

Taxation of investment income

The treatment of collective investment vehicles and offshore portfolio investments in shares

A government discussion document

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Chapter 1

INTRODUCTION

- 1.1 The financial system is an important contributor to growth in New Zealand and has a role in allocating scarce capital to productive use.
- 1.2 For this reason it is important that the tax rules for investment income operate efficiently and that investors' decisions are not distorted by different tax treatments for income from investments that are similar in nature. Under the current tax rules, for example, an investor who buys shares directly is taxed differently from an individual who buys them indirectly through an investment manager, such as a unit trust. Similarly, income from investments made in New Zealand are treated differently from those made offshore.
- 1.3 The proposals outlined in this discussion document aim to resolve these inconsistencies and the distorting effect they have on investor decision-making. The proposals are the culmination of a series of reviews of the tax rules for investment income, specifically focusing on the rules for investment via collective investment vehicles (CIVs), and for offshore portfolio investment in shares.¹ The most recent of these reviews, completed in 2004 by Craig Stobo, identified several significant tax problems and put forward recommendations for reform. The proposals in this discussion document build on the valuable work undertaken by Mr Stobo.
- 1.4 The key tax problems identified in the Stobo review were that different tax outcomes can arise depending on:
 - whether an investor invests directly or through a collective vehicle; and
 - whether the investment is in a New Zealand company or a foreign one.
- 1.5 When New Zealanders invest directly in a company, they are generally taxed only on dividends received from that company. When they pool together to make investments or have their monies managed by a professional, they will usually pay more tax. This is because dividends and capital gains are taxable for those in the business of investing, with most professional funds managers falling into this category.
- 1.6 In a pooled or collective fund, the tax treatment is based on the character of the fund and not on the nature of the individual investing into that fund. From the perspective of individual investors, this often results in over-taxation, because if they were to make similar investments directly, they would typically not pay tax on those capital gains.

¹ The term Collective Investment Vehicle (CIV) is used to refer generically to vehicles that pool the capital of different investors. The term Qualifying Collective Investment Vehicle (QCIV) is used to refer to entities that will qualify for the new tax rules.

- 1.7 The government proposes to adopt rules so that the tax treatment of pooled funds better reflects the treatment of individuals who invest in those funds.
- 1.8 Problems also arise in relation to different tax rules applying to different types of pooled vehicles, such as unit trusts or superannuation schemes. The government proposes to provide rules allowing these different structures to be treated similarly.
- 1.9 For offshore investments, special tax rules, known as the “grey list” exemption, apply to investments in entities resident in Australia, Canada, Germany, Japan, Norway, the United Kingdom and the United States. Investments in those countries can be taxed more favourably than comparable investment in New Zealand or countries that are not on the grey list.
- 1.10 The unintended effect is that incentives are created to invest directly and in offshore assets for tax purposes. This can disproportionately affect lower and middle-income savers because they are unlikely to have sufficient funds to invest directly and get diversified returns.
- 1.11 Balancing onshore and offshore taxation of investment is complicated. One reason is that New Zealanders pay tax on their domestic investments through the tax payments of companies that they invest in (though, often, people do not think about the tax paid by companies in this way). The company tax system levies tax on the earnings of companies even if they do not pay dividends, which provides a measure of tax on investments, even though rises in share price may not be directly taxable. In other countries, some companies pay a similar level of tax, while others pay little to no tax. Further, some offshore investments pay regular dividends, as most New Zealand companies do, while others rarely if ever do so. As a result, finding one tax treatment that suits all offshore investments and does not leave some offshore investments significantly under-taxed is a challenge.
- 1.12 The proposals outlined here are aimed at better aligning the tax treatment of direct and indirect investment in New Zealand shares, and ensuring that a reasonable level of tax is payable on offshore portfolio share investments.
- 1.13 The proposals also have wider links with other government initiatives being undertaken in the area of savings and investment. The main link is with the KiwiSaver proposal announced in the 2005 Budget, which aims to encourage employees to save through work-based savings schemes. It is important that if employees are encouraged to save through work-based savings, that the earnings from such investments are taxed consistently and fairly.

- 1.14 The proposals contained in this document are designed to achieve this, and have been developed in consultation with a number of stakeholders, including the Investment Savings and Insurance Association of New Zealand, the Association of Superannuation Funds of New Zealand, the Institute of Chartered Accountants of New Zealand, and various other financial industry and tax experts. This consultation has been very constructive and the government welcomes further input from these and other interested groups.

SUMMARY OF PROPOSALS

New tax rules for collective investment vehicles

- From 1 April 2007, a pooled fund that qualifies as a qualifying collective investment vehicle (QCIV) would be able to elect a new set of tax rules.
- Under the new tax rules for QCIVs, assessable income would generally exclude realised domestic share gains, although certain domestic share gains that are close debt substitutes would continue to be taxable.
- To qualify as a QCIV, a pooled vehicle would need to meet a number of criteria. These include that the vehicle's principal activities are in the nature of savings and investment; it is sufficiently widely held; investors in the vehicle are "portfolio" investors; and the vehicle is itself a "portfolio" investor.
- Under the new tax rules for QCIVs, assessable income would be required to be "flowed through" to investors, with the QCIV deducting tax at investors' elected tax rates.
- Under the flow-through model, to the extent possible, investors' income would need to be attributed and taxed on a regular basis.
- Investors in QCIVs would generally need to elect a tax rate for QCIV income, based on the previous year's total assessable income from all sources. For individuals, the rate elected would generally be a final withholding tax and would not affect family assistance or child support and student loan obligations. Companies and other non-individual investors would elect their statutory rate. The tax deducted on behalf of these entities would not be a final withholding tax.
- If the QCIV incurs a tax loss, the loss can be carried forward and used by the QCIV to offset assessable income in future years, or can be allocated to investors' accounts.
- Tax credits received by the QCIV, such as imputation credits, will be available to offset assessable income derived via the QCIV.

