

## ***Income Tax Bill***

25 October 2006

Attorney-General

### LEGAL ADVICE

#### CONSISTENCY WITH THE NEW ZEALAND BILL OF RIGHTS ACT 1990: INCOME TAX BILL

1. We have considered the Income Tax Bill ('the Bill') for consistency with the New Zealand Bill of Rights Act 1990 ('the Bill of Rights Act'). We understand that the Bill is to be considered by the Cabinet Legislation Committee at its meeting on Thursday, 26 October 2006.
2. We have concluded that the Bill appears to be consistent with the rights and freedoms affirmed in the Bill of Rights Act. In reaching this conclusion we have considered possible inconsistencies with sections 19 (freedom from discrimination) and 14 (freedom of expression) of the Bill of Rights Act.

#### **PURPOSE OF THE BILL**

3. The Bill repeals and replaces the Income Tax Act 2004 which provides the overarching framework for the collection of income tax in New Zealand. It sets out rules for calculating tax obligations and for satisfying the obligations imposed. The Income Tax Act 2004 involved a rewrite of Parts A to E and Y with the remaining Parts of that Act being a consolidation of the Income Tax Act 1994. The Bill consolidates Parts A to E and Y of the Income Tax Act 2004 and rewrites the remaining Parts.

#### **SUMMARY OF ADVICE**

4. We have considered the Bill for consistency with section 19(1) of the Bill of Rights Act because of possible discrimination on the basis of marital status, family status, employment status and age.
5. The Bill provides exceptions to ensure that people in a relationship are not penalised because of their financial dependence on each other, as well as restrictions preventing them from gaining an inequitable tax advantage. For the same reason, the Bill applies various restrictions to financial arrangements with close relatives in some cases. We have examined whether these measures give rise to an issue of discrimination on the basis of family status. It is arguable whether any disadvantage is created but, if so, it appears to be justifiable under section 5 of the Bill of Rights Act because it is necessary to create a fair and equitable tax regime.
6. We have considered whether the family assistance scheme set out in Part M of the Bill discriminates against people who do not have responsibility for caring for children or who have responsibility for caring for other kinds of dependents. The objective of the family assistance scheme is to address this disparity and also improve the living standards of families. People without dependent children may be eligible for other kinds of assistance.

We therefore consider that the family assistance scheme is unlikely to give rise to disadvantage and that, if there was disadvantage, it would be a justifiable limit on the right.

7. Clause MC6(b)(i) of the Bill excludes a person on an income-tested benefit from receiving a family assistance credit. Families receiving an income-tested benefit are treated differently from those receiving family assistance credits in that they receive a different form of government assistance. Nevertheless, in most cases, the level of assistance received by families on an income-tested benefit is greater than the amount they would receive through a family assistance credit. For this reason, it can be argued that clause MC6 does not create any disadvantage. If disadvantage did arise, this would be justified as the purpose of the provision is to provide assistance to families that do not already receive substantial government assistance. The non-payment of family assistance credits to families that already receive substantial government assistance reflects the economic constraints on government.
8. The Bill draws some distinctions between individuals on the basis of age. In particular, clause LC3 of the Bill exempts from income tax the earnings of some children to a maximum of \$2,340 a year. These allowances are intended to offer modest support to children who have either left school or who are about to leave school. Also, clause GB24(2) sets out when a contract between relatives may be treated as genuine for the purposes of clause GB23 (which deals with excessive remuneration). Clause GB24(2)(c) includes as one of the criteria that each party to the contract is 20 years or older. The purpose of section GB24(2)(c) is to ensure that a person under 20 is not used to stream excessive remuneration out of an entity in order to gain a tax advantage. Young people could be more easily persuaded by a family member to participate in an income streaming tax avoidance scheme and are also most likely to be targeted because of their lower incomes. For these reason we have concluded that the age limits in clauses LC3 and GB24(2) can be justified under section 5 of the Bill of Rights Act.
9. For completeness, we have also considered whether provisions of the Bill requiring parties to supply information to the Commissioner of Inland Revenue infringe upon the freedom of expression affirmed in section 14 of the Bill of Rights Act. It is arguable whether such information is truly "expressive" and, in any case, such a provision is clearly justifiable as it is necessary for the proper administration of the tax system.

## **SECTION 19(1) OF THE BILL OF RIGHTS ACT**

10. Section 19(1) of the Bill of Rights Act states:

*Everyone has the right to freedom from discrimination on the grounds of discrimination in the Human Rights Act 1993.*

11. The key questions in assessing whether discrimination under section 19 exists are:
  - i. does the legislation draw a distinction based on one of the prohibited grounds of discrimination; and
  - ii. does the distinction involve disadvantage to one or more classes of individuals?
12. If these questions are answered in the affirmative, we regard the legislation as giving rise to a *prima facie* issue of "discrimination" under section 19 of the Bill of Rights Act. Where a provision is found to be *prima facie* inconsistent with a particular right or freedom, it may

nevertheless be consistent with the Bill of Rights Act if it can be considered reasonable and can be justified under section 5 of that Act.<sup>[1]</sup> A limitation on a right might be justifiable where:

- i. the provision serves an important and significant objective; and
- ii. there is a rational and proportionate connection between the provision and that objective.

