That the submission be accepted.

Issue: Penalty should not be based on 39% tax rate

Submission
(12 – Institute of Chartered Accountants of New Zealand, 29 – New Zealand Law Society)

If, contrary to this submission, there is any penalty charged to a promoter in respect of a shortfall by a taxpayer, it should be based on the actual shortfall, and applicable tax rate or tax type, not an arbitrary amount based on gross income figure multiplied by an arbitrary tax rate of 39%. *(Institute of Chartered Accountants of New Zealand)*

Deeming the promoter to have a tax shortfall equal to the total of all tax shortfalls generated by the arrangement determined using a 39% tax rate, and imposing a penalty of 100 percent of the deemed tax shortfall is draconian. *(New Zealand Law Society)*

Comment

In the case of income tax, the majority of taxpayers investing in such arrangements will have a marginal tax rate of 39% as the benefits from these schemes are tax-related and maximised by those who have large incomes. The alternative of using the marginal tax rates of each of the investors would have significant administrative costs. For example, one arrangement may involve hundreds of investors and multiple income years. Officials consider the administration costs outweigh any increase in accuracy in using the marginal tax rates of the investors. Further, it should be noted that the calculation is used to determine the penalty on the promoter, not the investors.

Recommendation

That the submission be declined.

Issue: Determining the tax figure to which the penalty should apply

Submission
(Matter raised by officials)

The promoter penalty should not be based on the actual tax shortfalls of the individual investors in the arrangement, but rather on the expected tax impact.

Comment

We consider that the legislation should be clear as to the amount to which the penalty applies. We recommend that the legislation be amended to provide that the penalty is calculated on the tax effect of the arrangement rather than actual tax shortfalls of the individual investors. This ensures that the promoter's liability is independent of, and does not vary with, changes in individual taxpayers' positions. This amendment also addresses a concern regarding taxpayer certainty.

This will also mean that, in relation to other taxes, the appropriate tax rate is used to determine the penalty. For example, for an arrangement involving GST, the penalty would be calculated using a rate of 12.5% rather than 39%.

Recommendation

That the submission be accepted.

Issue: Aiding and abetting

Submission
(13 – Business New Zealand)

The current law already allows Inland Revenue to take action against people, such as promoters of mass-marketed schemes, who "aid and abet" those taking unacceptable tax positions. The submission therefore asks whether this law change is really necessary.

Comment

The penalty for aiding and abetting is a criminal penalty and hence the standard of evidence required is higher, that is, beyond reasonable doubt. It is, therefore, an administratively difficult penalty to impose. It is also a very difficult to prove that the promoter aided and abetted the taxpayer, as in many cases promoters will say that they merely offered the taxpayer an arrangement and it was up to the taxpayer as to whether or not to make the investment.

Instead of attempting to make the aiding and abetting provisions apply, the government is proposing the promoter penalty as a way to prevent promotions of these arrangements.

Officials therefore consider that it is appropriate to penalise promoters of arrangements involving abusive tax positions.

Recommendation

That the submission be declined.

ONUS OF PROOF

Clause 105

Issue: Guidelines

Submission
(21W – KMPG)

Some guidelines need to be developed to give taxpayers and Inland Revenue some certainty about how this test will apply in practice.

Comment

This minor clarifying amendment to the onus of proof legislation puts in place a Committee of Experts on Tax Compliance recommendation 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. Because the amendment affects only the decisions of the courts, and not Inland Revenue, there is no reason to issue administrative guidelines for the department. The scope of the amendment will be described in the relevant *Tax Information Bulletin* once the legislation is enacted.

Recommendation

That the submission be declined.

Issue: Inland Revenue to apply onus of proof

Submission
(21W – KPMG)

Inland Revenue should apply the onus of proof test when they are considering making adjustments to a taxpayer's return or considering a matter raised by a taxpayer.

Comment

The amendment is only concerned with where an assessment is challenged and is within the judicial process. Officials consider that the issue of applying the onus of proof test when Inland Revenue is considering making adjustments to a taxpayer's return or considering a matter raised by a taxpayer is outside of the scope of the post-implementation review of the compliance and penalties legislation. Officials note that a post-implementation review of the disputes resolution process began recently and recommend that this issue be referred to that review for consideration.

