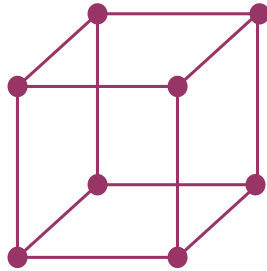


Towards Consensus on the Taxation of Investment Income



Report to the Minister of Finance and Revenue

By
Craig Stobo
Chair

October 2004

SEMI-KIWI

*The barn roof needs painting
and the spouting is ruined.
Likewise the roof of this house
in which we live, borer here,
rot there. I'm neither handy,
in the great Kiwi DIY tradition,
nor monied, which rather leaves
us up shit creek without a shovel.
I grub to find what Stevens called
the 'plain sense of things'
and come up empty-handed
more often than not, but
I'm a dab-hand at recognising,
if not suppressing, self-pity,
and I can back a trailer
expertly, so all is not lost.*

Brian Turner

Te Mata Estate New Zealand Poet Laureate

*(Reprinted from "Taking Off", Victoria University Press, 2001,
with kind permission of the author)*

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Foreword

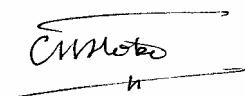
I consulted a large number of stakeholders during this consensus building process. They represented a range of interests reflecting the breadth of the investment and savings industry in New Zealand. The basis for my engagement was not that New Zealand necessarily has a poor savings rate, but that taxation is distorting the efficient allocation of what savings New Zealanders do have. Taxation rules are necessarily arbitrary, but in the case of the taxation of investment income, outcomes have become sub-optimal, in my judgment, as after-tax return considerations mean investors incur transactions costs and assume different portfolio risks than would be the case if investors focused on gross (pre-tax) returns. The optimal allocation of our scarce capital resources is therefore distorted and New Zealand's potential growth rate is arguably lower as a result.

The options developed in this process were designed to reduce both the tax disincentives prevalent in New Zealand collective investment vehicles (CIVs), relative to direct investment in New Zealand assets; and the distortions created by our tax rules favouring a small number of high tax countries (the grey list) for international portfolio investment in equity. This process did not seek a constituency to support tax incentives for savings.

In my capacity as Chair I was assisted by David Carrigan, Darshana Elwela, Tracey Davies, Keith Taylor and Robin Oliver from the Policy Advice Division of Inland Revenue; and Brock Jera, Felicity Barker, David Snell, Andrew McLoughlin, and Vicky Robertson from the Treasury. I want to personally thank them for their support and intellectual integrity during the consultation process. Thanks are also due to the stakeholders who put aside their self interest, and contributed their time to wrestle with the issues and the proposed solutions. I hope I have adequately captured their concerns and aspirations.

I should not neglect the fact that the options presented in this review build on the generation and exchange of ideas of past contributors to the improvement of public policy on the taxation of investment income. If I have misrepresented any of their views I take full responsibility.

Signed

A handwritten signature in black ink, appearing to read 'C Stobo', with a horizontal line underneath it.

Craig Stobo
29 October 2004

Disclosure: Craig Stobo was formerly the CEO of BT Funds Management Ltd and board member of the Investment, Savings and Insurance Association of New Zealand. He is currently deputy chairman of Industrial Research Ltd. He contributed to the Periodic Report Group, Savings New Zealand and the officials' issues paper, *Taxation of non-controlled offshore investment in equity*. He has worked as an independent contractor for this consensus building process. He has financial interests in direct shares, direct property and CIVs.

Chapter 1

Executive summary

The Government has asked me to “develop options for change that would minimise the extent to which the tax system distorts the way New Zealanders invest (direct versus via an intermediary or via different intermediaries)”.

The Terms of Reference (see Appendix I) restricted the development of options to all offshore portfolio equity investment, whether direct or through a New Zealand collective investment vehicle (CIV), and New Zealand CIVs that own domestic equity. It did not extend to the treatment of debt instruments or New Zealand equity/property held directly.

This consultation process uncovered a strong consensus to change the way New Zealand taxes investment income. Therefore the objective of this process was welcomed by almost all stakeholders. Stakeholders agreed on the tax boundaries under discussion and the economic distortions that arise from those boundaries, which affect investor behaviour.

Options presented for improving the taxation treatment of investment income in New Zealand were agreed by stakeholders as the best set of options available, given my Terms of Reference. I did not receive any comments or submissions that materially improved the options presented. Options provided to me on flattening the tax scale and extending the brief to direct New Zealand assets are economically sound suggestions but are outside the Terms of Reference.

An analysis of stakeholders’ preferred combination of options shows majority support for:

- a) A change in the definition of “income” for defined New Zealand CIVs by shifting the capital/revenue boundary to exclude capital gains on domestic equity.
- b) The abolition of the grey list and foreign investment fund (FIF) rules for offshore portfolio equity investment, the removal of dividend taxation, and the institution of an investment and savings tax (IST).
- c) The alignment of taxation through a New Zealand CIV with investor marginal tax rates by way of a “flow through” regime.

An analysis of this consensus and my Terms of Reference, which demand consistency, leads me to differ on the combination of options preferred by stakeholders. My preference is for an IST to extend to domestic equity held through New Zealand CIVs, since this gets us closer to the taxation of full economic income and is consistent with the preferred option for taxation of offshore equity.

I believe there is considerable momentum for change. It is not obvious to me that a democratic process of consensus building towards an improved sustainable system of taxation of investment income for New Zealand investors during a clear window of goodwill can be surpassed as a strong process for change.

Chapter 2

Taxation of investment income – principles and practice

In the course of the consultation process it became clear that sections of the investment community sought clarification on what it was I was trying to solve. I hope the following articulates the issues clearly.

THE TAXATION OF INVESTMENT INCOME

The guiding principle of income tax policy is to tax an economic definition of income. The most common definition of income, attributable to Haig-Simons,¹ is the change in market value of net assets for a defined period plus consumption over the same period. Deviations from this principle would result in some economic activities being preferred relative to others. Haig-Simons income is therefore the benchmark which I have used to assess options for taxing investment income in New Zealand.

Unrealised capital gains on net assets under this benchmark are part of economic income. New Zealand does not have a comprehensive capital gains tax.² That is not to say that capital gains taxes are a preferred way of dealing with this anomaly. The McLeod Review concluded in 2001 that "... New Zealand should not adopt a general realisation-based capital gains tax. We [the Review] believe that such a tax would not necessarily make our tax system fairer and more efficient, would not lower tax avoidance and would not raise substantial revenue that could be used to lower tax rates. Instead, any such tax would be more likely to increase the complexity and costs of our system. The experience of other countries (such as Australia, the UK and the US) supports that conclusion."³

New Zealand has instead opted for business and purpose tests to define whether investment is on revenue account, and therefore subject to tax on realised gains, or on capital account, in which case taxation is not due on realised gains. The tests effectively try to distinguish between what is the apple tree (untaxed capital) and what is the apple (taxable income).

¹ Haig, Robert M. (editor) (1921), *The Federal Income Tax*, Columbia University Press, and Simons, Henry C. (1938), *Personal Income Taxation*, University of Chicago Press.

² While capital gains are tax-free in the main, New Zealand deems the proceeds of sale from certain assets to be income under ordinary concepts.

³ *Final Report of the Tax Review 2001 (October 2001)*.

The tests cannot fully be described in legislation. They do, however, have a long history in the common law. Recently, participants in the investment and savings industry have had to resort to the judiciary to seek clarity. An example of this guidance is *Alexander and Alexander Pension Plan v CIR*.⁴ Additional common law guidance comes from *CIR v City Motor Services*⁵ and *Grieve v CIR*.⁶ None provide watertight definitions of what is capital and what is revenue. The problems drawing the boundary between capital and revenue were summed up eloquently as “... an intellectual minefield in which the principles are elusive and the analogies treacherous”.⁷

The major tax-driven side effects from New Zealand’s deviation from the taxation of economic income are:

- Investors’, suppliers’ and advisors’ efforts to mitigate tax liabilities require expensive tax advice on whether an investment is on capital or revenue account.
- Compliance outcomes are asymmetric. Trustees of CIVs with tax liabilities will tend to be conservative in their definition of income by treating both realised and unrealised gains on revenue account. This is due to equity issues associated with pooling and the threat of official audit. Other investors may “game” the definition and not treat realised gains as income because the threat of official audit is perceived as low.
- Taxpayers can apply to the Inland Revenue for private rulings on whether an investment is on capital or revenue account in order to gain certainty of tax treatment. However, these rulings are expensive and time consuming.
- Inland Revenue rulings on the interpretation of the capital/revenue boundary in relation to passive products have also created a tax driven demand for passive products, which has led to over-investment. This means that companies within relevant indices may be receiving more capital than is warranted, while others outside these indices go wanting.
- Investors may have a strong preference to own directly high dividend New Zealand shares, and a bias away from directly owned high dividend shares offshore. Investments offshore may be directed to growth oriented companies to minimise double taxation due to their inability to utilise offshore imputation credits.

⁴ (1995) 19 TRNZ 884

⁵ [1969] NZLR 1010 (CA)

⁶ (1983) 6 NZTC 61,682

⁷ *Tucker v Granada Motorway Services Ltd* [1979] 2 All ER 801; per Templeman J.

- Traditional CIVs migrate to entity forms which replicate the status of direct investors on capital account such as individually managed accounts, blind trusts and passive funds, even though the spread of underlying assets may be equivalent to assets held by more traditional CIVs. While these newer forms may well have platform technology and client servicing advantages, and competitive fee structures, it would be a long bow to pull to say that the absence of a tax on realised gains is not the principal competitive advantage. The consequences of this shift in form is that compliance obligations are pushed down to the beneficial investors; and it is not clear that these forms are optimal channels for lower income savers with small initial balances. If they are pooling funds (reducing risk and administration costs), then they must have robust systems of individual investor identification to ensure they do not meet the definition of “unit trust” in the Income Tax Act.

THE TAXATION OF OFFSHORE PORTFOLIO INVESTMENT IN EQUITY

The taxation treatment of offshore portfolio investment in equity must necessarily differ from the taxation treatment of onshore portfolio investment, because the New Zealand Government does not collect taxation from foreign entities, whereas it does collect taxes from New Zealand entities (e.g. company taxation). New Zealand investors should regard foreign taxes as simply a cost of investing overseas and arrange their portfolios to minimise offshore tax accordingly. The New Zealand Government should be indifferent to capital outflows when New Zealand investors face an after-tax foreign return that is at least as high as a pretax domestic return on similar risk-adjusted assets. National welfare is enhanced as a result.

As a net capital importing country, New Zealand should implement this “residence principle”-based taxation strategy. New Zealand residents should be taxed at the same rate of New Zealand tax on all sources of domestic and foreign income, recognising foreign taxes as a cost of doing business by allowing them to be deductible. Ideally therefore New Zealand tax rules should approximate the after-foreign tax income earned by the foreign entity and attribute it to the New Zealand investor.

Currently the New Zealand tax rules deviate from this principle. Two sets of rules apply to offshore portfolio investment. Non-grey list countries are subject to the foreign investment fund (FIF) rules. These rules generally apply the residence principle by taxing, on an accrued basis, the investor’s economic income derived from the foreign entity. They therefore get fairly close to Haig-Simons income. However, the four income calculations available to FIF investors are costly to comply with, have harsh cashflow consequences in certain circumstances and have timing disadvantages.

The grey list refers to investment in seven countries – Australia, the United Kingdom, Canada, Norway, the United States, Germany and Japan – which, because of the similarity of their tax systems to that of New Zealand, have achieved a concessionary treatment resulting in a tax preference for New Zealand investors. Grey list non-business investors (who generally argue that they invest on capital account) are generally only required to pay New Zealand tax on dividend income. It is therefore not surprising to learn that around 80% of offshore portfolio investment occurs in grey list countries. From an economic perspective, quite why any of these investment destinations (least of all Norway) should receive tax preferences over non-grey list destinations such as France or China is illogical. The current country composition is economically meaningless. Our tax rules should encourage New Zealand investors to focus their foreign portfolio decisions on income net of foreign tax paid, relative to gross returns available from portfolio investments onshore. Furthermore, effective tax rates (on economic income earned by New Zealanders after foreign tax) can diverge significantly from an equivalent pre-tax domestic investment.

