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

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

Supplementary report

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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 – FURTHER ISSUES

Introduction

At its meeting of 13 November 2002 the Finance and Expenditure Committee raised a number of issues relating to the taxation of Maori organisations as part of its consideration of the Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill.

This report provides officials' comment on these issues. Several of these issues are covered in greater detail in volume 2 of the *Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill*.

Te Puni Kokiri were involved with the preparation of the advice relating to Maori organisations.

Issue: Rationale underlying the Maori authority tax rate of 19.5%

The Committee has sought advice on the rationale underlying the proposed Maori authority tax rate of 19.5%.

Comment

Once it was clarified that there was a case for separate tax rules for a certain class of Maori organisations, the question of the appropriate tax rate arose.

The proposed tax rate for Maori authorities has been set at 19.5% because this is the statutory tax rate applying to most of their members. This view is based on the fact that 90 percent of Maori earn less than $38,000 and the appropriate tax rate that applies to that level of income is 19.5%. This estimation was undertaken by extrapolating from Statistics New Zealand Household Economic Survey data for the 1997/98 year. (See attached appendix for further information.)

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 Maori authority membership is unrelated to income level. In contrast, most company shares belong to shareholders with a statutory marginal tax rate of 33% or higher.

Matching the tax rate applied to the entity to that of its members brings savings in compliance and administration costs. This is consistent with recent tax policy changes which have focused on removing the need for a significant number of taxpayers to file tax returns or income statements. The Maori Trustee is charged with the administration of over 2,000 properties, and each of these properties is a separate taxpayer. In any income year, the Maori Trustee could make distributions to over 50,000 individual members associated with these properties. The average size of distributions is about $135 per annum. If the Maori authority tax rate exceeded 19.5%

there would be a stronger inducement for individual members either to file tax returns or request income statements from Inland Revenue in order to claim refunds on overpaid tax, thereby increasing both compliance costs and administrative costs.

Issue: Proposed definition of "Maori authority"

Ms Therese Turner, Tax Advisor to the Committee, advised that Maori organisations are generally subject to certain restrictions on the trust funds that they hold and that some assets, particularly Maori freehold land, cannot be traded easily. Even so, it is also true that settlement funds can be used to acquire or begin commercial enterprises that compete on the open market, but the ownership interests in these enterprises can in fact be traded.

In response to these comments, the Committee sought advice from officials on how the proposed definition could be narrowed and what would be the resulting implications.

Comment

There are a range of options for narrowing the proposed definition of "Maori authority", but none of these options would be sufficient to address the main concern raised by submissions that expressed the view that the proposed definition is too wide.

Those submissions consider that Maori authorities should be taxed at the same tax rate as other entities as this would be consistent with the principle of competitive neutrality. Their concern centres on the application of differential tax rates rather than the scope of the proposed rules per se. This suggests that the simplest way of addressing this specific concern would be to align the Maori authority tax rate with the tax rate applying to other organisations, such as the company tax rate of 33%.

Exclude wholly-owned companies of Maori authorities

The proposed definition could exclude wholly owned companies from the proposed definition. These companies would be taxed under the ordinary company rules and face a tax rate of 33%. Dividends paid to the "parent" Maori authority would be taxable but imputation credits would be attached.

Taxing companies wholly owned by Maori authorities at a higher rate than their "parents" is likely to encourage Maori authorities to use tax minimisation techniques to reduce the profit that would be subject to the higher tax rate. For example, they could use 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. 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. It is recognised that such techniques are used by sole proprietor companies to transfer profits to the proprietor so that the profit can be taxed at the marginal tax rate of the shareholder/proprietor. However, such techniques are not so readily available to more widely owned companies. A parent authority is more akin to an entity with a large number of members rather than a sole proprietor company.

Maori authorities may also be encouraged to undertake their commercial activities within the parent structure. It would not be administratively feasible to differentiate streams of income from different kinds of assets held within the parent authority. Furthermore, the behaviour change is likely to lead to Maori authorities using inefficient structures to hold and manage their assets. 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.

The costs associated with transferring profits or activities to the parent entity is an inefficient use of resources.

Including such entities in the proposed definition (where they elect to be Maori authorities) 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. It recognises in economic terms that the group of companies is really one economic unit.

Maori authority tax rules originally came into place because Maori organisations were different from other types of commercial entity. Not only are they subject to some different rules governing the use of their assets, but they also face unique challenges in terms of communal ownership. For example, the land may not be able to move to its highest value use, it is difficult to borrow money on Maori land, and the title to the land can be fragmented over time.