### **APPLICATION OF SECTION 19(1) TO THE INCOME TAX BILL**

13. We have considered the Bill for consistency with section 19(1) of the Bill of Rights Act on the following grounds of discrimination set out in section 21 of the Human Rights Act 1993:

- marital status which includes being single, married, in a civil union, or in a de facto relationship;
- family status, which includes having, or not having, responsibility for the care of children or other dependents, or being a relative of a particular person;
- employment status including being unemployed or a recipient of a benefit under the Social Security Act 1964; and
- age, starting at 16 years old.

### **Discrimination on the Basis of Marital Status**

14. One of the main features of the income tax regime is that people who are married, in a civil union or a de facto relationship are, to some degree, presumed to be financially interdependent on one another.
15. The Bill sets out a number of exceptions to taxation rules and some tax credits to ensure that people in a relationship are not penalised by having income declared taxable because of their financial dependence on each other. For example, clause CB21(1) provides an exception from the tax rules relating to income received from disposal and division of land for farming or agricultural purposes where a spouse or partner occupied the land immediately prior to it being divided.
16. The income tax regime also uses "restrictions" to rules and exceptions to prevent a taxpayer with a spouse or partner from gaining an inequitable tax advantage. A tax advantage might result where a couple is able to use their relationship to create an "artificial" impression of their financial situation to avoid, or limit the impact of, a particular taxation rule. For example, clause CD6(1) provides that a payment made by a company to a person is a dividend if that person is a shareholder of that company. A payment is also considered a dividend if it is paid to a trustee where a beneficiary of the trust is a spouse, civil union partner or de facto partner of a shareholder.
17. It is arguable whether the exceptions and restrictions applied to couples create any disadvantage. If any disadvantage is created, it appears to be justifiable for the purposes of section 5 of the Bill of Rights Act. This is because these provisions are intended to create a fair and equitable tax regime by recognising the financial interdependence of people in a relationship and to prevent people in a relationship using that relationship to gain a tax advantage.

## **Discrimination on the Basis of Family Status**

### *Application to Relatives*

18. The Bill also applies some restrictions to financial arrangements with relatives in some cases and could give rise to discrimination on the basis of family status. For example, subpart FC3 deals with the transfer of property to close relatives (defined as a person within the second degree of relationship). Also, subpart GB deals with tax avoidance including excessive remuneration to relatives.
19. As with people who are married or in a civil union or de facto relationship, the purpose of these provisions is to prevent people using their family relationship to gain an unfair tax advantage by structuring their finances in order to avoid, or limit the impact of, a particular taxation rule. For the same reasons, it is unlikely that disadvantage would be caused.

### *Family Assistance Scheme*

20. Part M of the Bill deals with the family assistance scheme which provides tax benefits for some families. Eligibility for the family assistance scheme depends, in part, on whether a person is the principal caregiver of one or more dependent children aged less than 18 years old or aged 18 where the child is not financially independent and is attending school or a tertiary educational establishment.
21. We have considered whether the family assistance scheme discriminates against people who do not have responsibility for caring for children or whether it discriminates against people who have responsibility for caring for other kinds of dependents.
22. The family assistance scheme is designed to address a problem specific to working parents. In 2002, the Ministry of Social Development published *New Zealand Living Standards Survey 2000*. The report showed that 28 per cent of families with dependent children have either restricted or somewhat restricted standards of living compared to 17 per cent of families without dependent children. The objective of the family assistance scheme is to address this disparity and also improve the living standards of this group. It is important to note that people without dependent children may be eligible for other kinds of assistance.
23. We therefore consider that the ineligibility of those without responsibility for the care of dependent children for the family assistance scheme is unlikely to give rise to disadvantage for couples or single persons who have no child care responsibilities. If disadvantage were to arise from this distinction we consider that the distinction is a reasonable limit on section 19(1) for the reasons set out above.

## **Discrimination on the Basis of Employment Status**

24. Clause MC6(b)(i) of the Bill excludes a person on an income-tested benefit from receiving a family assistance credit. This provision is similar to section KD2AAA(1)(e) of the Income Tax Act, which was inserted by the Taxation (Working for Families) Act 2004 (divided from the Future Directions (Working for Families) Bill).
25. In our advice on the Future Directions (Working for Families) Bill, we concluded that section KD2AAA(1)(e) raised an issue of discrimination on the grounds of employment status, but the provision was justified in terms of section 5 of the Bill of Rights Act. While we consider

that clause MC6(b)(i) is also consistent with the Bill of Rights Act, we have developed our thinking around whether the provision does differentiate on the grounds of employment status, whether any disadvantage arises from the provision and the justifiability of any resulting discrimination.