THE TAXATION OF ENTITIES

Entities, or more specifically CIVs, such as investment companies, unit trusts and superannuation schemes are economic agents of their owners. Entity taxation is economically a tax on the beneficial owners of entities. After all, entities do not derive economic income – their beneficial owners do. Entity taxation should therefore reflect the marginal income tax rate of the ultimate investor.

In New Zealand the corporate tax regime places a single withholding tax on the company on behalf of the ultimate investors. Our imputation regime provides a mechanism to align our progressive income tax rate scale with the withholding tax levied in the entity. The more progressive the income tax scale becomes, however, the more advantages accrue to taxpayers on higher marginal tax rates (in terms of timing of final tax payments); and the more disadvantages accrue to those on lower marginal tax rates (in terms of timing and potential use of excess imputation credits).

With regard to New Zealand CIVs such as superannuation schemes, where the final 33% tax liability resides inside the vehicle (and therefore there is no imputation regime) there is no alignment with taxpayers on 19.5% or 39% marginal tax rates. Investors on 19.5% face tax penalties while those on 39% receive a tax incentive.

It is difficult to find evidence that differences between entity and marginal tax rates drive investor behaviour. The anecdotal evidence suggests 39% investors prefer direct investment (due to the treatment of capital gains). Investors on 19.5%, however, not only find it difficult to save, face the same capital gains hurdle, but also face the additional hurdle of over-taxation in the entity. (The interaction of the tax system with the benefit regime is important. See Appendix V.) Furthermore, tax-exempt entities, such as charities, find it very difficult to align their tax status with the taxation of CIVs.

The tax treatment of CIVs that potentially hold the same underlying assets should be equivalent. Currently taxation regimes differ for unit trusts, GIFs, life products and superannuation (see Appendix IV). This is not efficient when the vehicles may hold exactly the same assets. Real economic costs are incurred by the ultimate saver or investor as they or their advisors search for and select the most tax effective entity.

Chapter 3

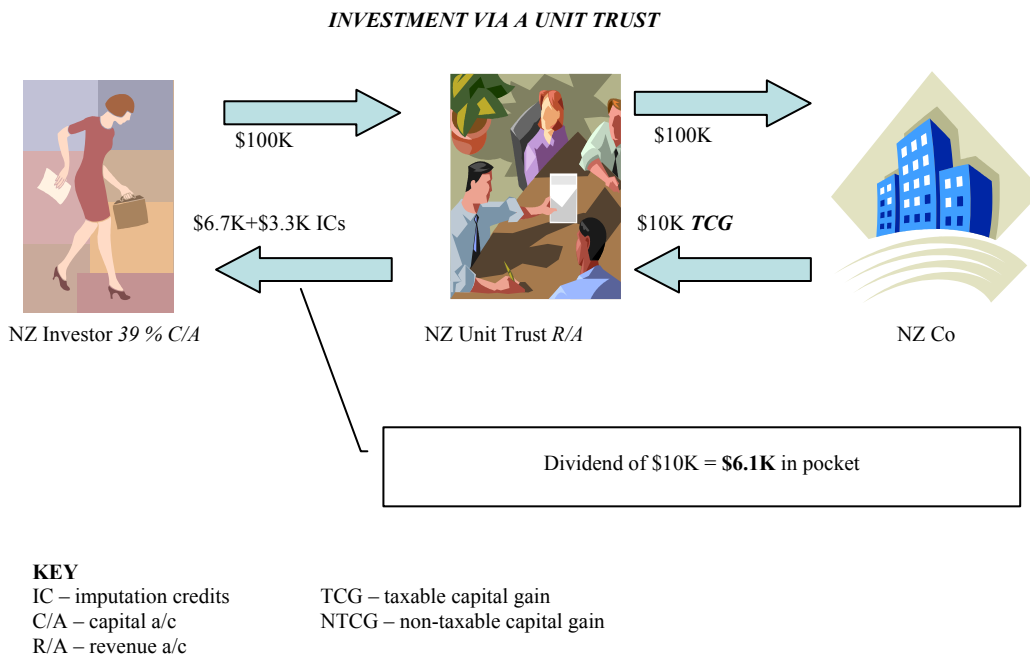
The impact of the current tax boundaries

THE DEFINITION OF “INCOME”

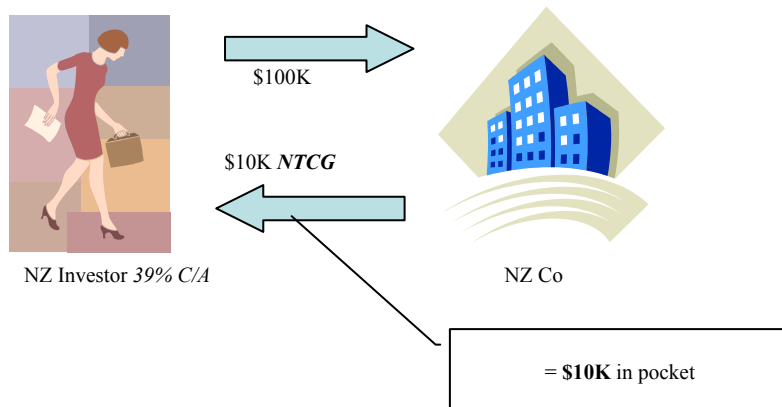
The capital/revenue boundary receives a conservative treatment by almost all New Zealand CIVs. As a result almost all CIVs provide for tax on realised and unrealised capital gains at 33%, despite the absence of a legislated capital gains tax in New Zealand. The principal reason for this is that, in the absence of clear legislation or judicial rulings on the business and purpose tests, trustees opt to treat all gains on revenue account. To do otherwise could introduce inter-temporal inequity between classes of investors should the Inland Revenue be successful in challenging a capital account tax treatment. Those investors that exited prior to the successful challenge would escape any tax liability.

As noted in the previous chapter, the economic impact of this boundary is threefold. Firstly, the treatment of capital gains inside CIVs is a major turnoff to all investors who have the opportunity to invest directly in the same underlying assets on capital account. Secondly, the direct channel is not easily accessible to investors with small initial balances and small amounts of regular savings. Thirdly, the direct channel clearly favours investors with existing accumulated capital. Figure 1 illustrates why direct investment in a New Zealand share is preferable for a 39% investor on capital account relative to investing in the same share through a unit trust.

Figure 1: Direct/indirect investment boundary



COMPLIANT DIRECT INVESTMENT ON C/A



In addition, there has been a rapid increase in investor interest in the provision of investment management services on capital account which effectively push the liability for tax to the investor. These new services include individually managed accounts, blind trusts and passive funds with Inland Revenue rulings. In relation to passive funds, their tax-favourable investment has seen a rapid growth in their popularity from 1996 (the year that the first Inland Revenue ruling was granted). There is now estimated to be around \$5.5 billion in passive funds.⁸ Tax is creating a wedge against the use of pooled investment services, which have become relatively tax-disadvantaged.

I do not want to belittle the real advantages that these innovations may provide in terms of service, choice, fees, and investment performance. However, tax is clearly a major competitive advantage, and the ability of the Inland Revenue to monitor the end investor's compliance with the tax rules is weak. Table 1 details the latest figures for the net wealth of New Zealanders by asset type.

⁸ According to FundSource Research Ltd.

Table 1: Intermediated assets versus direct assets versus total assets of New Zealanders⁹

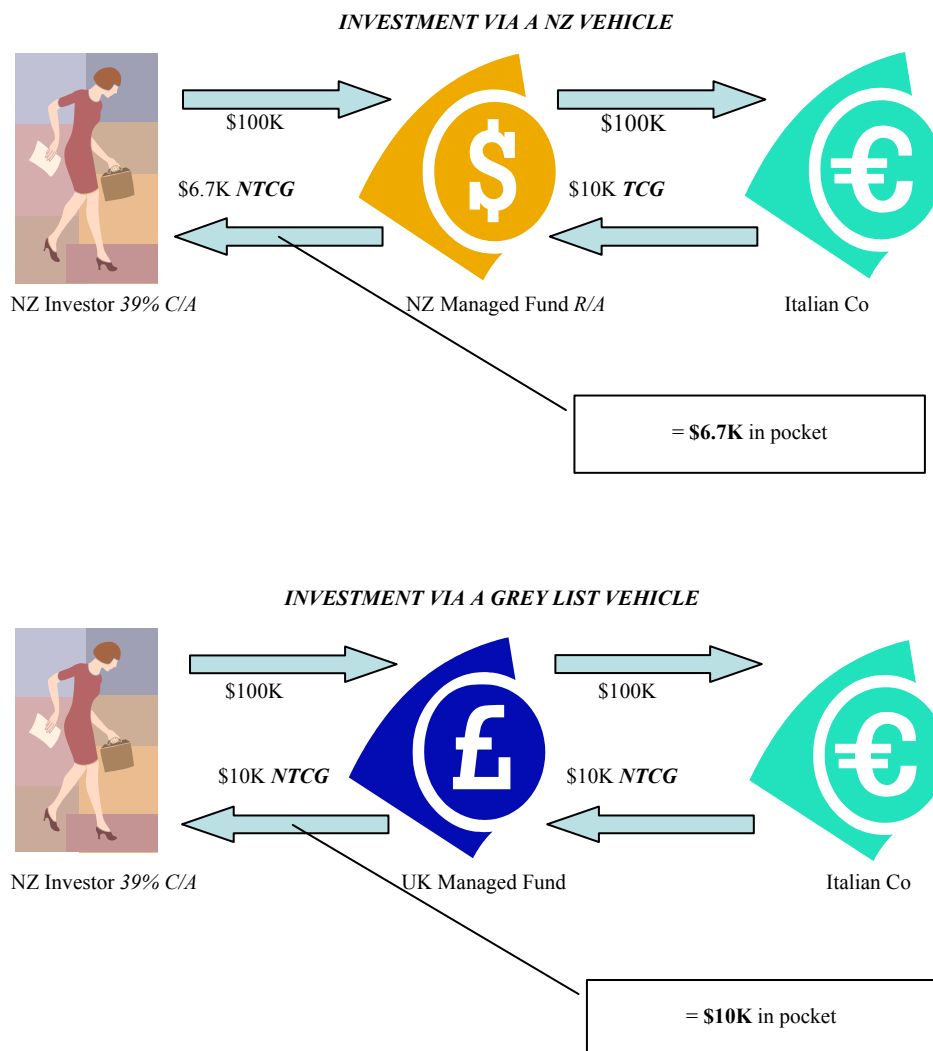
Asset Type	Pop with asset %	Total value (million) \$	Prop of total asset value %	Median \$
<i>Maori Assets</i>	3	8,790	2	15,000
<i>Trusts</i>	4	28,709	6	216,000
<i>Farms</i>	4	38,257	9	350,000
<i>Businesses</i>	12	38,574	9	43,000
<i>House living in</i>	48	159,205	36	160,000
<i>Time share</i>	1	137	0	8,000
<i>Holiday home</i>	2	4,361	1	80,000
<i>Rental property</i>	6	18,887	4	135,000
<i>Overseas property</i>	1	4,194	1	40,000
<i>Commercial property</i>	2	7,343	2	150,000
<i>Other property</i>	4	9,863	2	95,000
<i>Superannuation</i>	21	24,737	6	25,000
<i>Life insurance</i>	14	8,797	2	15,000
<i>Credit cards (positive balances)</i>	3	95	0	500
<i>Bank deposits (including bonus bonds)</i>	91	26,000	6	2,300
<i>Shares</i>	21	13,986	3	5,000
<i>Managed funds</i>	9	11,864	3	23,900
<i>Other financial assets</i>	5	5,792	1	30,000
<i>Money owed to respondent</i>	8	3,835	1	5,000
<i>Motor vehicles</i>	77	16,871	4	8,000
<i>Cash</i>	3	191	0	1,600
<i>Collectibles</i>	25	6,857	2	5,000
<i>Other assets</i>	44	6,685	2	3,000
<i>Total</i>		444,030		125,300

ONSHORE/OFFSHORE BOUNDARY

The offshore tax rules encourage the migration of offshore portfolios from New Zealand CIVs with implicit capital gains taxes to foreign CIVs in grey list jurisdictions on capital account, as depicted in figure 2.