The Committee has asked to what extent these restrictions flow through from the parent entity to the subsidiary. The issue is not only the extent that legal restrictions flow through to the subsidiary, but also to what extent the legislative and other issues affecting the group's ability to support a wholly owned subsidiary and its development.

In economic terms, a group of wholly owned companies is really one economic unit. Therefore constraints in one area may affect the overall performance of the whole economic unit. Some of the constraints faced by the parent Maori organisations may impact on the development and growth of its wholly owned subsidiaries. For example, common commercial practice in debt financing is to initially secure against the assets of the subsidiary. When this security is insufficient the financier will look at the parent entity to satisfy its security requirements. Therefore the constraints on the assets mentioned in the preceding example will affect the ability to provide this security. In some circumstances this will be a constraint upon the commercial activity of the subsidiary.

Include Maori land based entities only

The proposed definition could be restricted to Maori organisations that administer Maori freehold land under Te Ture Whenua Maori Act 1993. Maori Trust Boards, settlement entities, the Crown Forestry Rental Trust and the Fisheries Commission would be excluded from Maori authority tax status. They would be taxed under the general tax rules.

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

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

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

This option is unlikely to address the concern raised by submissions that commercial activities should be taxed at the same tax rate as other commercial entities. Maori land based entities may also undertake commercial activities unrelated to their land assets. In order to ensure that competitive activities are taxed at the same rate, complex apportionment rules would be required to ring-fence activities related to the land from other commercial activities of the authority giving rise to significantly higher compliance costs and administrative costs.

Issue: Distributions from a Maori authority

The Committee raised a concern that high tax-rate individuals would receive Maori authority distributions taxed at the lower rate of 19.5% and asked whether there would be any mechanism to ensure that such individuals pay the correct amount of tax on their distributions.

Comment

Clause 77 of the bill requires a Maori authority to provide members with information detailing the amounts distributed including the name of the Maori authority providing the distribution, the date of the distribution, the name and address of the member to whom the distribution is made and the amount of the distribution and any credit attached. There is also provision for the Commissioner to require other information be provided to the member.

Clause 87 of the bill requires a Maori authority to complete a distribution statement and provide it to members that receive distributions. The statement shows the amount of the distribution and any credits attached, the date on which the distribution is made, the base ratio of the distribution and any such further information as the Commissioner requires.

Although the proposed information requirements do not specifically require the IRD numbers of members to be provided, the Commissioner does have the ability to request this information.

In order to address the specific concern of the Committee, a specific requirement to provide IRD numbers of members could apply to Maori authorities. The provision of this information would provide Inland Revenue with appropriate information to ensure taxpayer compliance and for audit purposes. This requirement is also consistent with current law requirements imposed on Maori authorities under the resident withholding tax rules and should not in general impose additional compliance costs on Maori authorities.

Furthermore, to ensure that Inland Revenue can ensure compliance with the need for members that have a higher tax rate to square-up their tax obligations, Maori authorities could be required to file a schedule as part of its tax return detailing the names and IRD numbers (if known), and the amount of distributions over certain threshold such as $1,000. This will allow Inland Revenue to match that information with the tax return of the member.

Issue: Relaxing the public benefit requirement

Ms Turner commented that with the removal of the blood ties component of the public benefit requirement there will be a degree of uncertainty of what this means for entities seeking to satisfy the amended public benefit requirement in practice.

The Committee seeks clarification on the practical application of the amended public benefit requirement.

Comment

The proposed amendment is limited to relaxing the blood ties component of the public benefit requirement for all trusts, societies or institutions seeking "charitable" tax exemption. This means that in order to qualify for a "charitable" tax exemption, an entity must still meet the other requirements of a charity – this 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.

The proposed amendment applies to both Maori organisations and non-Maori organisations but it is especially relevant to Maori organisations because they often define their beneficiary class by reference to a blood relationship to a named person.

In determining whether a trust, society or institution benefits the public or an appreciably significant section of the public, 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 *Dingle v Turner* [1972] AC 601.

Applying specific rules as to what constitutes "the public or an appreciably significant section of the public" would be arbitrary – for example, the number of potential beneficiaries exceeds a certain number. Given this, officials consider that the status quo should be retained. This means that the specific facts of each case will be taken into account in determining whether the amended public benefit requirement is met.

Issue: Marae charitable exemption

The Committee seeks clarification of the problem that the proposed charitable exemption for marae is attempting to solve. Mr Copeland expressed a concern that marae exemption creates a new class of charity.

Comment

The proposed amendment is intended to confer a "charitable" income tax exemption on a trust, society or institution that administers marae situated on Maori reservations that solely apply their funds to administer and maintain the marae's physical structure.