Proposals to change the tax rules for offshore portfolio investment in shares

- Tax rules for offshore investment in shares where the investor owns 10% or less of the foreign entity invested into ("portfolio" investment) will change.

- The grey list, which allows for concessionary tax treatment of investments into seven countries, will be removed for portfolio investments.
- QCIVs and other non-individual investors will, broadly, use the change in an offshore asset's value over the tax year to calculate their assessable income for that asset. This method will apply to assets for which there is a readily verifiable market value.
- Individuals will also base their assessable income on an offshore asset's change in value over the tax year. However, the tax paid will generally be spread over a number of years to reflect the investor's cashflow. This method will apply to assets for which there is a readily verifiable market value.
- Assessable income on assets that do not have a readily verifiable market value will be calculated under a simplified deemed rate of return approach.
- The new rules would not apply to individuals' investments below \$50,000 (total cost of investments) into companies listed on a recognised stock exchange in a country with which New Zealand has a double tax agreement.

1.15 Submissions on any aspect of this discussion document are welcome and can be mailed to:

Taxation of Investment Income
C/- The Deputy Commissioner
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON

1.16 Alternatively, submissions may be made in electronic form to:

policy.webmaster@ird.govt.nz

Please put "Taxation of Investment Income" in the subject line for electronic submissions.

1.17 Submissions should be made by 30 September 2005 and should contain a brief summary of the main points and recommendations. Submissions received by the due date will be acknowledged.

1.18 Please note that submissions may be the subject of a request under the Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you consider that there is any part of your submission that could be properly withheld under the Act, please indicate this clearly in your submission.

Chapter 2

BACKGROUND

- 2.1 New Zealand is a small, open economy that relies heavily on capital imports. Like all economically valuable inputs, capital is scarce relative to the uses it could be put to, so it is important that this capital is allocated to its most productive use.
- 2.2 The current tax rules for investment distort the productive allocation of capital and can generate widely varying tax results for similar types of investment. They also provide an incentive for New Zealanders to invest offshore to seek after-tax returns in just a few countries, when better overall returns may be available in New Zealand or in countries that do not receive concessionary tax treatments.
- 2.3 The taxation of investment income is a long-standing, complex and controversial issue. It has been the subject of many reviews, the most recent being:
- The Tax Review 2001, which looked at the structure of New Zealand's tax system, including those for investment, and recommended the government consider changes to the tax rules for portfolio offshore investment in shares. The proposal put forward for taxing offshore investment was a risk-free return method (RFRM) which would tax deemed income.
 - A review of the tax rules for offshore investment in shares by tax policy officials, which culminated in an issues paper released in late 2003. This document outlined two options for reform – a method based on a deemed rate and a method based on taxing actual changes in value. Submissions on this document overwhelmingly favoured considering tax problems relating to domestic savings vehicles at the same time as any changes to the offshore rules.
 - A review of the tax rules for investment income by Craig Stobo, the former CEO of BT Funds Management, in late 2004. It looked at both the vexatious issue of offshore investment, and the tax issues facing investment in New Zealand shares undertaken via a savings vehicle such as a managed fund.
- 2.4 These reviews and, most notably, the Stobo review have clearly revealed the extent of tax problems in this sector and put forward different options for mitigating various distortions that arise. These distortions are discussed in more detail later, together with the recommendations made for reform in the Stobo report.

Scope of the problem

- 2.5 Under the current tax rules for investment income, different tax outcomes can arise depending on whether an investor invests directly or through a savings vehicle such as a unit trust or superannuation fund. Equally, different tax outcomes can arise depending on whether the investment is in a New Zealand-based company or a foreign one, with different tax rules also applying to different investments offshore depending on whether the investment is in a grey list country. The grey list exemption applies to investments in entities resident in Australia, Canada, Germany, Japan, Norway, the United Kingdom and the United States. Finally, problems arise owing to the lack of integration, in certain cases, between an individual's marginal tax rate and the tax rate applying to the savings vehicle being invested into.
- 2.6 In light of these concerns, Craig Stobo was appointed by the government last year to look at the structure of the tax rules for investment income. His role was to consult with the various stakeholders in the New Zealand savings industry, and make recommendations for reform that were consistent with industry consensus.
- 2.7 The scope of the review included the taxation treatment of New Zealand-resident savings vehicles on their domestic investments in shares and the tax rules for offshore portfolio investment in shares by both savings vehicles and other investors. Direct investment by New Zealanders in domestic shares was not part of the terms of reference for the review. This was to ensure that the review of the taxation rules for investment income was feasible within the review's timeframe, from July to October 2004. It was also recognised that encompassing all aspects of the taxation of investment income, including investment in debt and other non-equity investments, would not have been possible without significantly delaying consideration of key areas such as the tax rules for savings vehicles and offshore investment.
- 2.8 The review provided a detailed summary of the existing tax boundaries for investment. One of the main distortions identified for domestic investment was the inequity in tax treatment depending on whether an investor acquires an ownership interest in a New Zealand company directly or via an investment vehicle. In most cases, a direct investment in a New Zealand company will be treated as being held, for tax purposes, on capital account. This means that only dividends, not increases in share value, are taxable. On the other hand, if the investment were made via an investment manager, most investment vehicles would hold investments on revenue account, with tax payable on realised gains as well as on dividends. This is because such vehicles are usually in the business of dealing in shares, which requires trustees or fund managers to maintain equity amongst current and future investors. This revenue account treatment occurs despite the fact that the investor may hold the investment in the CIV on capital account. The fact that the investor's capital account status is generally not reflected when he or she invests through a fund manager creates a disincentive for individuals to invest domestically using financial intermediaries.