⁹ Taken from Statistics New Zealand and the Retirement Commission (2002) “*The net worth of New Zealanders: a report on their assets and debts*” available at www.stats.govt.nz and www.sorted.org.nz.

Figure 2: Offshore/onshore boundary



There are now very few (if any) New Zealand CIVs that hold foreign portfolios directly as investors and CIV providers prefer foreign CIVs. The migration may be driven by other factors such as economies of scale, but the tax advantages are too large to ignore.

This migration to foreign CIVs may not be optimal from a New Zealand portfolio investor's perspective. Firstly, foreign CIVs may not manage currency risk from a New Zealand perspective. Secondly, their world view is not New Zealand-domiciled, so an international equities portfolio managed principally for Australian investors will not include Australian stocks but may include New Zealand stocks.

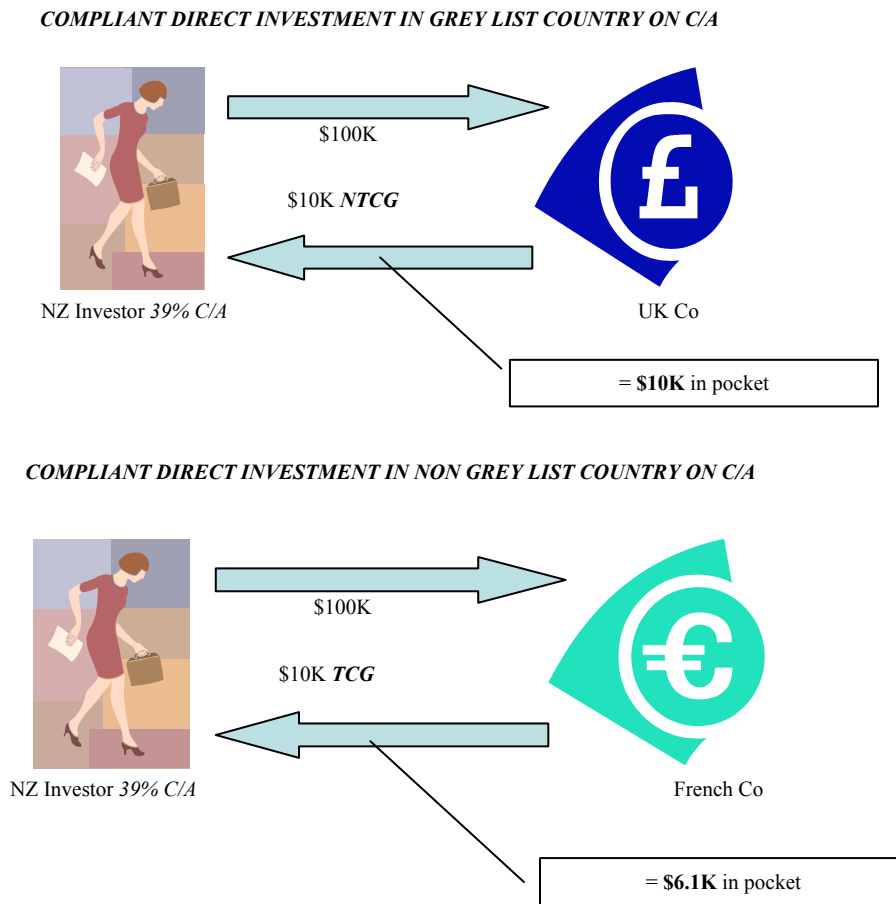
From the Government's perspective, compliance shifts from New Zealand entities to New Zealand individuals.

THE TAXATION OF OFFSHORE PORTFOLIO INVESTMENT

According to the officials' issues paper,¹⁰ fund managers and other New Zealand entities manage around \$17 billion of offshore portfolio investment. Individuals hold another \$5.5 billion, of which approximately 60% is either invested directly in Australia or using an Australian entity as a vehicle to invest elsewhere.

The first impact of the preferential tax treatment attached to the grey list is that 80% of New Zealanders' portfolio investment goes into grey list countries, a rationale for which is evidenced in figure 3. This statistic is not necessarily very helpful and will almost certainly be lower, since in many cases New Zealand portfolio investment into grey list countries includes intermediate vehicles such as Australian unit trusts and UK open-ended investment companies which on-invest globally, including into non-grey list stocks. Available data cannot assist officials to look through the intermediate vehicles to the final investment to determine the actual country exposure of our total portfolio investment. However, it is interesting to note that the Morgan Stanley Capital International (MSCI) benchmark country weighting of the seven grey list countries was 83.6% as at 31 August 2004.

Figure 3: Grey list/non-grey list boundary



¹⁰ *Taxation of non-controlled offshore investment in equity: an officials' issues paper on suggested legislative amendments.* Prepared by the Policy Advice Division of Inland Revenue and by the New Zealand Treasury. December 2003.

Effectively, New Zealanders are able to access non-grey list stocks through the grey list and avoid the FIF rules. The original rationale for the grey list (that effective grey list tax rates approximate New Zealand effective tax rates) has broken down. The soon-to-be introduced rules relating to offshore unit trusts will remove the ability of some offshore vehicles to avoid income tax by issuing bonus units in lieu of distributions. However, the ability to avoid the FIF rules remains because offshore vehicles can still be used as conduits for New Zealanders to access non-grey list investment destinations.

I do not understand why New Zealanders should be discouraged from investing in low tax countries (which is the result of the grey list bias). Foreign taxes are a cost of investing, just as labour costs are a cost of that company doing business. There is no welfare gain for New Zealand households or the Government by encouraging New Zealanders to invest in high tax regimes (which is what the grey list represents).

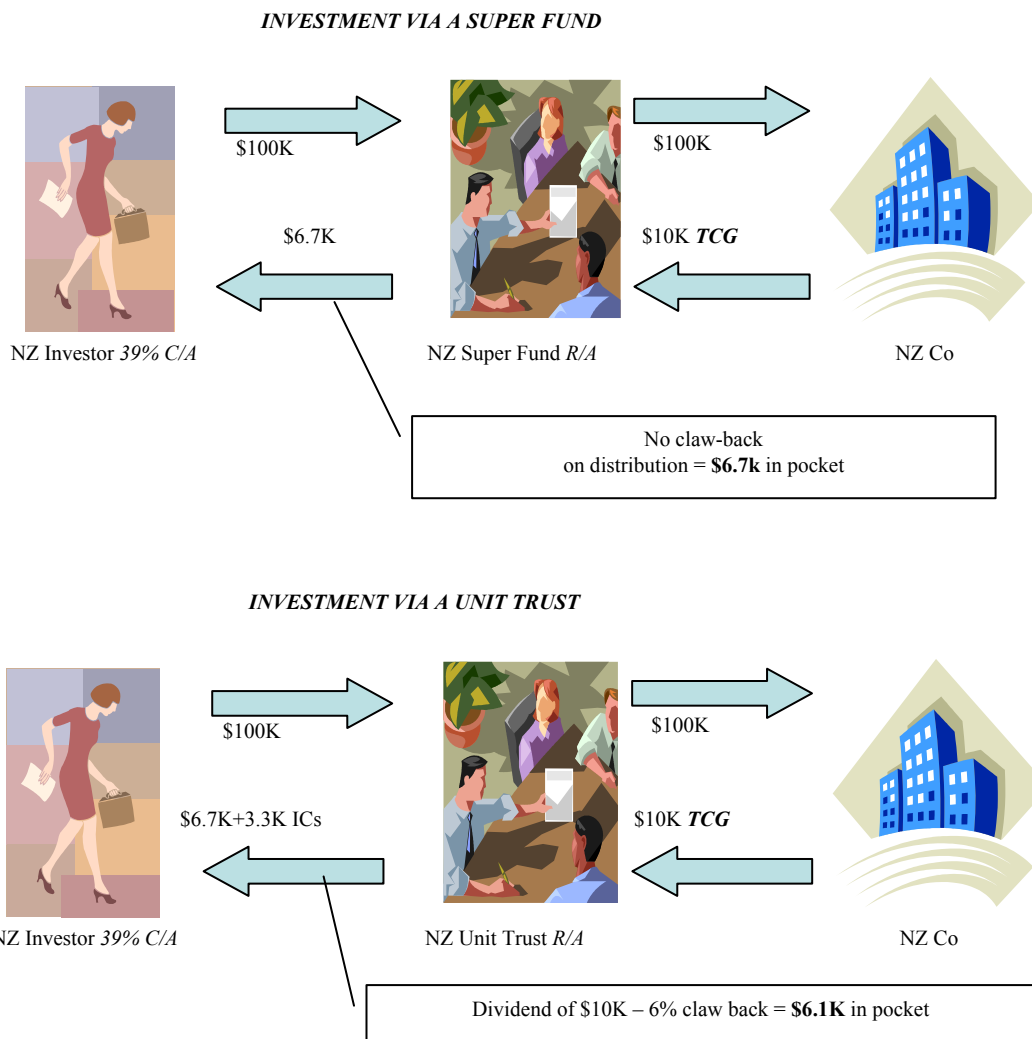
Thirdly, through an act of serendipity, foreign conduit vehicles in the grey list provide opportunities for New Zealand investors to access global stocks on capital account, and avoid the FIF rules. Do we honestly think that these CIVs are the best in the world? And why should they be preferred to CIVs that may be prevalent in non-grey list countries?

THE TAXATION OF CIVS

There are effectively two boundaries in this area, namely the boundaries amongst CIVs that potentially hold the same assets, and the boundary between the taxation regime applicable in CIVs and that prevailing for the individual. The net effect is that investors who are committed to using CIVs can be expected, a priori, to choose vehicles based on their effective tax rate, despite underlying assets being the same in each case.

Figure 4 illustrates that it is rational for committed CIV investors on 39% tax rates to use superannuation schemes and insurance products as their preferred savings vehicle, while 19.5% taxpayers should use unit trusts, other things being equal.

Figure 4: Vehicle/marginal tax rate boundary



The evidence to support this behavioural expectation is anecdotal. However, the evidence, such as it is, would suggest that (counter intuitively) a reasonable proportion of savers are 19.5% taxpayers. Perhaps other reasons, such as employer contributions, may be driving this behaviour. As far as I am aware, no public data is collected on the marginal rates of investors using different CIVs.

SUMMARY

It is clear to me that tax is driving investment behaviour. This adds to transition costs in that, as Appendix III (a summary of a recent Treasury working paper) discusses, the resulting misallocation of resources may be contributing to a lowering of our potential economic growth rate.

Chapter 4

Options for reform

SYSTEMIC THINKING

When approaching the options I was very conscious of the need to apply synthesis thinking to understand the “system” under examination, the rules for taxing investment income. A “system” is a “whole that cannot be divided into independent parts without loss of its essential properties or functions”,¹¹ hence the illustration on the cover page. If we were to try to improve one part of the system, as officials attempted to do with the issues paper issued last year to address the taxation of non-controlled foreign equity, the performance of the whole system may not be improved. This is because in a modern deregulated economy, capital is mobile across boundaries.

I do acknowledge that a weakness in my brief from the Minister is the exclusion from examination of the taxation of income from New Zealand assets where the investor does not use a CIV. However, the addition of domestic assets held by CIVs to offshore portfolio investment to the reform agenda is an improvement in holistic thinking. Additionally, if the options provide flexibility for further sensible reform then we have an improved outcome.

What is most important is that I attempt to move beyond simply an optimal solution under current thinking, to a different conceptual framework where the problems can be eliminated and the taxation regime can get closer to the principles outlined earlier.

ADVANTAGES AND DISADVANTAGES

The advantages and disadvantages of the various options should be read in light of the objective of the consultative process, namely “the minimisation of the extent to which the tax system distorts the way New Zealanders invest (direct versus via an intermediary or via different intermediaries)”. The intention of the Terms of Reference was to limit the scope for reform to offshore portfolio equity (directly held and through CIVs) and CIVs holding domestic portfolio equity. The options therefore do not consider domestic portfolio equity held directly. Some options reduce the distortions outlined in Chapter 3 but do not eliminate them. My preference is to aim for greater simplicity at the expense of accuracy when this tradeoff is confronted.

¹¹ *Recreating the Corporation*, Russell L Ackoff, Emeritus, Wharton School at the University of Pennsylvania, 1999.