Recommendation

That the submission be considered as part of the post-implementation review of the disputes resolution process.

Clause 100

Issue: Risk to the revenue

Submission
(12 – Institute of Chartered Accountants of New Zealand, 21W – KPMG)

The Institute of Chartered Accountants rejects the proposal giving Inland Revenue the power to require payment of all of the tax in dispute when there is a risk to the revenue as there is no indication, or definition, of what is meant by significant risk. That if, contrary to the submission, the proposal proceeds, then a definition of significant risk or the specific circumstances that are considered to give rise to such a risk should be included in the legislation. *(Institute of Chartered Accountants of New Zealand)*

KPMG supports the proposal to remove the requirement to pay 50 percent of the tax in dispute. However, it does not support leaving a residual discretion available to the Commissioner to collect payment of all revenue when there is a significant amount at stake. The submission expresses concern that the amendment will be interpreted as applying when a significant amount is at stake. If a residual discretion is available to the Commissioner to collect payment of all revenue when there is a significant amount at stake then there needs to be some objective criteria to determine the circumstances when the revenue is actually at risk. *(KPMG)*

Comment

The discussion document *Taxpayer compliance, standards and penalties: a review* recommended that:

> … Inland Revenue will be given the power to require payment of all the tax in dispute in those rare cases where there is revenue at significant risk – that is, where there is a risk that the amount in dispute might never be paid.[17]

Submissions on the proposals in the discussion document expressed concern that there was no definition of "revenue at significant risk", so when the bill was drafted the words "risk to the revenue" were used instead. These words are currently used in section 138J, which allows the Commissioner to waive payment of non-deferrable tax in dispute if the Commissioner considers that payment of the tax will unduly prejudice the taxpayer's business and there is no risk to the revenue in waiving payment. There is no definition of what is meant by "risk to the revenue".

[17] *Taxpayer compliance, standards and penalties: a review*, August 2002, paragraph 5.21.

As noted in the *Commentary on the Bill*:

> 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.[18]

Officials consider that requiring taxpayers to pay the entire amount in dispute will only occur in rare cases where there is a risk that the amount outstanding will never be paid. Further, officials consider that defining what is meant by “risk to the revenue” or providing a list of the specific circumstances that are considered to give rise to such a risk could result in taxpayers using that information to not pay their tax.

The provision does not apply in cases where the amount being disputed is large, but rather where the Commissioner is concerned that the dispute is being entered into to delay the payment of tax and there is a risk that the payment will never be made. If a list of objective criteria were issued, taxpayers would be aware of every instance where the Commissioner would require payment and would structure their disputes so as never to meet the criteria and thus never be required to make the payment. Officials consider that this provision will be used in rare circumstances and that objective criteria are not required.

Recommendation

That the submission be declined.

Issue: Only 50 percent should be payable

Submission
(21W – KPMG)

If the risk is significant only 50 percent of the tax should be required to be paid.

Comment

Officials disagree. The proposal that all of the tax in dispute is payable where there is a risk to the revenue ensures that if there is a risk that the tax will never be paid – for example, where there is risk of taxpayer flight – the tax in dispute is paid. To require payment of only half of the amount in dispute would mean that taxpayers could take very aggressive tax positions, dispute the amended assessment, pay half the amount in dispute and then leave the country.

[18] Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill, *Commentary on the Bill*, May 2002, page 34.

Recommendation

That the submission be declined.

Issue: Assessment must be made on reasonable grounds

Submission
(13 – Business New Zealand)

Business New Zealand is concerned that the amendment requiring all the tax in dispute to be paid if there is a risk to the revenue could be used unreasonably and defeat the intent of the amendment. The clause should be amended to at least require such an assessment to be made on reasonable grounds.

Comment

The Courts have held that all public powers must be exercised in good faith. This requirement is a real barrier to the power to require all of the tax in dispute to be paid being used unreasonably.

Recommendation

That the submission be declined.

Issue: Should review use-of-money interest rates

Submission
(29 – New Zealand Law Society)

The Society supports the removal of the obligation and points out that the removal is an indication that, in the normal course of events, the government is no longer concerned about the risk of the taxpayer not being able to pay the tax ultimately upheld in the challenge or objection. That being the case, there is good reason to review the thinking behind the relatively high use-of-money interest rate taxpayers have to pay, which is based in the view that taxpayers are generally high-risk debtors. The removal of the requirement to pay 50 percent of the disputed tax upfront would suggest that the risk of taxpayers not meeting their tax obligations is less than it used to be.