The reason for the specific exemption is because the trustees of a Maori reservation are statutorily debarred from alienating the land subject to the reservation. This poses a problem 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 proposed amendment, therefore, 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 any trust, society or institution that administers marae situated on Maori reservations.

Submissions consider that the exemption as it appears in the bill should be wider than merely the administration and maintenance of the physical structure. Volume 2 of the *Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* recommends extending the exemption to also allow marae funds to be applied to recognised charitable purposes if the appropriate requirements are satisfied.

Most, if not all, of the entities that administer marae should meet the definitions of either a "trust", "society" or an "institution".

Marae not situated on Maori reservations would be excluded

Entities administering marae not situated on Maori reservations could seek charitable status under the general "charitable" income tax exemption (as amended by the public benefit requirement). 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.

Numbers of Maori reservations

It is too difficult to provide any accurate statistics of how many marae are situated on Maori reservations or what the proportion of marae on Maori reservations is to total marae. There is no national Maori Land Court database on reservations and reservations may be established for purposes other than marae such as recreation or conservation.

Issue: Potential private residence to qualify for the marae exemption

The Committee raised the concern that a private residence could be set up as a marae on a Maori reservation and qualify for the proposed exemption.

Comment

The process for establishing a Maori reservation for the purposes of a marae begins with a meeting of the owners of the land. The minutes of that meeting, the attendance list and the application are filed with the Maori Land Court. The Maori Land Court then considers the application and makes a recommendation. If the recommendation is to establish the reservation the Chief Executive of the Ministry of Maori Development must approve the reservation by placing a notice in the *Gazette* declaring the land to be a Maori reservation.

There are safeguards in Te Ture Whenua Maori Act 1993 which limit possible abuse or non-compliance with the terms of the reservation. The Maori Land Court has wide powers to exclude from the reservation any part of the land comprised in it, cancel the reservation, redefine the purposes for which the reservation is made or redefine the persons or class of persons for whose use and benefit the reservation is made.

It should also be noted that land cannot be set apart as a Maori reservation while it is subject to any mortgage or charge. This should limit the extent to which private residences can be used as a marae situated on a Maori reservation.

Issue: Memorandum from Mr Gordon F Copeland MP

A memorandum from Mr Gordon F Copeland MP was also tabled at the Committee's meeting of 13 November 2002. The memorandum noted that Mr Copeland was a member of the Government Working Party on the introduction of a system for the registration, reporting and monitoring of charities. The memorandum sets out the Working Party's recommendations for an updated definition of "charitable purpose".

One of the limbs of the suggested updated definition is:

> *"the advancement of culture and heritage, which includes:*
>
> - *the promotion and fostering of culture*
> - *the care preservation and protection of New Zealand heritage*
> - *the practice and development of Tikanga Maori, and*
> - *the practice, development and protection of Te Reo Maori."*

Mr Copeland suggested that this recommendation could be pertinent to the Committee's consideration of the current bill. The Committee asked for officials' views on the content of Mr Copeland's memorandum.

Comment

Officials understand that the suggested updated definition of "charitable purpose" is based on a draft of the proposed definition of "charitable purpose" to be introduced in Australia.

The government's position on this issue is that it will not make any changes to the definition until it has seen the results of work being done in other commonwealth countries.

While it is accepted that the activities of a marae may be covered by current law, the purpose of the proposed exemption is to address the issue of the non-alienation of land subject to a Maori reservation to reduce the compliance costs of using a separate entity to administer the marae.

Issue: Meaning of "wholly owned company"

In discussions with the writers of some submissions, the issue of the meaning of "wholly owned company" in the context of the proposed Maori authority rules has been raised and should be clarified.

Comment

In determining whether a company is wholly owned by a Maori authority or a group of Maori authorities, the shareholder continuity rules in the Income Tax Act 1994 should apply. These rules measure a shareholder's voting or market value interest in a company to determine whether they are commonly owned.

It is recommended that the bill clarify that the continuity rules will apply when determining whether a company is wholly owned by a Maori authority or a group of Maori authorities.

APPENDIX

Maori Income Data for 2000-01[1]

Below is an estimated income distribution for Maori individuals 15 years and older for the 2000-01 tax year. The Treasury has undertaken the estimation by extrapolating from Statistics New Zealand Household Economic Survey (HES) data in 1997-98.