26. First, clause MC6(b)(i) does not differentiate on the grounds of employment status as defined in the Human Rights Act 1993. Not all employed persons are eligible for family assistance credits and not all unemployed persons are ineligible. Nor are all persons receiving a benefit under the Social Security Act 1963 or an entitlement under the Injury Prevention, Rehabilitation, and Compensation Act 2001 ineligible. Accordingly, employment status is not the operative ground of differentiation between those who are eligible for the assistance and those who are not.
27. Secondly, even if MC6(b)(i) can be characterised as creating a distinction on the grounds of employment status there is no disadvantage arising from this different treatment. While denying family assistance credits to those on an income-tested benefit could be seen as disadvantageous to such persons, in most cases the amount of government assistance received by these persons is greater than that provided by the family assistance credit. Accordingly, clause MC6 does not create any disadvantage for people receiving an income-tested benefit and, consequently, does not give rise to discrimination for the purposes of section 19(1) of the Bill of Rights Act.
28. In saying this, we note the findings of the *Living Standards Survey*, which identified that families with dependent children who were in receipt of an income-tested benefit have a lower average living standard than families who receive market income.<sup>[2]</sup> In our advice on the Future Directions (Working for Families) Bill, we observed that the extra level of support provided only to those in work appeared to exacerbate this situation further and, therefore, an argument could be raised that this measure disadvantaged those on an income-tested benefit.
29. We consider, however, that such disadvantage would be justified under section 5 of the Bill of Rights Act. The purpose of the provision is to provide assistance to families that do not already receive substantial government assistance as an acknowledgment of the contribution that such families make. The non-payment of family assistance credits to families that already receive substantial government assistance reflects the economic constraints on government.
30. We also note that one objective of the policy is to provide parents with the appropriate incentives to enter into and remain in the paid workforce. This is the most immediate means through which parents are able to improve living standards for families with dependent children.<sup>[3]</sup> The state has a legitimate interest in ensuring that those on benefits are provided with the appropriate incentives to assist themselves in moving off state-provided social assistance.

### **Discrimination on the Basis of Age**

31. The Bill draws some distinctions between individuals on the basis of age. In particular, clause LC3 of the Bill exempts from income tax the earnings of children to a maximum of \$2,340 a year. It applies where the child has left school (15 years), is under 18 years and still at school, and to a child who has left school part way through their 18th year. Clause LC4 allows a transitional allowance for children engaged in full-time work and who are over the age of 15

years and younger than 18 years who have left school. Young people generally have lower incomes and these allowances are intended to offer modest support to children who have either left school or who are about to leave school. This appears to be significant and important objective and is achieved in a rational and proportionate way through a small tax exemption.

32. Clause GB24(2) also raises an issue of discrimination on the basis of age. This provision sets out when a contract between relatives may be treated as genuine for the purposes of clause GB23 (which deals with excessive remuneration). One criteria is that each party to the contract must be 20 years or older (clause GB24(2)(c)). This differs from the Minors' Contracts Act 1969, which sets the age of contract at 18 years old. Clause GB24(2)(c) could be seen as creating disadvantage for people who are younger than 20 years old because a particular contract might be held to be genuine for a person who is 20 years old but not for person less than 20 years old.
33. The purpose of section GB24(2)(c) is to ensure that a person under 20 is not used to stream excessive remuneration out of an entity in order to gain a tax advantage. Young people could be more easily persuaded by a family member to participate in an income streaming tax avoidance scheme. Young people are also most likely to be targeted by people wanting to promote such avoidance arrangements. For a tax avoidance scheme involving income streaming to work optimally, the person receiving the excessive remuneration has to be on a low marginal tax rate. A person under 20 is more likely to be on a low marginal tax rate.
34. Preventing tax avoidance through income streaming appears to be a significant and important objective. Based on the reasons set out above the use of age as one of the criteria seems to be rationally connected to that purpose. Since the provision does not relate directly to the validity of the contract there is not necessarily a correlation with the age of contract in the Minors' Contracts Act. It is also worth noting that the 20 year age limit is not the only policy setting for the anti-streaming rule. It applies to any contract involving impermissible income streaming or excessive remuneration, regardless of age. Before consideration is given to the validity of a contract, the Commissioner of Inland Revenue must have found that there has been excessive remuneration.

## **CONSISTENCY WITH OTHER RIGHTS AND FREEDOMS**

35. For completeness, we have also considered whether provisions of the Bill requiring parties to supply information to the Commissioner of Inland Revenue infringe upon the freedom of expression affirmed in section 14 of the Bill of Rights Act. For example, clause IP6 requires a company to supply accounts in support of a claim to carry forward losses. It is arguable whether such information is truly "expressive" in nature so as to engage section 14. In any case such a provision is clearly justifiable as it is necessary for the proper administration of the tax system.

## **CONCLUSION**

36. For the reasons set out above, we have concluded that the Income Tax Bill appears to be consistent with the rights and freedoms affirmed in the Bill of Rights Act.

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## Footnotes

1 *Moonen v Film and Literature Board of Review* [2000] 2 NZLR 9

2 Ministry of Social Development *New Zealand Living Standards Survey* (2002), 111

3 *New Zealand Living Standards Survey*

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