- 2.9 A secondary issue considered was the non-alignment of investors' marginal tax rates and the tax rate applying to the savings vehicle invested into. Under the company tax model, imputation allows alignment of company and shareholder tax rates on payment of dividends and other distributions. However, for other entities, alignment of tax rates is either inefficient or absent altogether. An example of this is the tax treatment of superannuation funds where income is taxed to the fund at the rate of 33% but distributions are tax exempt. This creates alignment problems for taxpayers on marginal tax rates of 21% and 39% because the latter are under-taxed in a superannuation fund and the former are over-taxed. The tax treatment of income from unit trusts, superannuation funds and life insurance also varies.
- 2.10 The other major tax problem identified in the Stobo report was the different tax treatment that applies to investments made in New Zealand or offshore.
- 2.11 Under the current grey list exemption, non-controlled investment on capital account in companies resident in grey list countries is taxable only on distributions. While similar investment in domestic companies is also taxable on distributions, the company invested into is required to pay tax at 33% each year on its assessable income. Clearly, New Zealand does not have the power to tax offshore companies that New Zealanders invest into. The grey list effectively deems the tax paid by the foreign company in the foreign jurisdiction to be equivalent to New Zealand tax. It operates on the assumption that the entity resident in the grey list pays a similar level of tax to what would have been paid if the investment was made into a New Zealand company. When this level of tax is not paid offshore, the grey list creates an investment distortion in favour of investing offshore.
- 2.12 Finally, even with the grey list exemption, a different treatment applies depending on whether the offshore investment into a grey list country is made directly or via a New Zealand-resident CIV. That is because the domestic capital/revenue boundary applies on grey list investments. This means that a direct investor will generally hold grey list investments on capital account, whereas active investment managers will typically be deemed to hold an equivalent investment on revenue account, in the same way that domestic shares are treated as being held on revenue account. As with non-controlled investment in New Zealand shares, this creates a disadvantage for an investor when using savings vehicles to hold offshore investments.

Intermediation

- 2.13 The government is concerned about the tax distortions to investment identified by the Stobo review for several reasons.

- 2.14 One is the unintended inequity resulting from the current rules. The tax barrier to investing via savings vehicles may disproportionately affect lower and middle-income savers as these groups are unlikely to have sufficient funds and expertise to invest directly in a diversified portfolio of assets. For them, savings and investment vehicles may be an important source of portfolio diversification, but one that is currently tax-disadvantaged.
- 2.15 Another cause for concern is the effect of tax distortions on the financial system. The pooling of investment and its reallocation generates a broader range of investments than individuals would generally be able to undertake on their own, providing benefits both to investors and to the economy. Work carried out by the Treasury has highlighted the economic importance of the system of financial intermediation, including its role as a key source of finance for certain types of firms. The existing tax distortions impede the productive use of capital and misallocate investment by discouraging intermediation.
- 2.16 The tax distortion favouring direct investment may naturally lead to investment into larger, more established firms at the cost of investment in financial intermediaries, which affects the investments those intermediaries would make. This is because investors are likely to have incentives to invest directly in established companies. These companies are likely to pay a reasonable level of dividend, providing a greater level of comfort to an individual investor that the investment would be treated on capital account. That could limit access to external finance for some firms or investment types that are better serviced by the pooling of investment through financial intermediaries. Those more likely to be affected include newer firms, those with novel business plans or for whom intellectual property is a large portion of assets, smaller firms or those entering the export sector.
- 2.17 Discouraging the use of financial intermediaries can have broader costs on the financial system as well. Institutional investors may also play an important role in the efficient functioning of financial markets because investors rely on them, to some degree, to evaluate the governance of firms.

Taxation of offshore investments

- 2.18 The viability of the grey list as the basis for New Zealand's tax rules for offshore non-controlled investment in shares is increasingly under strain because of various investment entities that result in little or no tax paid in the grey list jurisdiction. Examples include Australian unit trusts (AUTs) and United Kingdom open-ended investment companies (OEICs).
- 2.19 In relation to Australian unit trusts, when the investment income is non-Australian sourced and derived immediately by non-residents, the AUT is not subject to tax on that income in Australia. Until recently, AUTs were able to pass through tax-free gains to New Zealand resident investors. Open-ended investment companies are slightly different in that they pay tax in the United Kingdom on dividends and other income, but not on capital gains.