THE OPTIONS

	Income Calculation	Vehicle/Marginal Tax	NZ assets held directly – outside scope
Onshore CIVs only	(a) IST	<i>1. Tax in the CIV</i> (a) Tax on managed fund vehicle with credit for tax paid (b) Final tax at variable rates	
	(b) Shift capital/revenue boundary	<i>2. Flow through</i> (a) Withholding tax at proxy rate deducted and paid at source with investor wash up (b) Withholding at variable rates deducted and paid at source	
Offshore CIVs and offshore direct equities only	(a) IST (b) Comparative Value	Not applicable	

The matrix above was constructed by officials when they were responding to my requirement for a simple, integrated flipchart presentation of the options available to mitigate the tax boundaries detailed in Chapter 3. The matrix elegantly integrates potential solutions to the three relevant problematic tax boundaries, namely, capital/revenue, offshore/onshore, and CIV tax rates/investors' marginal tax rates; and of course the boundaries overall relationship with direct New Zealand assets, which lies outside my Terms of Reference. My sphere of influence was to reduce the distortionary tax treatment of everything inside the matrix.

Before reviewing the options available I want to articulate a prospective definition of a CIV.

WHAT SHOULD CONSTITUTE A CIV?

For the purposes of the consensus building process I have come to the conclusion that the definition of a CIV should be a vehicle that owns a portfolio of securities where that entity owns no more than 10% of the issued capital of the underlying company and has no control over the company, and where each individual owner of the vehicle owns no more than 10% of it. Ten percent is an appropriate boundary as it is an internationally accepted distinction between portfolio and non-portfolio investment. In addition, a business activity test should be developed in order to ensure that a vehicle's main function was managing investments. This means that unit trusts, defined contribution superannuation schemes, GIFs, and life insurers' savings and annuity products should be included within the CIV definition.

Closely held entities (such as some partnerships and some venture capital funds) would not come within the proposed definition because of avoidance concerns. Furthermore, where the current benefit of the investment is not directly linked to the current market value of the CIV's underlying assets, or where there is no accurate surrender value such as for certain life policies or defined benefit superannuation schemes, these would not fall within the definition. The reason is that these vehicles cannot equitably assign income to each beneficiary.

DEFINITION OF INCOME FOR ONSHORE ASSETS

The options are either an Investment and Savings Tax (IST)¹² or a shift in the capital/revenue boundary, to the point where capital gains on equity are tax-free and tax is paid on all other forms of income (e.g. rent/interest/dividends).

Investment and Savings Tax (IST)

This title is a simple umbrella term for the variants of the risk free return method (RFRM) proposed over the last four years in New Zealand – the real RFRM, the nominal RFRM method and the standard return method. Each variant has similar features. Essentially, at the beginning of each tax year, a universal rate of return on a portfolio of assets is assumed (i.e. ex ante). Taxable income is calculated by applying that rate of return to the dollar value of the portfolio at the commencement of the tax year. The tax due on that income is based on an investor's marginal tax rate and is paid at the end of the tax year. Returns above the assumed rate are tax-free; returns below the assumed return still require payment of the tax. The relevant formula is provided below:

$$\text{Opening value} * \text{assumed rate of return} * \text{investor's marginal tax rate}$$

Depending on the method chosen, an IST moves our taxation regime closer to the principle of taxing full economic income. If returns to risk are considered to be entirely random, given a level of risk, then the Government should be indifferent between obtaining a share of positive returns to risk and returning a share of losses from risk to taxpayers. The essentially random nature of these returns would suggest that Government is in no better position after the tax compared with the position before the tax.

The Government could capture the expected value of a positive return to participation in financial markets by directly investing in equity. Assuming the Government does not want to hold equity directly, the average portion of positive return that the Government will collect over time would depend on the IST benchmark used. Whether a tax approach based on this logic meets the objective of taxing (on average) full economic income would depend critically on the rate. The IST rate that would

¹² My thanks to Louis Boulanger for conceiving this title.

get us closest to taxing full economic income would be one that proxied expected average dividend yield plus capital gain.

An IST represents a shift from traditional transaction-based taxes applied ex post, such as a typical capital gains tax, where the Government and the investor are exposed to the full volatility of equity cycles, to an ex ante tax on a low “risk free” rate, where the investor collects all capital gains above the risk free rate, in return for which the investor pays the tax through all equity cycles. The Government’s taxation revenue exposure shifts from an equity-like profile to one that has a profile closer to debt, in which case revenue volatility is reduced.

An IST removes the uncertainty of the capital/revenue boundary – since the definition of what is capital and what is revenue is redundant. It replaces dividend taxation. The potential for error when estimating provisional tax reduces under an IST. Tax losses are no longer generated. IST liabilities would be reduced to the extent that imputation credits are available from portfolio investments.

In terms of whether an IST gets us closer to the after-tax treatment of direct portfolio investment on capital account, it may, depending on the IST rate. In the short term there may be mismatches. However, while an IST may move the income tax treatment of CIVs closer to the income tax treatment of direct investments, it will not be equivalent. Direct investors on capital account will be indifferent between the two regimes if the ex post tax on their underlying portfolio’s dividend yield is the same as the ex ante IST on income from a CIV.

Direct investors on revenue account should have a schizophrenic response. When ex post returns are higher than the IST rate, they should prefer to use a CIV; when total returns are negative they should prefer the status quo since they can claim a tax credit for capital losses. However, in both cases revenue account investors cannot predict ex post market returns.

Alternative IST rate setting methodologies

A higher IST based on expected dividend yield and capital gains will be closer to a tax on full economic income. A lower IST will be closer to the tax treatment of direct New Zealand equities. I have considered the following three methods:

- *Real risk free return method.* The McLeod Review proposed a single risk-free rate of return applicable to all investments in the ambit of the regime. The rate would be based on New Zealand Government debt with a one-year term to maturity, adjusted for expected inflation over the year in question. This methodology is transparent and is credible because it is linked to deep liquid markets.

- *Nominal risk free return method.* This replicates the first method, but does not adjust for inflation, on the basis that our existing income tax system is largely not inflation-adjusted.
- *The standard return method.* This method, which is nominally-based, would be set by Government fiat. Officials have suggested referencing the standard return rate to New Zealand dividend yields. The rate setting methodology is simple but less transparent. The Netherlands Government has introduced an IST (known as an “investment yield tax”) set at 4% on net assets.

I do not know whether the real risk free return method or the nominal risk free return method get us closer to the taxation of full economic income. This is because it is unclear whether one-year Government bond yields (adjusted for inflation) equate to expected dividend yields and capital gains (also adjusted for inflation). The standard return method appears to get us closer to the taxation treatment of direct New Zealand equity.

Other IST issues

- *Opening market value/base value.* The IST should be applied by multiplying an income tax rate by the IST assumed rate based on the asset value of an investor’s portfolio prevailing at the commencement of the tax year. This presumes a readily identifiable market value for relevant assets, where pricing is not discontinuous.
- *Part-year adjustments.* Considerable work has already been undertaken by officials to resolve the issue of applying an IST regime to capital contributions and withdrawals over the course of an income year. I am not satisfied that this work has yet reached a degree of simplicity required for successful implementation of an IST regime. I am confident that a simple solution could be found.
- *IST cash flow mismatches.* Inevitably, at some stage, market circumstances will dictate that IST liabilities will exceed actual income during a tax year. This is analogous to a New Zealand direct investor on capital account who always pays tax on dividends despite fluctuating share prices; or the payment of tax on rental income despite fluctuating house prices. In both cases effective tax rates will vary according to actual returns. CIVs will be required either to maintain cash or income assets to prudently cover this known liability, or to sell assets. This is easily conceived while the tax liability rests with the CIV. When the liability is pushed out to beneficial investors under the flow through option a “unit sell-down authority” mechanism will be required to facilitate the payment of tax, since there is no cash flow

- *Compliance costs.* The introduction of an IST means CIV tax accounting teams will be required to take into account an IST regime. However, the need to account for tax on dividend and capital gains would cease.

Shifting the capital/revenue boundary

This option proposes a shift in the capital/revenue boundary to the point where tax is not paid on capital gains on New Zealand equity but remains on all other forms income (rents, interest, dividends, etc). A shift such as this would be equivalent to the tax treatment of direct investment on capital account. The capital/revenue boundary would become well defined, eliminating uncertainty. The potential for estimation errors for provisional tax is reduced, but not to the same extent as under an IST. Tax losses in the CIV are eliminated. Accounting for capital gains taxation on domestic equity is removed. Inland Revenue rulings on passive funds would be redundant.

This option gets us closer to the prevailing tax treatment of direct equity investment on capital account. A major weakness is that it does not get us closer to taxing full economic income, and is less consistent with either option presented for the taxation of portfolio investment from offshore.

Where retail CIVs interpose intermediate wholesale CIVs for their equity investment, an issue arises on how to distinguish between the capital gains component and the taxable income component when all that the retail CIV receives is a single gross unit price. This would need to be resolved.

Common issues

Both options presented create a “brightline”, since the uncertainty over the capital/revenue boundary is either shifted and legislated, or eliminated. Transaction costs for providers and investors are reduced, and because tax liability is clear, the Inland Revenue can become more effective in monitoring compliance.

Income tax liabilities would be reduced to the extent that domestic imputation credits and credits for foreign non-resident withholding tax are available from portfolio investments. Under both options expenses would continue to be deductible according to current tax rules.

All options eliminate uncertainty over the definition of “income” for onshore equity. Income under either definition can be taxed in the CIV (option 1(a) or 1(b)) or flowed-through and taxed to the beneficial investors (under 2(a) or 2(b)). All options require an identification of what constitutes a CIV in order to protect investors using a CIV with a “safe harbour”. This safe harbour ensures that the actions of the CIV do not taint the capital/revenue status of the beneficial investor. However, if the investor’s activity or purpose in investing in a CIV so determines, the investment may be on revenue account.

TAXATION OF INCOME FROM OFFSHORE PORTFOLIO EQUITY

There are two options to tax income from offshore portfolio equity. These options would apply to offshore investments through CIVs (New Zealand domiciled and overseas) and to offshore assets held directly. The options presume that the current grey list disappears for portfolio equity, which means that New Zealand investors can switch from high tax to low tax jurisdictions without a change in tax treatment.

It is important to note that as the New Zealand Government cannot tax a foreign entity on its non-New Zealand sourced income, it must tax New Zealand investors as a proxy for the foreign entity. Because New Zealand investors and their advisors have the capability to reduce taxable income by exploiting the capital/revenue boundary in respect of offshore assets, and because the compliance and monitoring costs of looking through foreign structures to the final investment is prohibitive, it makes sense to tax full economic income. In addition, deferral opportunities make it sensible to tax this income on an accrued basis.

Regardless of the options, a New Zealand CIV which holds foreign portfolio assets and has flow through tax treatment may be less attractive to some New Zealand investors who might enjoy some timing advantages from holding the same underlying foreign portfolio assets directly or in a foreign CIV (the timing advantage relates to the deferral in filing a tax return). The quid pro quo is the compliance costs associated with filing tax returns.

Both options apply to all foreign CIVs regardless of the underlying assets. If those assets are, for example, global fixed income assets the accrual rules will not apply, as at present. It is difficult to say whether that would create a greater investor preference for CIVs taxed under these options relative to existing grey list arrangements.

Investment and Savings Tax (IST)

The prospective features and principles of an IST offshore are similar to an IST on domestic assets. Credits for foreign non-resident withholding taxes would be available but not credits for underlying foreign tax paid by the entity.

While all three rate setting methodologies are available for an IST on offshore equities, they have a different starting point. The real RFRM would be based on global Government debt (adjusted for expected inflation over the coming year). The rationale for the difference is that the investment is in foreign assets. Where global Government debt is hedged back to New Zealand dollars, the currency gains are taxed under the accrual rules and parity reigns. The nominal RFRM rate replicates this but does not adjust for inflation. The standard return method using a global dividend benchmark is further away from taxing full economic income, and there are issues around the selection of the appropriate dividend yield (e.g. US, global?). It is not obvious that this benchmark is consistent with any other tax boundary.

Compliance costs rest with the New Zealand investor, whether it is a CIV, other entity or an individual. I do not believe compliance costs will change much since, in most instances, the requirement for filing tax returns to account for dividends will be replaced by an IST return. Risks associated with incorrectly calculating one's tax liability must diminish since capital/revenue boundary issues disappear.

