Regulatory Impact Statement

Lower the income tax rate for Māori Authorities

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue. It provides an analysis of options to change the income tax rate applicable to entities that are Māori Authorities for tax purposes. It recommends that the income tax rate for Māori Authorities should drop from 19.5% to 17.5% as a consequence of the changes to the personal statutory tax rates of individuals included in Budget 2010.

The existing Māori Authority tax regime is based on an underlying policy assumption that the tax levied at the Māori Authority level should be a proxy for the statutory tax rate that would have been imposed on the majority of Māori Authority members. No attempt has been made to reassess the validity of this assumption. Instead, analysis has focussed on whether the existing Māori Authority tax rate is set at the correct rate given its policy function and, if not, what rate would be more appropriate.

Consultation was therefore focussed on transitional issues with the major stakeholders. The consultation confirmed that the transitional issues are similar to the transitional issues faced by companies with their impending tax rate change.

The lowering of the income tax rate for Maori authorities to 17.5% does not impose any significant additional costs on businesses, impair private property rights, restrict market competition, or reduce the incentives on businesses to innovate and invest or override fundamental common law principles.

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STATUS QUO AND PROBLEM DEFINITION

1. Māori Authorities may take the legal form of either a trust or a company. However, irrespective of its legal form, an eligible person may elect to be subject to the Māori Authority tax regime. The Māori Authority regime operates in a similar manner to the company imputation model. In particular, tax paid by a Māori Authority forms a credit in its Māori Authority credit account. These credits can then be attached to distributions made to its members (shareholders or beneficiaries, depending on the legal form of the Authority). Members then use the credits received to offset their individual tax liability.

2. The current Māori Authority regime was introduced in the 2004/2005 income year. One of the key drivers for the introduction of a specific rate for Māori Authorities was that the rate would be the best proxy for the tax that would be incurred by members if the income was attributed to them. This would in turn reduce compliance costs by ensuring that most distributions to Māori Authority members would be imputed at the correct ratio, minimising the need for end of year square-ups.

3. At the time that the current Māori Authority regime was introduced, the relevant statutory rates for individuals were:

Income band	**Tax rate**
\$0 – \$38,000	19.5%
\$38,001 – \$60,000	33%
\$60,001 and over	39%

4. At the time that the revised Māori authority regime was proposed in 2002, it was estimated that approximately 90% of Māori individuals earned less than \$38,000 per year, meaning they had a statutory tax rate of 19.5%. The 19.5% rate was therefore the appropriate proxy for the tax rate applicable to the majority of Māori Authority members. The 19.5% rate has not changed since its introduction.

5. Subsequent changes to the individual tax rates have seen a disparity emerge between the Māori Authority tax rate and the prevailing tax rates of members.

6. The Taxation (Budget Measures) Act 2010 introduced the following statutory tax rates for individuals:

Income band	**Tax rate**
$0 – $14,000	10.5%
$14,001 – $48,000	17.5%
$48,001 – $70,000	30%
$70,000 and over	33%

7. As a result of these changes (and previous movements in the tax rates for individuals), a rate of 19.5% is difficult to justify from a policy perspective.

8. No attempt has been made to reassess the validity of the assumption that the rate should be the best proxy for the tax that would be incurred by members if the income was attributed to them. Instead, analysis has focussed on whether the existing Māori Authority tax rate is set at the correct rate given its policy function and, if not, what rate would be more appropriate.

OBJECTIVES

9. The objective is to ensure that the Māori Authority tax rate is set at the correct rate given its policy objectives and the recent changes to personal and company tax rates. The existing Māori Authority tax regime is based on an underlying policy assumption that the tax levied at the Māori Authority level should be a proxy for the statutory tax rate that would have been imposed on the majority of Māori Authority members.

REGULATORY IMPACT ANALYSIS

10. Assuming that no wholesale review of the policy underpinning the Māori Authority regime is desirable, there are three main options:

- to retain the 19.5% rate;
- to amend the rate to 17.5%; or
- to amend the rate to 10.5%.

Retain 19.5% rate

11. As mentioned above, it is difficult to justify this option from a policy perspective. If the Māori Authority is taxed at a rate that does not apply to *any* of its members, then compliance costs will arguably be increased. If the rate is retained at 19.5% (or, for that matter, any other rate that is not an individual statutory tax rate), every Māori Authority member who is required to file an individual tax return (all other things being equal) will be eligible for a refund or be required to pay additional tax. Therefore, although the rate would be lower than other entity tax rates, the administrative advantages of that particular rate will be lost.