- 2.20 The grey list also assumes that investments into grey list countries actually represent investments into “bricks and mortar” in those countries. The experience with AUTs and OEICs demonstrates that investments into grey list countries often flow through into other countries, where the assumption of adequate taxation is even less likely to hold. The popularity of AUTs and OEICs suggests strongly that the grey list will be unsustainable in the long-term.
- 2.21 By taxing grey list investments only on their distributions, the tax rules encourage New Zealanders to make overseas investments that do not distribute much of their income. Even when the grey list investment actually pays little or no tax overseas, the New Zealand tax rules deem them to have paid sufficient overseas tax. In effect, this exposes the New Zealand tax base to loopholes in the tax bases of the world’s largest economies.
- 2.22 The assumptions underpinning the grey list increasingly no longer hold credibility, particularly for portfolio investment. Retention of these concessionary tax rules results in an increasingly significant incentive to invest offshore, and in a small number of countries, at the expense of investment in New Zealand or non-grey list countries which would offer diversification and growth opportunities for investors.
- 2.23 While direct portfolio investment by an individual in a company that is resident in a grey list country is typically taxable only on distributions from the company, investments in non-grey list companies can be taxed on an accrued basis. This typically occurs on unrealised changes in value, under the foreign investment fund (FIF) rules. The difference in tax treatment has created a real incentive for individuals directly investing offshore to invest in the grey list rather than lower-tax jurisdictions and certain high-growth non-grey list countries. That does not make sound economic sense.
- 2.24 Finally, the grey list retains the same distortion between direct and indirect investment for offshore investment that occurs domestically. New Zealanders are discouraged from using domestic investment vehicles in favour of overseas vehicles, which undermines the viability of investment vehicles based in New Zealand. If New Zealand-based investment vehicles are important economically for domestic investment, or for effectively managing overseas investments of New Zealanders, this is an undesirable outcome.

Stobo report’s options for dealing with tax boundary concerns

- 2.25 The Stobo report proposed a number of options for resolving the identified concerns with the tax treatment of investment income:
- To resolve the non-alignment of personal and entity tax rates when investing via a managed fund and the different tax treatment across entities, it was recommended that qualifying savings vehicles, known as “qualifying collective investment vehicles” (QCIVs), be given flow-

through treatment. Under a flow-through model, the vehicle would be transparent for tax purposes. The underlying income would be treated as being derived directly by the investors, with tax withheld at investors' marginal tax rates. QCIVs would simply operate as a withholding agent for tax purposes.

- To resolve concerns in relation to the inequity in tax treatment depending on whether an investor invests in domestic shares directly or via a QCIV, two options were provided:
 - Option (1): exempting from taxation realised gains on domestic shares made via a QCIV.
 - Option (2): taxing domestic shares held through a QCIV using a deemed rate approach (an investment and savings tax, a variant of the risk-free return method or RFRM).
- To resolve concerns in relation to the current tax rules for offshore portfolio investment in shares (the grey list and non-grey list distinction), the report recommended replacement of the grey list and FIF rules with an investment and savings tax.

2.26 In consulting on the tax boundaries and options to mitigate the impact of these on investment decisions, about 70 parties were consulted with as part of the review. They included individual fund managers, financial planners, tax advisors, consumer advocates and industry associations such as the Investment, Savings and Insurance Association, the Institute of Chartered Accountants of New Zealand, the Association of Superannuation Funds of New Zealand, the New Zealand Law Society and the Corporate Taxpayers Group.

2.27 The Stobo report necessarily evaluated any options for the resolution of the identified tax distortions at a high level, noting that the options needed to be developed in more detail, with relevant stakeholders. The report provides a sound basis for discussions with key stakeholders on detailed design issues around the options identified. These discussions have framed the proposals for change that are outlined in this document. Some proposals are different from those recommended by the Stobo report. Reasons for these differences are outlined later in this chapter, with greater detail included in the next few chapters.

Evaluation of options from the Stobo report

2.28 The options for changing the tax rules for savings vehicles put forward in the Stobo report were aimed at providing greater neutrality between the tax treatment of direct and indirect investment in onshore and offshore investment in shares. According to stakeholders consulted during the review, the distortion between direct and indirect investment (both offshore and onshore) was the key issue.

Domestic investment

- 2.29 As noted earlier, realised profits on New Zealand shares that are held directly are not taxed, while those made via a CIV generally are taxed. The current treatment therefore creates a distortion in favour of holding domestic shares directly, rather than through managed funds.
- 2.30 The Stobo report suggested that an investment and savings tax should replace the current rules that tax managed funds on their realised profits from shares held in New Zealand companies. Under this approach, assessable income would be calculated by deeming the value of a fund's share portfolio to have a return equivalent to the government stock rate. While such an approach is arguably better than the status quo, it would not provide sufficiently similar treatment to direct investment.
- 2.31 Of the two domestic reform options identified in the report, the option to exempt from tax most realised equity gains derived via a QCIV would bring the taxation of this income into alignment with that of direct investment better than an investment and savings tax would. As this was a key objective of the review, the option to exempt most domestic share gains would seem to be desirable from both an equity and efficiency perspective and is therefore the government's preferred option for reform. This was also the preferred option of most stakeholders consulted and is discussed in more detail in chapter 4.
- 2.32 Stakeholders consulted during the review also broadly supported a flow-through of assessable income to investors via QCIVs on the basis that this would allow for better alignment with investor tax rates and reduce the tax risks for QCIVs. While some concern was expressed over the cost required to change systems to accommodate the new approach, most stakeholders accepted that there were benefits in such an approach.
- 2.33 A flow-through model for QCIVs should result in taxpayers' personal tax rates applying to their investment income derived via a QCIV and should better align with the treatment of direct investment. The government therefore supports this option, which is discussed in greater detail in chapter 4.

Offshore investment

- 2.34 For the taxation of offshore investments, the option put forward by the Stobo report would remove the current grey/non-grey list distinction for portfolio investments, resulting in investment decisions being less influenced by the tax system. The government supports the removal of the grey/non-grey list distinction as this should remove tax biases in favour of investment in some countries and should encourage New Zealanders to invest in other countries based on after-foreign tax returns.