There is a clear tension between the convergence of this option with the domestic IST option, and the divergence from the remaining FIF regime for foreign assets where ownership is greater than 10% but does not represent a controlling interest.

Comparative value

This option is based on one of the existing four income calculation methods available under the FIF rules.¹³ It does attempt to tax full economic income. The change in the market value of offshore portfolio assets and any distributions are deemed to be income (or losses) for the year and are taxed. The officials' issues paper suggested taxing 70% of the change in asset value in the year. This method, when combined with removing the grey list, was broadly revenue neutral. Credits for foreign non-resident withholding taxes would be available but not credits for underlying foreign tax paid by the entity.

This option can also create potential cashflow complications, since exchange rate fluctuations mean taxable income can vary from actual income.

I do not have any reasonable economic rationale for suggesting that 70% or any other rate is appropriate.

This option is more consistent with the FIF regime prevailing for New Zealand investors who have a greater than 10% non-controlling interest. In terms of consistency with domestic options, it is not immediately clear whether this option is preferable.

¹³ The FIF rules provide the following methods for calculating income in respect of an offshore investment:

- *Branch Equivalent* – taxable income is calculated as if the foreign entity invested into were a NZ branch;
- *Accounting profits* – taxable income is calculated as the investor's share of a foreign company's net, after-tax accounting profit;
- *Comparative value* – taxable income is calculated as the net change in value of a FIF interest and any distributions derived; and
- *Deemed rate of return* – taxable income calculated by applying a deemed rate of return to the book value of the investment at the start of a tax year.

CIV AND INVESTOR TAX ALIGNMENT

Options 1(a) and (b) in the matrix provide alternatives under a regime where the liability for income tax resides within the CIV. Tax on the income of the managed fund with a credit for tax paid (option 1(a)) replicates the current treatment of unit trusts. A single proxy rate provides a degree of administrative simplicity and addresses tax avoidance and, to some extent, deferral concerns. However, business risks stemming from calculation errors would be high, and tax asset (i.e. accumulated tax losses) treatment would be inconsistent and opaque across CIV providers. Timing advantages would accrue to investors on marginal tax rates higher than the proxy rate, while disadvantages would accrue to investors on marginal tax rates lower than the proxy rate. In some instances the latter may not be able to use the credits distributed. In addition, I do not know of an equitable method for setting the proxy rate.

Option 1(b) moves beyond a proxy rate to variable final tax rates in the CIV using rates of tax reflecting the marginal tax rate of the investor – 0%, 19.5%, 33% and 39%. Such an option, one that puts final variable rates at the CIV level, is unheard of in a New Zealand context. While it may theoretically be possible, different after-tax pricing streams from one asset would mean that unit pricing functionality would need to change. While such an approach would dissolve timing advantages and disadvantages for investors, it is not clear how CIVs would monitor investors' marginal tax rates when the liability for tax lies with the CIV.

Both options 1(a) and (b) continue to tax income in the CIV, with option 1(a) replicating the company model of taxation, including imputation. Under both options, tax is implicitly included in the calculation of the unit price. This requires CIV providers to assess the income tax liability of the CIV and deduct this from net-of-expenses investment returns to generate an after-tax unit price.

Options 2(a) and (b) provide alternatives under a regime where the CIV is not generally liable for tax and the income tax liability flows through to the final investor. Both options have implications for the recording of investor details (which is done in administration/unit registry systems). Both options require CIVs to allocate taxable income to individual investors' accounts on a regular (e.g. quarterly) basis – a deemed distribution. Tax liabilities on deemed distributions of income would be calculated, deducted and paid on behalf of the investor. The balance of the distribution would be added back into the investors' unit balance. All income would be required to be distributed or penalties would apply. Deemed distributions must be regular to reduce avoidance opportunities.

Option 2(a) would apply a resident withholding tax (RWT) with a wash-up. A tax calculation and payment on deemed distributions of taxable income at a single withholding tax rate would be required, with investors required to square up their tax liabilities through a tax return at the end of the tax year. This option, creates minor timing advantages and disadvantages for higher income and lower income investors respectively, and could mean that lower income investors may not be able to utilise tax credits efficiently. Compliance costs change and shift to the beneficial investor and the Inland Revenue. Where investors have excess tax to pay of \$2,500 or more they would be required to pay provisional tax.

Option 2(b) would be similar to the current arrangements for bank deposits, whereby investors provide their prevailing marginal tax rate to the CIV provider at the beginning of the tax year. Withholding at variable rates dissolves the timing and use of tax credit disparity issues associated with option 2(a). It successfully integrates the entity and investor marginal tax regimes. Compliance costs (systems upgrades) would be borne by the provider.

Both options increase administrative complexity but reduce business risks for CIVs. Transparency of performance would improve considerably because tax management would be removed from the unit price. In addition, the tax liability shifts from the CIV to the investor.

Chapter 5

Stakeholder reaction

THE PROCESS OF GATHERING VIEWS FROM THE INDUSTRY

I took the view that if policy was going to move forward then part of the Terms of Reference had to include wide consultation of different and in some cases competing industry groups, firms and individuals. In my own experience, I found the consultation of financial intermediaries during the gestation of GST in the mid-1980s to be a relevant benchmark for the successful implementation of policy change.

This consultative process was intensive, with over 70 parties identified for or asking for a face-to-face meeting or sending in comments (a full list of stakeholders consulted is contained in Appendix II). I was accompanied on most occasions by tax policy officials from the Inland Revenue and the Treasury. The format of the meetings took the form of a flip chart presentation on the objectives and constraints of the consultative process, the history and context of my Terms of Reference, the importance of efficient financial intermediation for economic growth, general taxation principles, the relevant tax boundaries and the consequent distortions, and finally options for reform.

Stakeholders welcomed the opportunity to discuss the issues. I am informed that this has been one of the widest ranging and most intensive consultative processes between tax policy officials and a relevant community of interest. As a consequence, I received a large number of written responses to my presentation which have helped me understand the advantages and disadvantages of prospective changes. I am very grateful for these views.

CONSENSUS ON THE OBJECTIVES OF THE CONSULTATIVE PROCESS

A clear consensus was expressed that New Zealand's tax policy should deliver greater consistency of tax treatment on investment income.

CONSENSUS ON THE PROBLEMS CONFRONTED

There was a general consensus that it was our unique tax treatment of different boundaries that has led to economic distortions, higher transaction costs and a misallocation of scarce capital. Most considered the implicitly different definition of income for direct versus indirect investment to be the most important boundary. Clear evidence was produced that the cost to industry and ultimately investors of defining and monitoring the existing capital/revenue boundary was significant, and yet, in the

absence of legislation or definitive case law, compliance was problematic, and industry was still none the wiser of the boundary's whereabouts. An appreciation was gained on what these economic distortions might mean for New Zealand's economic growth potential.

CONSENSUS ON THE OPTIONS FOR CHANGE

There was clear consensus that I had identified the viable options for change within the Terms of Reference given to me. Other options mooted were variants of the options presented or were not viable, in my view. Some, such as the extension of the reforms to direct investment in New Zealand assets or a flattening of the income tax scale, while economically sensible suggestions, were not part of my Terms of Reference. When stakeholders confronted the accuracy-simplicity tradeoff they expressed a clear preference for simplicity.

CONSENSUS ON THE TAX TREATMENT OF CIV INCOME

An overwhelming preference was expressed for a shift in the capital/revenue boundary to the point where the definition of "taxable income" for domestic equity gains in a CIV was in line with the tax treatment of direct investments on capital account. In addition to equivalence, business risks from accounting for tax, administration costs, and cashflow timing matching were given as advantages. Some considered that no change was necessary since current rules are the same for both investment channels, but an effective Inland Revenue compliance monitoring regime for individuals and a clear "brightline" for defining the capital/revenue boundary were both missing. Some considered trustee conservatism over the tax treatment of income in CIVs to be the cause of the relative tax disadvantage.

A number of stakeholders raised the issue of distinguishing between the capital gains and taxable income components of an intermediate/wholesale CIV, which will generally only publish a gross unit price.

There was some support for a shift from traditional transaction-based taxation to an IST. The reasons given were alignment with their preferred offshore solution, a superior tax on economic income, certainty of taxable income, and a reduction in tax receipt risks for the Government, while still moving closer to the tax treatment of direct investment on capital account since the IST would replace dividend taxation.

Issues to be resolved should the Government introduce an IST included selling the concept to investors; the funding of tax liabilities when actual income is lower than the tax liabilities; the methodology for setting the rate; opening market values/base values; and part-year adjustments (capital contribution or withdrawals).

CONSENSUS ON THE TAX TREATMENT OF OFFSHORE PORTFOLIO INVESTMENT

There was a grudging acceptance that the tax treatment of offshore portfolio equity investment necessarily has to be different from onshore investment because the New Zealand Government does not collect the tax on the foreign profits of foreign entities. Disagreement was expressed, however, with the application of the FIF framework, which effectively provides a deduction for foreign tax paid by the foreign entity rather than a credit.

Most stakeholders' submissions argued for the abolition of the grey list exemption and for an accompanying change in the FIF regime for portfolio investment. The principle rationale given was the distortions created by the boundary of the grey/non-grey list regimes and with onshore CIVs. Of those that advocated change, all preferred an IST regime over a comparative value regime. The rate of IST and the rate setting methodology were critical pre-conditions for assent. Despite this preference, very few stakeholders were able to enunciate a preferred methodology for setting the IST rate. Of the limited few that expressed a preference for an IST rate setting methodology, global real bond yields were preferred.

A much smaller number argued for the retention of the status quo or an extension of the grey list. Reasons given were:

- the loss of favourable tax treatment;
- that the appropriate policy response to the grey list distortion is to extend the favourable treatment and to manage consequential leakage on a case-by-case basis; and
- that New Zealand risked the emigration of high net worth investors whose capital is mobile.

CONSENSUS ON THE DEFINITION OF DOMESTIC CIVS

Most stakeholders supported a comprehensive definition around the concepts of "widely-held" entities which held portfolios of securities the individual shareholdings of which were no more than 10% and no effective control was exercisable over the company issuing the securities. Effectively, this should mean unit trusts, GIFs, superannuation schemes, and life insurance products, and investment companies could be included. Issues are outstanding on how to include defined benefit superannuation schemes and some insurance products. It is not envisaged that some venture capital and closely-held partnerships would meet the definition.

CONSENSUS ON THE ALIGNMENT OF TAX TREATMENT OF INVESTORS USING NEW ZEALAND CIVS

Of those who commented on this issue, complete consensus was expressed for flow through tax treatment for CIVs. All stakeholders wanted taxation liability moved from the CIV to the investor, which would replicate the tax treatment of individuals investing directly.

Of the two options presented for this form of treatment, a very strong preference was expressed for the introduction of a withholding tax treatment (at the investor's nominated marginal tax rate). The strong caveat to this support was the quantification of transition costs. The fallback option was the single withholding rate option.

I did receive some comments that these particular issues replicated TOLIS.¹⁴ If the vehicle/marginal tax rate was the only boundary being reviewed, I might have met resistance to change. However the passage of time, improvements to technology and the linking of this reform to reforms of the other tax boundaries have clearly reduced resistance to change.

CONSENSUS TO MOVE FORWARD

Almost all stakeholders argued for a move forward from the status quo. It should be emphasised that in the time available, and in the absence of final direction, some stakeholders were unable to provide objective support for combinations of options pending completion of transition cost estimates.

¹⁴ *Taxation of life insurance and superannuation fund savings, a report to the Treasurer and the Minister of Finance and Minister of Revenue from the Working Party on the Taxation of Life Insurance and Superannuation Fund Savings*. April 1997.

Chapter 6

My view of the options and recommendations for change

The development of options which minimise tax distortions was the core objective of the consultative process. I believe that the consensus of stakeholder views clearly signalled a more consistent outcome for the tax treatment of investment income than at present. There is therefore a strong base for refinement and legislative change.

MY VIEWS

My only difference with the majority of stakeholder views is a preference for an IST on domestic equity gains derived through CIVs, with the same rate setting methodology for an offshore and onshore IST.