12. Having a specific rate that differs from those of its members means that there will invariably be a "mismatch" between the credits that a Māori Authority attaches to its distributions and the tax payable by members. If the Māori Authority tries to attach the appropriate number of credits to distributions, it may result in an accumulation of credits at the Māori Authority level that are then difficult or impossible to distribute effectively at a later date. On the other hand, if the Māori Authority distributes as many credits as it is able, there will be a considerable number of members who, in their end of year returns, will be eligible for tax refunds of 2% of the value of these distributions (the difference between their personal 17.5% rate and the 19.5% Māori Authority rate). This would necessitate Inland Revenue incurring compliance costs processing a number of small refunds and additional compliance costs for taxpayers.

13. However, in many instances, there can be a long or indefinite delay between tax being levied at the Māori Authority level and final tax being imposed on distribution. This occurs when the Māori Authority retains the income, rather than distributing it to members. This is a feature that Māori Authority tax shares with company tax, and means that lowering the income tax rate for Māori Authorities would have a real fiscal cost.

14. Because retaining the status quo would be inconsistent with the underlying policy and create a compliance and administrative burden, this is not our favoured option.

Amend the rate to 17.5%

15. No accurate data is kept on the personal tax rates of Māori Authority members. Census data can be used to track the income of Māori generally. However, not all Māori are Māori Authority members. Equally, because members who received distributions of less than $200 are not required to file an IR3, the data for those Māori who file individual tax returns is also incomplete. However, these figures can be used to draw some conclusions.

16. Census figures for 2006 suggest that approximately 80% of Māori earn less than the $48,000 upper threshold for the 17.5% marginal rate. Of individuals who filed an IR3 for the 2008/09 income year, 71% of people who returned Māori Authority income were in either the 10.5% or 17.5% brackets. Of these, the vast majority (78%) were in the 17.5% bracket. By value, distributions to Māori in the 17.5% bracket account for just under half of all distributions retuned. The IR3 data can be summarised as follows:

Income range	Taxpayers	Taxable income
0-14,000 (10.5% rate)	15%	7%
14,001 - 48,000 (17.5% rate)	56%	48%
48,001 – 70,000 (30% rate)	16%	27%
Over 70,000 (33% rate)	13%	18%
IR3 total	100%	100%

17. This data suggests that a 17.5% rate is the most appropriate, both in terms of volume and money distributed.

18. Data from IR8J returns (the Māori Authority credit account returns) filed by Māori Authorities suggest that the bulk of income derived by Māori Authorities is retained at that level, rather than being distributed to members. As mentioned above, in these circumstances, there are fiscal costs associated with lowering the applicable income tax rate. The costs for lowering the rate from 19.5% to 17.5% are estimated as follows:

$ million	**Increase (decrease) in operating balance**				
	2011/12	**2012/13**	**2013/14**	**2014/15**	**4-year total**
Impact on operating balance	(3.0)m	(4.0)m	(4.0)m	(5.0)m	(16.0)m

19. Because the Māori Authority tax is designed to act as the best proxy for Māori Authority members, lowering the rate to 17.5% is the preferred option.

Amend the rate to 10.5%

20. A rate of 10.5% could only be justified if the policy behind the Māori Authority tax rate was that it should be aligned with the *lowest* statutory tax rate for individuals. However, this is not the case. Although the existing 19.5% rate did correspond with the lowest statutory tax rate for individuals at the time it was introduced, this was only because the lowest rate was the most effective proxy rate for members (as mentioned above, census data estimated that approximately 90% of Māori individuals were subject to the 19.5% rate at the time).

21. Given the data provided above, a 10.5% rate would be an *inaccurate* proxy for 85% of Māori Authority members by number and 93% of members by volume. A rate that required 85% of members to square-up by paying additional tax at the end of the income year would largely defeat the purpose of having a proxy rate.

22. Māori Authority members who do have a marginal tax rate of 10.5% will also be able to take advantage of the fact that Māori Authority tax credits that represent an “over-taxation” (i.e. the difference between the 10.5% and 17.5% rates) are available as cash refunds – unlike company imputation credits, which would have to be carried forward.