- 2.35 The report also recommended that an investment and savings tax replace the current tax rules on share gains derived via a QCIV, largely because it would remove the onshore/offshore boundary for QCIVs. However, the boundary would remain for non-QCIV investors, because the investment and savings tax would apply to their offshore direct holdings, whereas the current rules would apply to domestic shares. Under the Stobo recommendation, the onshore/offshore tax boundary would remain for direct portfolio investment in shares.
- 2.36 An investment and savings tax, although conceptually simple, is also relatively complex to apply. The complexity arises when investors make adjustments to their portfolio of offshore assets during a year – in other words, buys certain shares and sells others.
- 2.37 Under an investment and savings tax, if these “part-year” adjustments are not accounted for, a situation could arise where a taxpayer could be under-taxed or over-taxed. Investors would be under-taxed when they did not hold any assets at, say, the beginning of the year and they acquired assets during the year, because the investment and savings tax would calculate tax on an opening value of zero. They would be over-taxed when they held some offshore shares at the start of a year, but sold a portion of their holding during the year. If no adjustment were made to account for the fact that the holding at the beginning of the year was not retained for the entire year, tax would be paid as if none of the shares had been sold. Likewise, calculating tax on a full year’s worth of income would occur on shares that were held for as little as one day.
- 2.38 Mechanisms exist for accounting for such portfolio adjustments. Officials developed such a method for shares held in a non-business context. (See the issues paper, *Taxation of non-controlled offshore investment in equity*, released in December 2003.) Funds could manage such adjustments relatively easily by simply calculating investment and savings tax on daily unit prices. However, the method developed for non-business investors is much more difficult.
- 2.39 While it would be possible to further simplify the investment and savings tax income calculation mechanism for smaller investors, the government does not consider that the simplification benefits are likely to be significant. Such a measure would still result in high compliance costs for investors, and any simplicity would come at the cost of greater inaccuracy in the income calculation measure. The potential for abuse of such a measure could easily outweigh the benefits.
- 2.40 The government is also concerned that an investment and savings tax would result in New Zealanders having to pay tax even when the value of their investment declined. While the assumptions underlying an investment and savings tax would support such a proposition, in practical terms, this could result in tax having to be paid on an offshore share, even when there is no cashflow, such as a dividend to meet the tax liability.

2.41 Finally, it is not clear that an investment and savings tax (or an RFRM) is the appropriate mechanism for taxing offshore portfolio investment in shares. Other options appear to be more suitable for dealing with the tax boundaries raised in the Stobo report. One such alternative, developed in consultation with stakeholders and which the government considers addresses many of the boundary issues identified in the Stobo report more comprehensively than an investment and savings tax/RFRM, is discussed in more detail in chapter 5.

Chapter 3

NEW TAX RULES FOR COLLECTIVE INVESTMENT VEHICLES

- 3.1 This chapter and chapter 4 outline a new set of tax rules for the calculation of assessable income derived through qualifying savings vehicles (termed qualifying collective investment vehicles or QCIVs) on their investments in domestic shares. It is envisaged that savings vehicles that meet the definition of QCIV will be able to elect into the rules from 1 April 2007. This will allow those vehicles that meet the QCIV definitional requirements to remain under the existing tax rules until they are able to make the transition. Whether the new rules remain elective will be reviewed in the future.
- 3.2 The aim of the proposals outlined in this chapter is to create a set of tax rules that allow investment vehicles to overcome the tax distortions discussed in the previous chapter. The proposals must therefore ensure that investors in QCIVs have their investment income taxed appropriately. The starting point for this is articulating which entities are eligible to use the new rules.
- 3.3 The current company tax rules generally tax distributions from companies even when the distributions were not taxed at the company level. While this treatment is being relaxed for QCIVs (on the basis that they are effectively operating as an investment decision-maker for their investors) it is important to note that these proposals do not aim to relax the rules outside this limited area.

Definition of a collective investment vehicle

- 3.4 To achieve the policy objectives described in chapter 2, it is necessary to define the nature of the vehicles that will qualify for the relaxation of income tax on certain share gains derived. Accordingly, the term “QCIV” needs to be defined, and difficult boundary issues will need to be resolved. The government aims to ensure that the boundary is appropriately defined to enable valid savings and investment vehicles to access the rules, while maintaining the tax base and preventing abuse of the rules. It is envisaged that the rules will be elective to prevent other entities from inadvertently falling within them and being subject to the associated QCIV tax obligations.

Features of a qualifying collective investment vehicle

- 3.5 Given the main policy objectives of the review, it is the government’s view that an entity seeking QCIV status should have these key features to qualify for the proposed special tax treatment:

- Its principal activities should be in the nature of savings and investment.
- It should be sufficiently widely held.
- It does not issue units of different classes to its investors.
- Its investors should be “portfolio” investors.
- It should itself be a “portfolio” investor.
- It should be resident in New Zealand for tax purposes.

Principal activity of savings and investment

- 3.6 One of the key aims of the proposed rules is to remove a significant tax barrier to diversified portfolio investment faced by those investing via savings and investment vehicles. The government therefore considers that a QCIV should be a vehicle whose principal activity is the pooling and allocation of capital for the purposes of diversified saving and investment, and from which investors will be provided with investment returns. It is envisaged that this would involve the provision of facilities by the entity to enable many non-associated investors (such as subscribers, purchasers, or contributors) to come together and pool monetary capital, invest the pooled capital in a diversified manner, and share in the investment income and gains.
- 3.7 This requirement would aim to ensure that only genuinely diversified savings and investment vehicles were eligible to access the special tax QCIV rules. Entities with principal activities that are other than that of savings and investment, such as manufacturing firms, would therefore not be eligible. The meaning of “principal” should reflect the underlying objective that virtually all of the activities of the entity should be of a savings and investment nature.
- 3.8 The government welcomes submissions on this proposal.