Income reported in the table is pre-tax and includes most forms of income. It does not include interest and investment income, which accounts for 8.5 percent of total income. This type of income tends to be unevenly distributed towards the higher income brackets. This tends to suggest that the figures presented below are slightly biased towards the low-income end of the distribution, and this slight bias is likely to be stronger for non-Maori than Maori.[2]

The HES information is considered the best available for assessing income distribution by ethnic group. It also has the advantage that it can be grouped according to current marginal tax rates. The HES information on income is consistent with income data from the 1996 Census and the income supplement to the Household Labour Force Survey (June 2001).

The HES is a sample survey that collects information on the income and expenditure patterns of private households throughout New Zealand. The HES was an annual survey until 1998, and then became a survey produced at three-year intervals.

Approximately 3000 households (out of an eligible 1.4 million) are randomly selected to be surveyed. Income and expenditure data are not collected from children under 15 years.

Like all surveys, there is a degree of error in the survey results. Although Statistics New Zealand is continuously trying to improve the methodology used, there is evidence of variation in the measurement of components. Some of this occurs from sampling error and under-coverage of specific population groups. The degree of variation will also vary from year-to-year.

Estimated income distribution for individuals over 15 years of age for 2000-01

Tax rate	15%	21%	33%	39%	Total[3]
Taxable income	\$0-9500	\$9501-38000	\$38001-60000	\$60001+	
Number of Maori	80000	154000	21000	4000	259000
Percentage of Maori	31%	59%	8%	2%	100%
General population	767000	1624000	389000	202000	2981000
Percentage of general population	26%	54%	13%	7%	100%

1 The results presented are the work of the Treasury, not Statistics New Zealand. Access to the data used in this study was provided by Statistics New Zealand under conditions designed to give effect to the security provisions of the Statistics Act 1975.
2 New Zealand Income Supplement (June 2000) indicates that 32 percent of non-Maori surveyed receive interest, dividends, rent or other investment income compared with 10 percent of Maori survey population.
3 Owing to rounding errors, rows may not add exactly.

Superyacht crew tax exemption

SUPERYACHT CREW TAX EXEMPTION

Submission
(New Zealand Marine Export Group)

The marine industry generally feels that the time restraint of 365 days in any 24-month period could be difficult as many of the large refit projects can take fourteen to eighteen months to complete. The industry considers that this limitation could affect international competitiveness on large projects. The tax exemption period should be increased so that non-resident crew members of superyachts can be present in New Zealand for 18 months in any 24 month period.

Comment

On 28 May 2002 the government announced that people visiting New Zealand as superyacht crew members would be exempt from New Zealand income tax on income derived in this capacity, with application from the date of announcement.

The proposal resulted from consultation with the marine industry and was designed to address the problem that New Zealand's tax laws could be discouraging superyachts from undertaking refits in New Zealand, to the detriment of the New Zealand economy. In particular, the government did not want to discourage valuable refit and maintenance work on superyachts from being carried out in New Zealand.

On 4 October 2002 the Hon Paul Swain, Associate Minister of Finance and Revenue, wrote to the Chair of the Finance and Expenditure Committee requesting the Committee to include the tax exemption for superyacht crew members in the Taxation (Annual Rate, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill when reporting the bill back to the House following its consideration.

The Finance and Expenditure Committee invited the New Zealand Marine Export Group (MAREX), which represents the marine industry on this issue, to make a submission to the Committee on the government's proposal.

The proposed legislation exempting superyacht crew members from income tax contains a number of conditions. One of these conditions is that the crew member must not be present in New Zealand on more than 365 days in any 24-month period. This time limit was designed to ensure the temporary nature of the exemption.

Officials do not support extending the tax exemption period to 18 months in any 24-month period, as suggested by MAREX, because such an extension would be inconsistent with immigration and customs practice and would undermine the intended temporary nature of the exemption.

The proposed 365-day period for the superyacht crew tax exemption is aligned with the normal maximum 12-month period for a visitor's permit issued by the Immigration Service. This alignment is relevant because one of the requirements in the proposed legislation for the exemption is that the relevant crew member is not in New Zealand unlawfully for the purposes of the Immigration Act 1987.

The proposed 365-day period is also aligned with the normal maximum period of the temporary import entry applying to the superyacht itself, which is issued by the Customs Service. This is relevant because another requirement for the superyacht crew exemption is that the superyacht on which the crew are employed is a temporary import under the Customs and Excise Act 1996 and therefore a recipient of a temporary import entry.

Officials note that the proposed 365-day tax exemption period is four times longer than the 92-day period allowed for non-resident employees generally under the Income Tax Act and twice as long as the 183-day period allowed under New Zealand's double tax agreements. An exemption period longer than 365 days would undermine the intended temporary nature of the exemption.

Recommendation

That the submission be declined.