Stakeholders' preferred options for the tax treatment of CIVs and offshore portfolio assets are compatible with minimising tax distortions and improving the consistency of tax treatment across boundaries. However, changing the definition of "taxable income" by shifting the capital/revenue boundary for domestic equity gains derived through CIVs is, in my view, inferior to the IST option, since an IST gets closer to taxing full economic income and is consistent with the preferred offshore option. I therefore favour the IST option subject to the rate setting methodology.

The IST rate setting methodologies set out in Chapter 4 describe differences, depending on whether the assets are New Zealand or offshore. From an investor's perspective, this does not seem reasonable. Policy from a national welfare perspective may differ from an investor perspective. In this case national welfare concerns may include avoidance (such as the potential for New Zealand investors to use offshore vehicles to access New Zealand assets with lower tax relative to investment in these assets directly) and capital flight (imperfect markets may result in a preference for offshore assets). The impact of the latter may affect capital-raising opportunities for New Zealand borrowers. Setting a higher IST rate on offshore portfolio equities may also lead to sub-optimal outcomes as it would affect adversely sensible investor diversification strategies.

The summary of these views is that the offshore IST should not be different to the onshore IST, and both should not be lower than nominal New Zealand Government bonds.

My preferred option is a single inflation-indexed IST rate. Realistically, however, if we were to introduce an inflation-indexed IST there would need to be a clear commitment from the Government to inflation-index the rest of the income tax system. Otherwise inconsistencies would arise. So far, Government commitment to inflation indexing has not been forthcoming. Without such a commitment, a second-best rate-setting methodology should approximate New Zealand Government bond yields. Investors would have to be content that this may rise or fall in each tax year. If issues arise around prospective rises and falls of a market linked IST, the Government should set an acceptable fixed rate.

TERMS OF REFERENCE

The Terms of Reference required that “any changes should, as far as possible:

- a) protect the New Zealand tax base from erosion;
- b) minimise compliance costs;
- c) minimise the extent that the tax system penalises lower income savers who may not have the means or the skills to invest directly and for whom employment superannuation is a likely to be significant for retirement savings.

My comments on these caveats are as follows:

a) Protecting the New Zealand tax base

Proposed options for change will mean that the Government faces fiscal costs. However, to the extent that the existing tax base already faces erosion problems, it is desirable to move to an economically sustainable, comprehensive and fairer basis for the taxation of investment income.

It is important to note the fiscal costs of moving from the current regime to the stakeholder preferred combination of reform options. The static costs of a shift to the stakeholders’ preferred options is likely to be in the low hundreds of millions of dollars. A detailed costing should be undertaken when the proposals are more fully developed. This ignores potential dynamic gains from the introduction of a comprehensive regime and the redistributive effects on investors who face a different tax regime.

b) Minimising compliance costs

Different options create different compliance costs for the Government, industry and investors. The preferred options will result in a sharing of these costs. These costs need to be linked to the benefits from a reduction in tax distortions.

Industry compliance costs are concentrated within the preferred options proposed for aligning the taxation of CIVs and the marginal rate of their investors. Principally, the costs relate to upgrades to systems. I have endeavoured to scope costs using the advice of third party systems suppliers and do not believe that the costs are insurmountable.

On their own, the cost of these changes may be problematic. It is therefore highly desirable that if these changes are implemented, they are accompanied by changes to the definition of “taxable income”, where the costs of compliance are much smaller, but the benefits considerably larger. Additional costs may be incurred by suppliers from the alignment of investor tax rates through CIVs as providers move to rationalise product. The tax rationale for offering different products would be redundant.

Stakeholders were also concerned about part-year adjustments under an IST. A potential solution for investment through a CIV is to look at applying the IST to daily market values. This would mean that the final tax liability would represent an average through the tax year. This would eliminate the part-year adjustment complexity and would mitigate investor avoidance issues.

Government’s compliance costs are mainly concentrated in the options proposed for the redefinition of “taxable income”, which would require changes to administration systems (leaving aside the larger issue of fiscal costs of a regime change).

Investor costs are concentrated in the proposed IST following the removal of the grey list for offshore portfolio investment, which will alter tax liabilities. Compliance costs should not change as filing tax returns for dividends will effectively be replaced by filing an IST return. In the time available, I was not able to give enough thought to the level of a de-minimis threshold that would exempt an investor from an IST regime.

c) Lower income savers

Savers on marginal tax rates of 19.5% or less are penalised when using tax-paid CIVs such as superannuation schemes or life insurance, or where CIVs treated as companies for tax purposes distribute income (with excess and partially unusable credits attached). The preferred option for the taxation of CIVs largely dissolves this problem. However, there are several consequences that need to be thought through.

Beneficiaries

The interaction of the income tax system with the abatement of benefits upon receiving more income was acknowledged as an issue following the introduction of the Government's recent *Working for Families* package. This package will create high effective marginal tax rates (EMTRs) in certain circumstances (see Appendix V). Theoretically, beneficiaries with high effective marginal tax rates should be saving through tax-paid vehicles now, such as superannuation schemes, since they receive an obvious tax benefit. If the Government accepts the flow through option for taxing CIVs, beneficiaries who save through CIVs will receive more taxable income and their benefits will abate. An illustration of the abatement regime is also included in Appendix V.

I have no empirical evidence that such beneficiaries, per se, are an important source of savings. I therefore recommend that the proposed changes to the taxation of investment income are not altered to suit this class of investors. If the Government is concerned about the issue it should be addressed explicitly through altering how such benefits are administered.

Tax-exempt entities

Tax-exempt entities such as charities find tax-paid CIVs inefficient and cannot use imputation credits distributed by unit trusts, GIFs or companies. The only advantage they will derive from the preferred combination of options is the proposed flow through tax treatment for CIVs where those CIVs hold debt instruments. CIVs which hold equity are still inefficient for tax-exempt entities as imputation credits are unable to be used.

Workplace superannuation

The taxation of workplace superannuation was specifically raised by the Savings Product Working Group as an issue which may alter the conclusions of the Group's report, released in early September 2004.¹⁵ In terms of the crossover with my work, the Group specifically was interested in:

- “– The divergence between the marginal tax rate of the individual saving/investing through a managed fund and the tax treatment of the vehicle through which that saving is taking place;
- The matter of the tax treatment of capital gains made by such funds (the business and purpose test rules).”

¹⁵ *A Future for Work-Based Savings in New Zealand*, Final Report of the Savings Product Working Group, 31 August 2004.

I believe that the consensus-derived options solve the Group's concerns, since flow through preserves investors' correct marginal tax rates, with potentially no more compliance for the investor, and the business and purpose tests disappear for CIVs in relation to domestic equity.

However, there are issues to consider. Firstly, transition costs will be required to improve CIV unit registry, and employer-based superannuation scheme administration systems (which calculate entitlements, income distributions and taxation liabilities for investors). These will be required to record the correct marginal tax rates and liabilities of investors.

CIV providers use a variety of unit registry software systems, from proprietary-based to third party-sourced, but only one CIV product (a category of GIFs) record tax liabilities on income at the correct marginal rate of tax.

Many employer-based schemes outsource investor record keeping functions to third party administrators who have different systems. If the flow through option is to be pursued, and I recommend it is, then some time must be given to suppliers to cost the changes, and it must be accompanied by changes to the definition of taxable income. This will provide a reason for businesses to upgrade or invest in new platform technologies.

In addition, the proposed definition of CIVs currently excludes defined benefit employer superannuation plans. It would be more consistent if they were included but time has not permitted sufficient exploration of how this could be achieved.

MAIN TRANSITIONAL ISSUES

Communication of the IST

The most obvious communication issue is how investors should position their portfolios in response to the known annual tax liability generated by the introduction of an IST. We do not have information on where investors' growth/income asset mix is positioned now, and therefore whether they should become more or less risk averse, given the required cashflow to meet IST liabilities. However, it seems to me that because the tax liability is known from the beginning of the tax year, no one should have any excuses for not planning for its payment at the end of the tax year. In other words, investors should always hold cash or income assets to cover the known liability.

If legislators are concerned at the prospect of the "Holmes effect" – media amplification of constituents complaining of having to pay tax when total returns are negative – then I have little sympathy because:

- investors pay tax on dividends now when total returns are negative;
- an IST liability is quantified a year in advance of payment, providing plenty of opportunity for cashflow management; and
- if the actual issue is the volatility of equity returns, then portfolio rebalancing from growth to income assets, not challenging the tax impost, is the appropriate solution.

Treatment of accumulated tax losses

Some tax-paid CIVs have recently accumulated large tax losses (tax assets) as a result of falling capital values, principally due to global share prices. These will need to be preserved if the Government moves to the proposed flow through treatment for CIVs. Options could include cashing out the losses directly to prevailing investors, or distributing them as a tax loss able to be carried forward. The preferred solution is for this to occur at the point at which the reform commences.

Chapter 7

Next steps

I made it clear during the consultation phase that my formal contribution to this process concluded at the end of October 2004. Provided that subsequent public discussion mirrors issues raised in this document, I would strongly recommend finessing, costing and implementing the preferred combination of options, with enough time for stakeholders to cost and plan for the transition.

It is my sincere hope that, after this interactive process, Government and industry and investors continue to commit to reform. The alternative is not palatable. It is not obvious to me that a democratic process of consensus building towards an improved sustainable system of taxation of investment income for New Zealand investors during a clear window of goodwill can be surpassed as a strong process for change.

Appendix I

Terms of Reference

The Government will appoint an independent Chair to ascertain whether a consensus is emerging on how to address the current problems with the taxation of investment income, both domestically and offshore. The Chair would be responsible for consultation on options that are consistent with developing such a consensus. The Chair would consult widely with the New Zealand savings industry and other interested stakeholders.

The mandate of the Chair will be to resolve issues and inconsistencies in the tax law, (primarily as they apply to New Zealand portfolio investors – those under 10% ownership interests in companies or other entities), whether those investments occur directly in companies, other entities, or indirectly via intermediaries. It should be assumed that the basic structure of tax laws outside the area of investment will not be altered and will therefore be outside the Terms of Reference for this work. An across-the-board capital gains tax, taxation of owner-occupied housing and the basic treatment of debt instruments under the accrual rules are not within the Terms of Reference.

It would be outside the scope of the work for the Chair to consider alternatives to the tax treatment of savings that are not consistent with the TTE (tax/tax/exempt) model applied in New Zealand or to consider savings-related concessions. Some related specialist areas, such as the tax rules for life insurance may be impacted by any options put forward. While it would be useful to note these impacts, in the time available it would not be feasible for the Chair to consider the many detailed issues that changes to the tax treatment of savings might involve.

In its broadest terms, the Chair should consider options for making the tax law more consistent between direct and indirect investment so as to improve the efficiency and fairness of the taxation of savings and in particular to reduce any tax impediments to the ability of ordinary New Zealanders to save for their retirement.

The objective of this work is to develop options for change that would minimise the extent to which the tax system distorts the way New Zealanders invest (direct versus an intermediary or via different intermediaries). As far as possible New Zealand resident intermediaries should not face tax penalties compared to direct investment and similar offshore entities New Zealanders might invest in.

In meeting the above objective, any option for change should, as far as possible:

- (1) Protect the New Zealand tax base from erosion. Examples include investment in low or no tax jurisdictions, or investment in no or low tax entities in high tax jurisdictions.
- (2) Minimise compliance costs for New Zealand investors and the New Zealand savings industry. For example, any requirement for individual investors who are currently not required to file tax returns to start filing such returns would increase compliance costs. Similarly the New Zealand savings industry has expressed concerns regarding compliance costs imposed on them under certain current tax rules.
- (3) Minimise the extent to which the tax system penalises lower income earners who may not have the means or the skills to invest directly and for whom employment superannuation is likely to be significant for retirement savings. For example, it would be desirable that those on a low rate of tax are not taxed at a higher rate on their superannuation savings.

It should be noted that the points above, may at times be, contradictory in practice, which is why there is likely to be several options proposed along with their advantages and disadvantages.

Revenue neutrality is not an objective of this work. The Government would like to consider the most viable options (having regard to the objective and points (1) to (3)) above identified by the Chair, irrespective of their revenue implications. Revenue implications should however, to the extent possible, be identified since these would need to be taken into account in any final decision.