Sufficiently widely held by portfolio investors

- 3.9 The government considers that a QCIV should be a sufficiently “widely held” savings and investment vehicle. This leads to the conclusion that the definition of QCIV should require that:
- The entity has a reasonable minimum number of non-associated persons investing into it.
 - The entity’s investors are “portfolio” investors only.

Minimum number of investors

- 3.10 The absence of a formal capital gains tax in New Zealand is driven by practical considerations rather than the application of theoretical economic principles in defining the appropriate tax base. However, in a country without a capital gains tax, there are sound reasons why a government would still seek to tax certain forms of capital gains – for example, when there is a significant degree of substitutability between non-taxable gains and gains that would otherwise form part of assessable income. With respect to the definition of a QCIV, substitutability with the taxable labour income of individuals is a key concern. Not taxing genuine labour income could undermine the tax system and reduce the tax base that provides the revenue necessary to fund critical public services.
- 3.11 To be consistent with the policy objectives of the special tax QCIV rules, a critical requirement of the definition of QCIV would be that the savings and investment entity has a reasonable number of non-associated investors holding an ownership (or equivalent) interest in that entity. The rationale for this requirement is to reduce the potential for abuse by ensuring that the rules are not accessed by “closely held” entities, or the widespread use of entities by individuals seeking to shelter their investment-trading labour income from tax.
- 3.12 The government seeks to determine a minimum number of investors that will ensure QCIVs are sufficiently widely held, while allowing genuine savings and investment vehicles to access the new rules. It is also important to ensure that vehicles specialising in greenfields investments and investments in unlisted companies are able to access the new rules where practical. This is considered important because there is the potential for these investments to significantly contribute to a sustainable increase in New Zealand’s long-term economic growth, as well as lead to a greater diversification of investment portfolios. What constitutes a “sufficient number” of investors to be generally regarded as “widely held” is clearly a subjective issue, and it is acknowledged that any number used will ultimately be a question of judgement.
- 3.13 In seeking guidance for an appropriate minimum number of investors, current income tax legislation defines “widely held company” for certain purposes as essentially being a company that has at least 25 non-associated shareholders. In addition, the definition of “qualifying unit trust” in the income tax legislation requires a unit trust to have at least 100 non-associated unit holders (investors) in order to be treated as the same notional single person and prevent breaches of the shareholder continuity rules. Accordingly, there is some range in the current income tax legislation concerning the minimum number of investors typically required in a widely held context. When considering the minimum number of investors required for an entity to access the special tax QCIV rules, the government considers that the need to ensure that a QCIV is genuinely widely held should be balanced against not excluding funds that invest in unlisted New Zealand companies. Requirements on minimum investor numbers are relevant for

greenfields investments and investments in unlisted companies, as often these funds have a limited number of investors.

- 3.14 Given the policy objectives of the proposals, the concern over abuse and tax avoidance in a “closely held” context, and the importance of facilitating access to the special tax QCIV rules for greenfields investments and investments in unlisted companies, the government considers at this stage that the minimum number of non-associated investors required for an entity to qualify as a QCIV should be 20. While this requirement would not accommodate all greenfields investments and investments in unlisted companies, it would facilitate access to the rules for those that are genuinely widely held.
- 3.15 If a QCIV invests into another QCIV, the minimum number of investors would automatically be met, although non-QCIV investors would still be limited to a portfolio interest. The rationale behind this exception would be to accommodate the common commercial situation in the funds management industry whereby retail investment funds achieve efficiencies and diversification through the use of diversified wholesale investment funds.
- 3.16 Submissions are welcomed on these issues.

Owners are portfolio investors

- 3.17 Given that the new rules are designed to apply to widely held entities that pool capital for many investors, the government considers that it is appropriate for there to be a requirement that the owners of the entity seeking QCIV status should be portfolio investors. This requirement supplements the constraint outlined earlier in relation to the minimum number of investors. However, this requirement raises boundary concerns about the precise meaning of the term “portfolio investor”. The current taxation of offshore investment income rules – for example, the underlying foreign tax credit rules – and international norms on the taxation of portfolio investment, suggest that a “portfolio investor” is typically one holding equal to or less than a 10% actual ownership interest in any given asset or investment, taking into account any situation where there is a “market value circumstance”.² While the government considers that this is a reasonable and generally accepted concept of portfolio investment, submissions are welcome on this point.
- 3.18 As QCIVs are themselves widely held, however, an exception to the “portfolio investor” rule is proposed to allow a QCIV to have a greater than 10% interest in another QCIV.

² A “market value circumstance” exists when a person’s actual ownership interest in an entity does not accurately reflect the person’s economic interest in that entity.

- 3.19 It is also proposed that exceptions to the “portfolio investor” rule be allowed in “unusual or temporary breaches” such as the insertion of seed capital or when a fund is winding down. Such rules are a feature of the current definition of “qualifying unit trust”.
- 3.20 Submissions are welcome on developing workable “unusual or temporary breach” rules that do not give rise to significant tax base maintenance concerns and administration difficulties.

Entity seeking QCIV status must be a portfolio investor

- 3.21 To reduce tax barriers to portfolio investors accessing diversified investment portfolios, the government considers that the definition of QCIV should require the savings and investment vehicle seeking QCIV status to itself be a portfolio investor. The aim of this requirement would be to restrict access to the rules to those widely held entities that have pooled investors’ resources and invested into a diversified range of investments.
- 3.22 In principle, the 10% portfolio requirement would seem an appropriate starting point for determining the maximum actual ownership interest a QCIV could have in any given asset or investment. However, when considering the maximum actual ownership interest a QCIV should be allowed to have in a particular investment under the new rules, the ability to access greenfields investments and investments in unlisted companies is an important consideration.
- 3.23 By their nature, these investments are typically owned by a small number of investors in the early-growth stages of investment. Consequently, maximum actual ownership interest rules that are too restrictive may exclude such investments. Further, the government understands that it is common and prudent practice in the funds management industry for certain diversified investment portfolios to contain investments in which the fund has a 100% interest – such as commercial property investments, for example. While this would not generally be consistent with a “portfolio investor” principle, the government considers it may be appropriate to accommodate these situations by modifying the maximum actual ownership interest tests as they would apply to a QCIV’s outward investment.
- 3.24 To deal with these considerations, the government proposes two options in relation to the maximum actual ownership interest restrictions.