Comment

Officials disagree. The reason that the requirement to pay the tax in dispute can be removed is not because the government is no longer concerned about the risk of the taxpayer not being able to pay the tax ultimately upheld in the challenge or objection. The requirement is being removed because use-of-money interest provides the incentive to ensure that taxpayers do not dispute an amount payable merely to delay payment. If they did dispute an assessment and did not pay the amount in dispute and the assessment was subsequently upheld, they would be required to pay use-of-money interest.

Recommendation

That the submission be declined.

Issue: Section 138I

Submission

(Matter raised by officials)

Section 138I should be amended to give the Commissioner the power to require full payment of the tax being disputed if he considers that there is a risk to the revenue. The section heading should also be amended so that it more accurately reflects its contents.

Comment

The bill removes the current requirement for taxpayers to pay half of the tax in dispute, but also gives the Commissioner the power to require payment of the entire amount being disputed if there is a risk to the revenue. As the proposed legislation is currently drafted, the power to require payment of the entire amount applies only to disputes under the old objection procedures, which were generally raised before 1 October 1996. A similar change should be made to section 138I to provide that the amendment applies to cases under the new challenge procedures.

Recommendation

That the submission be accepted.

Issue: Penalties should be imposed on Inland Revenue

Submission

(10 – New Zealand Retailers Association, 12 – Institute of Chartered Accountants of New Zealand)

Inland Revenue should itself be subject to penalties in cases where it takes an unreasonable stance to the detriment of a taxpayer. (*New Zealand Retailers Association)*

If the Commissioner takes a tax position against a taxpayer which, if it were taken by the taxpayer, would be an unacceptable interpretation or tax position under the prevailing law, or Inland Revenue policy at the time, any shortfall penalties and costs, including interest, paid by the taxpayer in relation to maintaining its acceptable tax position should be refunded to the taxpayer at Inland Revenue's debit use-of-money interest rate at the time. (*Institute of Chartered Accountants of New Zealand)*

Comment

A structured system of reversed penalties or increased rates of interest in cases of Inland Revenue error would serve only a punitive function and would not necessarily result in an improved service by Inland Revenue. For example, if a penalties system were to be funded out of Inland Revenue's existing operating expenditure budget, resources would have to be taken from other projects. This would result in a lower quality of service to taxpayers as money allocated to services was diverted. This in turn could lead to further penalties, resulting in a downward performance spiral. Further difficulties might arise in determining whether Inland Revenue was actually at fault.

Officials consider that using *ex-gratia* payments together with appropriate problem resolution services and requiring appropriate performance standards from staff provides a more effective approach to ensuring high standards of taxpayer service.

Recommendation

That the submission be declined.

MISCELLANEOUS ISSUES

Issue: Small balances

Submission
(Matter raised by officials)

The provision allowing Inland Revenue not to collect small amounts of tax should be amended to allow Inland Revenue to write off those small amounts not collected.

Comment

Section 174 of the Tax Administration Act allows Inland Revenue to refrain from collecting tax if the amount payable is less than $20. As drafted, the section allows Inland Revenue not to collect the amount but the debt remains outstanding. Officials propose that these small amounts be written off permanently.

Recommendation

That the submission be accepted.

Issue: Application date for the taxpayer financial relief rules

Submission
(Matter raised by officials)

The application date for sections 73 (8) and (10), 86 (4), 87 (4), 88 (10), and 92 (4) of the Taxation (Relief, Refunds and Miscellaneous Provisions) Act 2002 should be amended to apply from 1 December 2002 rather than 1 July 2002.

Comment

The taxpayer financial relief rules are contained in the Taxation (Relief, Refunds and Miscellaneous Provisions) Act. The bill's progress was interrupted by the pre-election dissolution of Parliament in June and the convening of the new Parliament in late August. As a result of the delay, the application date of the rules had to be amended to apply from 1 December 2002 rather than 1 July 2002. Several dates were omitted in error and officials therefore recommend that these dates be amended.

Recommendation

That the submission be accepted.