The Government considers that the Chair should be charged with:

- Establishing if there is general agreement on whether the objective and points (1) to (3) above are the principal issues in the area of taxation of investment income.
- Identifying the boundaries that exist in the area of the current taxation of investment income, both domestically and offshore.
- Ascertaining whether a consensus can be achieved on how to resolve problems associated with these boundaries, in consultation with the New Zealand savings industry and other interested stakeholders.
- Developing options for reform that are consistent with these boundaries, in consultation with the New Zealand savings industry and other interested stakeholders.
- Developing options for reform that are consistent with such a consensus.
- Identifying the advantages and disadvantages of the options considered.
- Reporting to the Minister of Finance and Revenue on viable options by the end of October 2004.

Appendix II

Stakeholders consulted

ABN Amro Craigs	Mercer
AMA Capital Ltd	Milford Asset Management Ltd
Aon Consulting New Zealand Ltd	Ministry of Social Development
Association of Superannuation Funds of New Zealand	Minter Ellison Rudd Watts
Asteron Life Limited	MMc Ltd
Aventine Consulting	Morel & Co
AXA New Zealand	Morgan Taylor Ltd
Bank of New Zealand	Morningstar NZ
Brook Asset Management Ltd	Northplan
BT Funds Management (NZ) Ltd	NZ Assets Management Ltd
Chris Horton	NZ Business Roundtable
Cleary Financial Services Ltd	NZ Exchange Ltd
Consumers Institute	NZ Funds Management Ltd
Corporate Taxpayers Group	NZ Law Society
Deloitte	NZ Society of Actuaries
Direct Capital Private Equity Ltd	NZ Society of Investment Professionals
Diversified Investment Strategies Ltd	NZ Venture Capital Association Inc
Eriksen & Associates Ltd	Paul Dyer
Ernst & Young Ltd	PricewaterhouseCoopers
Fidelity Life Assurance Company Ltd	Public Trust
Financial Focus (New Zealand) Ltd	Reserve Bank of New Zealand
Financial Planners & Insurance Advisers Association	Retirement Commission
First NZ Capital	Rob Dowler
FMG Investment Advisors	Russell Investment Group Ltd
Fund Distributors Ltd	Russell McVeagh
FundSource Research Ltd	Savings Product Working Group
Greg Dwyer	Securities Industry Association
ING (NZ) Ltd	Select Asset Management
Institute of Chartered Accountants of New Zealand	Shortland Management
Investment Savings & Insurance Association of NZ Inc	Sovereign Ltd
John Key, National Party Spokesperson on Finance	Strategic Asset Management
KPMG	Tacit Group
Martini Consulting Ltd	Tower Limited
MCA Ltd	Trustee Corporations Association of New Zealand
Melville Jessup Weaver	Trustees Executors Ltd
	Tyndall Investment Management NZ Ltd
	Watson Wyatt NZ Ltd
	Women in Super

Appendix III

“Financial systems and economic growth: An evaluation framework for policy” – a summary

The full text of this Treasury working paper is available at <http://www.treasury.govt.nz/workingpapers/2004/04-17.asp>

The purpose of the paper is to develop an analytical framework for discussing the link between financial systems and economic growth. The paper does *not* attempt to assess the adequacy of New Zealand’s financial system in providing financial services. Rather it highlights the importance of financial development for economic growth and identifies key policy priorities.

Section 2 reviews the role of financial intermediaries and markets and their comparative advantages in providing external finance to firms. The following conclusions emerge: first, existing theory suggests a clear link between financial systems and economic growth. Financial intermediaries and markets can overcome an information asymmetry in credit markets. They help reduce information and transaction costs and improve the allocation of resources, leading to faster economic growth. Second, financial intermediaries and markets offer a range of financial services to firms that are not complete substitutes.

Section 3 establishes the theoretical link between financial systems and economic growth. There are two main channels through which financial systems can have an effect on economic growth: capital accumulation and technological innovation.

The cost of external finance is discussed in section 4. With imperfect information, capital is only available at a higher real interest rate. The supply curve may even become positively sloped at some point as the level of external financing increases. At a country level, the supply of capital may no longer be infinitely elastic, which has implications for a small open economy. At an individual supplier level, with imperfect information, the supply of capital curve may become backward bending or downward sloping, i.e. lenders reduce their supply of funds as interest rates increase, leading to forms of credit rationing.

Section 5 reviews the empirical evidence on the connection between a country’s financial development and its rate of economic growth, whether a shift to financial markets or intermediaries affects growth rates and the importance of financing constraints. Countries with better developed financial systems tend to grow faster than countries with smaller banking systems and less liquid financial markets. But cross-country comparisons do not reveal significant differences between the economic growth of countries with more market based or more intermediary based financial systems. The international evidence suggests that finance constraints are empirically

important in particular for small firms. The finding supports the theoretical proposition that credit rationing for some firms may represent a common response by financial markets and intermediaries as they attempt to resolve information asymmetries. New Zealand data and empirical analysis to date are limited.

Section 6 discusses the importance of the legal environment and other policy influences for financial development. The following conclusions emerge. Maintaining solid legal foundations is important because the financial system relies on these. Moreover, a legal system that is able to respond to the financial needs of an economy fosters financial development more effectively than a more rigid legal system.

Section 7 assesses the potential effects of the New Zealand tax system on the financial system. It first reviews the taxation of capital gains and then outlines how New Zealand's tax system, which classifies some capital gains as taxable income while exempting others, acts to distort the investment patterns toward direct investments in larger and less risky firms or toward passive indexing tracking funds. The section concludes that removing tax distortions that prevent/lower the production and discovery of information will lead to increased investment and output. The magnitude of these effects is uncertain but possibly significant. The economic benefit could be substantial if resolving existing distortions would increase firms' ability to borrow in future. Moreover, additional investment may lead to technological innovation as firms with high investment in intellectual property or with novel business plans are particularly affected by information asymmetry and as a result are more likely to face finance constraints.

Section 8 discusses the main sources of financial instability. It reviews the role of financial regulation and supervision and briefly examines the regulatory and supervisory approach in New Zealand. The need for regulation and supervision of the financial system arises because financial intermediaries and markets, like firms, are subject to asymmetric information. A key objective for financial regulation and supervision is to increase the effective functioning of the financial system in order to enhance the ability to absorb shocks and maintain financial stability. The section suggests a review of certain aspects of New Zealand's financial system in the context of financial regulation and supervision. Given the importance of financial development for economic growth, it is valuable to be certain that New Zealand's institutional framework and current responsibilities for financial regulation and supervision are best suited to meet its particular needs.

The last section summarises and concludes.

The paper's appendix outlines insights economics can provide to guide the taxation of financial intermediaries in a country such as New Zealand that has chosen not to tax full economic income by not employing a capital gains tax. The appendix suggests that to tax the capital gains of investors who use intermediaries is to apply a broader tax base to those investors than to those who use other, non-financial services. A lower use of financial services and a greater use of other services would be predicted and firms that rely on intermediated finance are likely to suffer in New Zealand as a result.

Appendix IV

Background to the tax rules for CIVs

Introduction

Currently there is a range of tax treatments that apply to investment entities in New Zealand. While the entity tax environment may, on the face of it, seem ad hoc a policy and/or historical rationale can generally be identified to explain the entity-specific rules.

The benchmark for the design of tax rules for investment entities is the tax treatment of the individual. The tax system should, to the extent that it is possible and practical, integrate the tax treatment of an entity with its beneficial owners. This means that an investor should be indifferent to investing via an entity and investing directly. The caveat on this is that for policy reasons it may be considered desirable to claw back tax preferences allowed at the entity level (e.g. taxing capital gains distributed as dividends) and/or to restrict access to entity losses. Nevertheless the useful benchmark is the tax treatment of the individual.

However, different entities have different characteristics and functions. Therefore, the extent to which integration is possible, and the means by which this is achieved, will vary.

Full integration versus company imputation

Essentially there are two approaches to taxing entities. The first approach is to impose a tax on the entity itself. The second approach is to attribute the tax base of the entity directly to the beneficial owners (i.e. integration).

It has generally been considered that an integrated model is problematic for widely-held entities for a number of reasons. First, taxing the beneficial owners on profits of widely-held entities as they accrue is complex administratively as it would involve allocating income to each owner and identifying owners' marginal tax rates. Second, not imposing a withholding tax on the entity could increase the likelihood that income is deferred or avoided. In addition, in a discretionary trust context, it would be extremely difficult to measure (or even approximate) the income that should be attributed to a discretionary beneficiary before it is actually allocated by the trustee.

The company tax with imputation model solves many of these problems for widely-held entities. It provides a single withholding tax (the company tax) at the entity level to address administrative, deferral and avoidance concerns. By taxing distributions at shareholders' marginal tax rates and providing a credit for company tax paid, the company tax model achieves a level of integration. This explains the current tax treatment of companies, unit trusts, GIF As and life insurance.

The history of the taxation of investment entities is quite closely related to the development of our company tax system. Prior to 1958 dividends were not taxable in the hands of shareholders (they were however included in the shareholder's income in order to establish the investor's marginal tax rate). Inclusion of distributions for tax rate calculation purposes raised the question as to why dividends were not taxed as income. This led to a "classical" company tax system in New Zealand from 1958 until 1988. Under the "classical" system income was taxed at the company level and again at the shareholder level upon distribution, with no credit provided for the company tax paid. In 1988 the imputation system for companies was introduced.

The following table provides a summary of the current tax rules applying to the main types of investment entities and a brief explanation of the history and underlying policy of the rules.

Entity type	Tax rules/Policy rationale
Individuals	Tax rules: taxation of income (i.e. not of a capital nature) is at marginal tax rates.
Partnership	<p>Tax rules: partnership income is taxed to the individual partners at their marginal tax rates ("look through" tax treatment).</p> <p>Policy rationale: under general law a partnership is not a separate legal entity (i.e. partnership is fiscally transparent and partners are jointly and severally liable). This explains the current tax rules that tax the individual partners on their share of the partnership income.</p>
Companies	<p>Tax rules: income of the company (i.e. revenue gains) is taxed at 33%. Distributions to shareholders are taxed at marginal tax rates with a credit for tax paid at the company level. Imputation claws-back preferences on distribution to shareholders (e.g. taxation of any untaxed capital gains of the company). Tax losses made at the company level cannot be passed through to shareholders.</p> <p>Policy rationale: the tax treatment of companies has been integrated to a large extent with the tax treatment of individuals (i.e. rate alignment) with the introduction of imputation in 1988. The full history is detailed above.</p> <p>Flowing-through preferences (e.g. capital gains) under imputation was rejected partly because, on introduction of imputation, companies had significant retained earnings for which no imputation credits were available. Allowing these amounts to be distributed with the preferences flowed-through would have resulted in a significant revenue loss.</p> <p>Pass-through of losses to shareholders was rejected due to concerns about "fake" losses in the tax system.</p>

Trusts	<p>Tax rules: income is taxed to the trustee at 33%. Beneficiary income (i.e. income of the trust that is distributed within the income year of derivation or six months after the end of the year) is taxed at the marginal tax rates of beneficiaries.</p> <p>Policy rationale: the company tax model was deemed inappropriate on the basis that, for a trust, property rights are uncertain – i.e. don't know how many beneficiaries there are and what their share of the trust's assets are. Consequently, it is difficult to have imputation.</p> <p>Instead, trusts have a final tax (on trustee income) with any income distributed to beneficiaries as it is earned by the trust (beneficiary income) taxed at the marginal rates of beneficiaries to provide a level of rate alignment for trust income. Where a trust distributes income as it is earned these amounts are clearly directly attributable to the recipient. It is therefore appropriate to tax this income as if it was earned by the beneficiary.</p> <p>There is no pass-through of losses. This is based on the trust concept that a beneficiary should only get positive amounts.</p>
Superannuation Schemes	<p>Tax rules: taxed as a trust (which they are) but with a final tax at the scheme level so trust income is not attributed to individuals – i.e. qualifying trust tax treatment. This means that the income of the superannuation scheme (i.e. revenue gains) is taxed at 33%. Distributions are tax free, which means that tax preferences (e.g. capital gains) are not clawed-back on distribution.</p> <p>Income earned by a superannuation scheme that is distributed immediately is not taxed at the investor's marginal tax rate (i.e. there is no "beneficiary income" rule) on the basis that superannuation should relate to saving for retirement (long-term). Schemes should therefore not be making distributions as income is earned.</p> <p>Policy rationale: superannuation schemes were given trust tax treatment as at the time of introduction of the rules, in the late 1980's, all schemes were established as trusts. Prior to this, certain superannuation scheme income received concessionary tax treatment.</p> <p>In late 1987, it was announced that the tax treatment of superannuation and life insurance would be moved onto the same basis as other forms of savings and investment. Broadly, the main reasons for the reform that led to the current rules were:</p> <ul style="list-style-type: none"> • A move to a broad base and low rate (i.e. removing concessions to make the rate lower and less variable). • Treatment according to the type of saving or institutional form through which saving was channelled distorted patterns of savings by favouring some taxpayers over others and added to the complexity of the system.
Life insurance	<p>Tax rules: tax is imposed on the life insurance business for profits attributable to shareholders (the life office base) and also on investment income attributable to policyholders (the policyholder base). This is the first level of tax. A tax credit is available to shareholders for tax paid at the first tier. Tax credits also available for distributions in respect of policyholders (e.g. an increase in actuarial reserves)</p> <p>Policy rationale: in 1990 the taxation of life insurance was moved to a basis analogous to the full imputation system applying to companies – i.e. shareholders and policyholders of a life insurance business treated similarly to shareholders in a limited liability company. The rationale for this was the provision of insurance becoming more substitutable with financial intermediation.</p> <p>Prior to 1990, the taxation of superannuation schemes was limited to the taxation of investment income.</p>