Option 1

- 3.25 Under this option, entities seeking QCIV status would generally be restricted to a maximum actual ownership interest of 10% in any given non-QCIV investment. That is consistent with international norms of what constitutes portfolio investment. However, the government acknowledges that the 10% portfolio investment requirement may significantly restrict access by investment funds designed to facilitate access to greenfields investments and investments in unlisted companies.

Option 2

- 3.26 Under option two, entities seeking QCIV status would generally be restricted to a maximum actual ownership interest of 25% in any given non-QCIV investment. Although that represents a departure from international norms in terms of the meaning of portfolio investment, it reflects a balance in order to ensure flexibility is provided to access certain types of investments, while ensuring QCIVs maintain diversified investment portfolios.
- 3.27 An additional requirement may be appropriate under this option to combat abuse of the rules. Specifically, an entity seeking QCIV status, that is not a registered superannuation scheme, would have a mechanism to ensure that investors could access their investments at an estimated market value (a “buy-back” mechanism).
- 3.28 The rationale for requiring a buy-back mechanism is to ensure that an investor in a QCIV is effectively in the same position as a direct investor – that is, the investor is able to redeem the investment at an estimated market value. While it is not proposed that such access would be available to investors on a daily basis (as this would preclude legitimate situations where investment lock-in was required by investors), the buy-back mechanism would need to be available to investors at a minimum of every five years.

Non-portfolio investment

- 3.29 Whether a portfolio interest is deemed to be 10% or 25% for a particular CIV, an exception could be provided for some non-portfolio investments. A QCIV could hold up to a 100% actual ownership interest in any particular non-QCIV investment, with the proviso that the aggregate value of all QCIV investments in which the QCIV has a non-portfolio interest do not represent more than 10% of the value of the entity’s total investment portfolio during the entire period that the particular investment is held.
- 3.30 The rationale behind this requirement is to ensure that there is sufficient flexibility within the rules to allow a QCIV to hold a significant interest in investments that are part of a genuine diversified investment portfolio. This would accommodate diversified investments that are both passive – such as investments that derive rental, interest, dividend, and royalty income – and those that are active in nature, such as income derived from manufacturing activities, while ensuring that the vehicle is still in itself a portfolio investor.
- 3.31 It is acknowledged that these rules may preclude certain property trusts from accessing the new QCIV rules (as they may breach the suggested maximum 10% non-QCIV investment threshold). The government seeks submissions on this point

- 3.32 The government appreciates that each option has its merits and drawbacks. It also acknowledges that these maximum actual ownership interest restrictions may involve some compliance costs for taxpayers in terms of investment-level monitoring activities, notwithstanding the extra flexibility being proposed. Accordingly, submissions on ways to minimise compliance costs while guarding against potential abuse and circumvention of the rules are welcomed.
- 3.33 Under both options a QCIV can hold real property directly, provided the property is not more than 10% of the value of the QCIV's total underlying assets. To the extent that real property is held on revenue account, that could pose problems for QCIVs in flowing through unrealised taxable amounts to underlying investors. This would suggest that QCIVs holding real property on revenue account should have the option of accounting for tax on the change in value of that property.
- 3.34 Submissions are invited on how difficult it would be to require flow-through of unrealised taxable amounts to underlying investors.

One class of unit on issue

- 3.35 A key aim of the proposals is to ensure that the correct amount of income is taxed at the correct rate. To achieve this it is necessary to be able to calculate each investor's share of the underlying assets. If an entity issued different classes of unit – for example, Class A units which entitled investors to income and Class B units which entitled investors to capital appreciation – it would not be feasible to calculate each investor's share. In addition, allowing different classes of units to be issued could give rise to tax integrity concerns. For example, it could be possible for a class of unit to be issued that would provide investors on high marginal tax rates with an entitlement to non-taxable capital gains, while a different class of units, giving an entitlement to assessable income, could be provided to low marginal tax rate investors.
- 3.36 The government therefore proposes a requirement that to meet the QCIV definition, the entity issues only one class of unit for each fund it operates. This measure is not intended to stop QCIVs that consist of several different funds, such as a balanced fund, conservative fund or growth fund, from offering different units for the different funds. This is current commercial practice. Rather, it is meant to stop the development of products designed to stream different classes of income to different investors, depending on the tax benefits involved. QCIVs that do not offer units such as defined benefit superannuation schemes would not be subject to the requirement as they do not operate on a unit basis.

QCIV must be New Zealand-resident for tax purposes

- 3.37 An entity granted QCIV status will be required to discharge certain tax obligations, as outlined in the next chapter. Among these obligations is the requirement to calculate, deduct and forward tax payments to Inland Revenue on behalf of investors for the taxable investment income they derive.
- 3.38 To ensure that these obligations can be adequately monitored and enforced, QCIVs should have a fixed New Zealand presence. It is envisaged that this presence would take the form of a New Zealand-resident entity through which tax calculation and tax payment activities are performed. In principle, it is an appropriate tax policy result to allow non-resident portfolio investors access to the rules as well as resident investors, thereby allowing non-resident investors the same exemption from income tax for domestic share gains as that provided to resident investors. The proposed withholding tax rate that would be applicable to distributions by the QCIV to non-resident investors is discussed in the next chapter.
- 3.39 Submissions are welcome on the issue of whether there should be a requirement that an entity seeking QCIV status should be resident in New Zealand for tax purposes.