23. Assuming that Māori Authorities would continue to retain the bulk of their income, a 10.5% rate would also significantly increase the fiscal costs associated with a rate decrease. This would also disadvantage businesses that directly compete with Māori Authorities. The existing 19.5% rate has been criticised for creating a two-tiered system that effectively provides a tax subsidy to certain businesses. (We note at this point that lowering the rate to 17.5% may, in itself, reopen this debate, but that rate is justified on the basis of the underlying policy).

24. For the reasons outlined above, we do not consider a 10.5% rate to be desirable.

CONSULTATION

25. Te Puni Kokiri have been consulted on the options outlined in this report and they agree with its recommendations.

26. Because the recommended amendment is effectively consequential on the changes to individual statutory tax rates in Budget 2010, no consultation has taken place on the rate change itself.

27. Consultation has taken place on possible transitional issues associated with the rate change. This consultation included the following core group of interested parties:

- Te Ohu Kaimoana
- The Māori Trustee
- The Federation of Māori Authorities
- Ngai Tahu Holdings
- Te Runanga a Iwi o Nga Puhi
- PKW Inc
- Atihau Inc
- Te Arawa Iwi
- Te Runanga o Ngati Porou /Porou Ariki Trust
- Ernst & Young
- Deloitte
- BDO New Zealand.

28. Consultation took the form of email exchange, telephone calls and meetings between Inland Revenue officials and the relevant parties. Feedback has confirmed that the following transitional issues should be addressed as a consequence of any rate change:

- *"Grandparenting" imputation ratios* – The maximum Māori Authority credit ratio is currently 19.5/80.5. If the Māori Authority tax rate decreases to 17.5%, the ratio will automatically change to 17.5/82.5. This ratio change can result in double taxation, as earnings taxed at 19.5% (prior to the any rate change) may carry a maximum imputation ratio of 17.5% if distributed after the rate change. The result is that pre-rate change credits can be "trapped" in the Māori Authority. Grandparenting the existing ratio for two years was enacted in respect of dividends paid by companies after the reduction in company tax levels in Budget 2010.

  Submissions suggested that a longer grandparenting period should be considered for Māori Authorities so as not to encourage rushed distributions of income. However, Māori Authorities are not materially different from many closely-held companies in this regard and we recommend that the two-year grandparenting period afforded to companies should also be used in respect of Māori Authority credit accounts.

- *Provisional tax adjustments* – Previously, when company tax rates have been decreased, an adjustment has been made to the provisional tax rules so that the decreases are immediately reflected in the tax paid by provisional taxpayers. This recognises the fact that, all other things being equal, the tax paid by an entity is expected to be less in the year of the decrease. For taxpayers who base their provisional tax on an earlier year's tax obligations, this is generally achieved by amending the uplift factor used to calculate their current year liability. Again, we recommend that similar rules to those enacted as part of Budget 2010 should be used for Māori Authority provisional taxpayers.

29. Submissions also noted that the 10.5% rate should be considered for Māori Authorities. The main reason put forward was that the 10.5% rate better reflects the average income of Māori. We have discussed this point with submitters and they now accept that the 17.5% rate is appropriate. Our reasons for supporting the 17.5% are outlined above.

CONCLUSIONS AND RECOMMENDATIONS

30. We consider that lowering the income tax rate for Māori Authorities to 17.5% is the best option. We recommend that this change takes effect from the 2011-12 income year. This minimises the gap between the commencement of the revised statutory tax rates for individuals (effective on 1 October 2010) and the changes recommended in this Statement. This would also align the effective date for this change with the lowering of the income tax rate for companies.

IMPLEMENTATION

31. We recommend that the rate change, and any necessary transitional amendments, be included in the Supplementary Order Paper to the Taxation (GST and Remedial Matters) Bill.

32. The rate change and consequential amendments would result in compliance costs being incurred by taxpayers for the first two years of implementation. However, we do not anticipate that these costs will be significant. Administrative costs will also be incurred by Inland Revenue in amending forms and informational material provided to Māori Authorities and their members. We anticipate these costs will be more than offset by the reduced need for end of year square-ups for individual taxpayers.

33. We have not identified any implementation risks.

MONITORING, EVALUATION AND REVIEW

34. The realigned rate of 17.5% would need to continue to be reviewed and considered alongside any future changes to the statutory tax rates of individuals.