Unit Trusts	<p>Tax rules: taxed as companies. The income of a unit trust (i.e. revenue gains) is therefore taxed at 33%. Distributions to unit holders are taxed with credits for tax paid by the unit trust (imputation). Preferences (e.g. capital gains) are clawed-back on distribution.</p> <p>Policy rationale: unit trusts were developed in the 1960s to compete with investment companies. Legislation was introduced to regulate the management of the trusts and to safeguard the interests of investors. It was thought logical (at the same time) to apply the tax law relating to companies to these entities because in substance they do not differ from investment companies. The history of tax treatment for unit trusts is therefore linked to the company tax treatment.</p>
Group Investment Funds	<p>Tax rules:</p> <p><i>Category A income</i> – defined as income that is not category B income. This income is subject to company tax treatment</p> <p><i>Category B income</i> – income from designated sources (i.e. income from trusts that are estates, or are created by statute or Court order). This income is subject to trust tax treatment</p> <p>Policy rationale: GIFs were primarily established to get around the company tax treatment for unit trusts. Tax rules for GIFs were introduced in the early 1980s and imposed one set of rules on Category A income and another set of rules on Category B income. The rationale for this is as follows:</p> <p>Category A GIFs were considered to be competing with investment companies and unit trusts – therefore received company tax treatment.</p> <p>Category B GIFs were not competing at this level as they were established to benefit widows/orphans, etc – therefore received trust tax treatment.</p>

Appendix V

***Working for Families* – effective marginal tax rates, and abatements**

Impact of flow through tax treatment on recipients of family assistance

One of the issues that will need to be considered by Government is the impact of allowing CIVs to pass through income to investors (for tax purposes) on the abatements of social assistance received by those savers – that is, savers who are recipients of family assistance and beneficiaries.

Currently, income is quarantined within certain CIVs (e.g. superannuation schemes) and so do not affect entitlements to and abatements of assistance. Anecdotally, this group does not seem to be a significant constituency for the New Zealand savings industry at present. However, the introduction of the new *Working for Families* family assistance package will mean that at the time of its full implementation (in 2008), savers on relatively high income levels may be recipients of Government transfers.

The graphs below (figures 5 and 6, respectively) outline the effective marginal tax rate (EMTR) for a single earner family of four (two adults, two children) in receipt of family assistance, pre and post the full implementation of the *Working for Families* package.

The assumptions that have been made are:

- the family lives in South Auckland and rents accommodation;
- accommodation costs are \$300 per week and the family receives an accommodation supplement; and
- the family does not receive any other social assistance.

Figure 5 illustrates the EMTRs faced in the 2005 year. If the market income of the single earner is \$60,000, their EMTR would be approximately 40%.

Figure 5: EMTRs in 2005

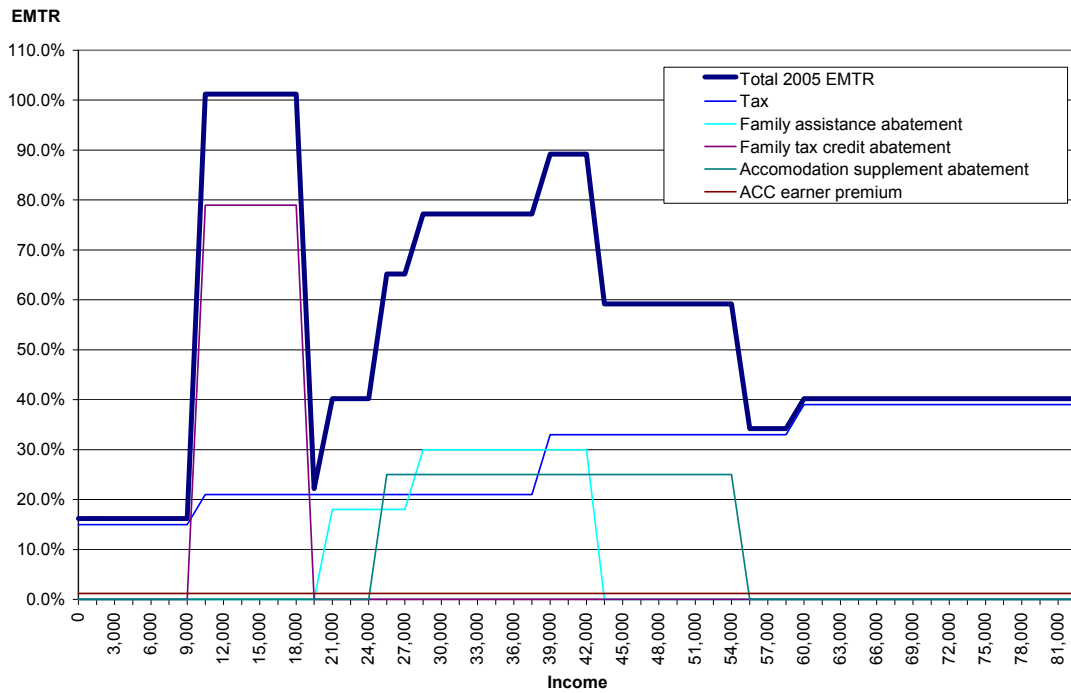
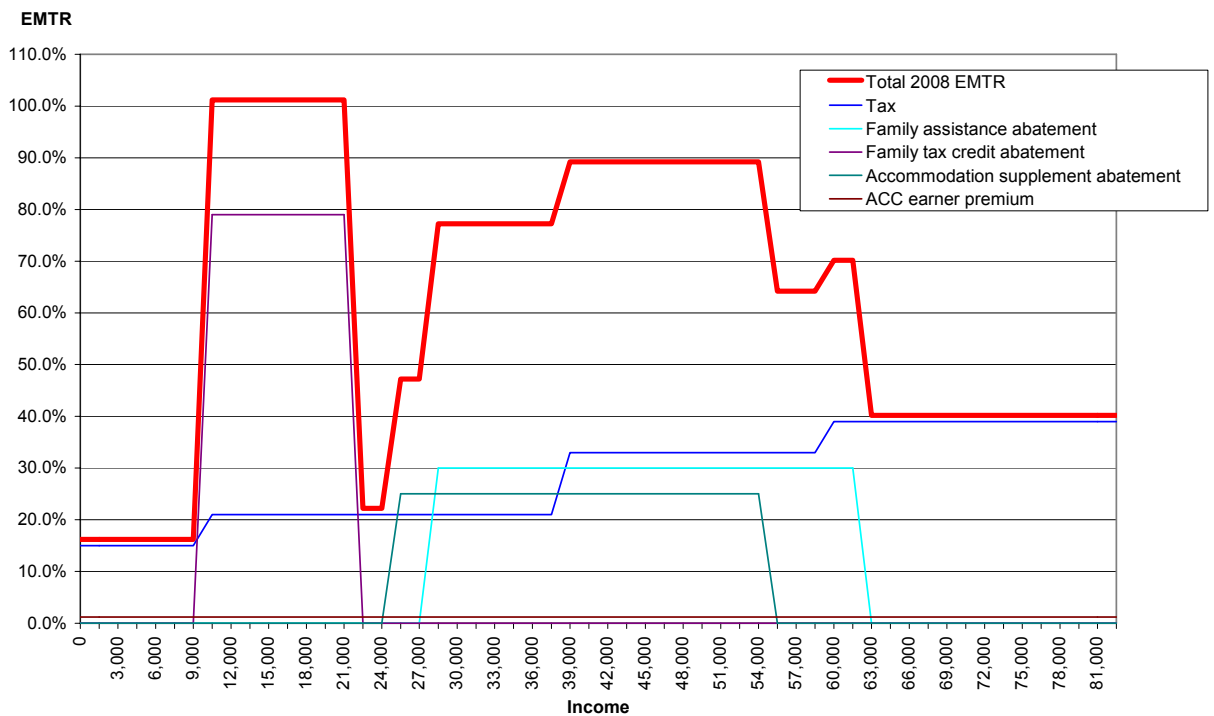


Figure 6 illustrates the EMTRs faced in the 2008 year, when the *Working for families* package will be fully implemented. For the same level of market, the EMTR of the single earner would now be 70%.

Figure 6: EMTRs in 2008



Glossary

Capital/revenue boundary – broadly, the boundary that divides investments held for the purposes of deriving an income stream, such as dividends (capital account investments) and those that are held mainly for the purposes of deriving a gain on sale (revenue account investments). The tests under the capital/revenue boundary are not fully described in legislation. They have a long history in the common law.

CIV – collective investment vehicle, a term used to describe various vehicles used by New Zealand investors to access a portfolio of investments. These vehicles offer pooling of risk and opportunities for portfolio diversification. Examples include unit trusts, superannuation schemes, and life insurance (so called “managed funds”). The issue of what should be a CIV for the purposes of the options for reform presented is discussed in Chapter 4.

FIF – the Foreign Investment Fund Rules, the regime that applies for calculating income from non-controlled equity investments in so-called non-grey list countries. The FIF rules provide four methods for calculating income from non-grey list investments, namely branch equivalent (income calculated as if the foreign entity invested into were a New Zealand branch), comparative value (income calculated as the change in share value plus dividends derived) and the deemed rate of return (income calculated based on an assumed rate of return) methods.

Flow through tax treatment – an option for reform whereby income derived by a CIV would pass through to its beneficial owners. The CIV would become transparent for tax purposes (like a partnership) with income and the consequent tax liability resting with the ultimate investor.

Grey list – a group of seven countries: the United States, the United Kingdom, Australia, Canada, Japan, Germany and Norway. Equity investments in these countries by New Zealand investors receive a tax preferred treatment – typically only taxation on dividends derived – relative to investment in other countries which are subject to the FIF rules. The grey list is based on the assumption that the countries in it have similar tax systems (and rates) to that of New Zealand, thereby reducing the incentives for New Zealand investors to use these destinations to avoid tax.

IST – the Investment and Savings Tax, an umbrella term used to describe the variants of the RFRM proposed over the last four years in New Zealand. Taxable income under an IST would be calculated by multiplying the opening value of an investor’s portfolio by an assumed rate of return (the IST rate).

Non-grey list – all countries outside the seven grey list countries. Investments by New Zealanders in these countries are taxed under the FIF rules.

Offshore portfolio investment in equity – investment of 10% or less in foreign equity (i.e. an ownership interest of 10% or less in the foreign entity). The 10% threshold is the internationally recognised distinction between portfolio and non-portfolio investment.

RFRM – the Risk Free Return Method, proposed by the Tax Review 2001. The Review recommended the RFRM as a means of rationalising the entity tax rules. Taxable income under an RFRM would be calculated by multiplying the opening asset value by the RFRM rate. The Review recommended that the RFRM rate be based on New Zealand Government bond yields adjusted for inflation (a “real” rate)

Standard Return Method – an option for reform of the tax rules for offshore portfolio investment that would tax the opening value of such an investment at a standard rate of return based on a reasonable dividend yield of 4%. The standard return method was suggested by tax policy officials in an issues paper released in late 2003.