Breach of QCIV criteria

- 3.40 Only entities meeting and continuing to meet the QCIV definitional requirements should have access to, and continue to have access to, the special tax QCIV rules. Rules will need to be developed to address situations where breaches occur that are not of an unusual or temporary nature.
- 3.41 Given that existing tax rules would continue to apply to non-QCIV entities after the implementation date of the new rules, it follows that those breaching the QCIV definitional requirements would generally revert back to the tax treatment applying under those existing rules. However, there is a concern that this approach would allow some entities with QCIV status to change between the two sets of rules when it suited them, in clear conflict with the policy intent of the new rules. To prevent this kind of activity, the following consequences are proposed when an entity breaches the QCIV definitional requirements as a result of a situation that is not regarded as unusual or temporary:
- The flow-through status of investment income would be lost.
 - The entity would revert to taxation under the tax rules existing for non-QCIVs from the beginning of the income year of breach. This may result in provisional tax liabilities arising and the imposition of tax penalties and use-of-money interest.
 - There would be a deemed disposition and acquisition of all investments at market value at the time the breach first occurred.

- Domestic share gains would become taxable.
 - Losses arising in relation to domestic shares would be available to offset against gains from domestic shares in the year of the breach. Any residual losses would be extinguished.
 - The entity would forfeit its ability to become a QCIV in future.
- 3.42 The aim of these restrictions is to provide a significant disincentive for taxpayers to be in permanent breach, defeating the policy intent of the new rules. Submissions are welcomed on the nature and details of rules that should apply to permanent breaches of QCIV definitional requirements.
- 3.43 A question arises in respect of how to treat tax previously deducted and paid to Inland Revenue by the QCIV on behalf of investors before the time of breach. It is also relevant to the issue of how this tax would factor into any provisional tax payable by the entity in breach. Submissions on any problematic aspects of the proposed rules are invited.

QCIV a taxable entity

- 3.44 To ensure that the investment management fees derived by QCIVs from investors are declared and appropriately taxed, QCIVs would be taxable entities in relation to their investment management-fee income. The income subject to tax would be the net income derived by the QCIV from its investment management activities, which would generally consist of its fee income less any deductible expenses. QCIVs would therefore be required to file annual income tax returns.
- 3.45 A key exception to the portfolio investment rules would enable QCIVs to acquire a 100% ownership interest in business assets necessary to provide their investment management services. This would enable them to wholly own business assets such as a business premises from which investment management and administration activities are carried out; furniture and fittings; information technology and communications equipment. QCIVs would also be able to employ personnel to carry out and provide investment management services.
- 3.46 The government recognises that the proposal may not be a perfect fit with how CIVs are currently structured. Submissions on practical problems the proposal may give rise to are welcomed.

Application

- 3.47 The special QCIV tax rules would be elective to prevent savings and investment entities from inadvertently falling within the rules and being unknowingly exposed to the associated QCIV tax obligations. Accordingly, the current taxation of investment income rules would apply unless an entity specifically elected into the rules. While it is appreciated that this proposal would involve the operation of two sets of rules concurrently and therefore result in greater complexity, it would preserve the special status of the new

rules by ensuring that only those meeting the definition of QCIV are exempt from income tax on domestic share gains. However, it is expected that the voluntary nature of the rules would be reviewed in future.

- 3.48 To combat possible abuse of the new rules by entities electing into the rules one year and out the next, the government considers it is necessary for elections into the new rules to be irrevocable. The new rules would cease to apply only on cessation and winding up of the particular entity, or in the case of a breach of the QCIV definitional requirements.

Points for submission

The government welcomes submissions on any points raised in this discussion document, with specific comment welcomed on the following:

- Whether the entity’s principal activities should be in the nature of savings and investment, and the meaning of “principal”.
- The appropriate minimum number of investors a QCIV should have in order to be sufficiently widely held.
- The concept that QCIV investors should be portfolio investors and the maximum investment that any one investor should be allowed to have in the QCIV.
- Whether workable “unusual or temporary breach” rules can be developed, and the nature of these rules.
- Whether the QCIV should itself be a portfolio investor and the maximum actual ownership interest a QCIV should be allowed to have in any given asset or investment.
- Whether there should be a requirement that an entity seeking QCIV status should be resident in New Zealand for tax purposes.
- The consequences of breaches of the QCIV definitional requirements when the breaches are not “unusual or temporary”, and the nature and detail of any rules to deal with such situations.
- The practical problems associated with the QCIV being able to have 100% ownership in business assets necessary to conduct investment management and administrative functions.

Chapter 4

PROPOSALS TO ACHIEVE NEUTRALITY AND ALIGN MARGINAL TAX RATES

Proposal 1: A new definition of assessable income for QCIVs

- 4.1 To achieve broad neutrality between direct investment in New Zealand shares and investment via a QCIV, the definition of “assessable income” for QCIVs should be the same as under the current rules, except that realised gains on domestic shares will generally no longer be taxed.
- 4.2 The realised gains on most direct investments by individuals in shares are not taxed. The reason is the difficulty in demonstrating that the taxing provisions have been met for many individual direct investments in shares. These tests rely on factors such as the presence of a business, which can be hard to show for individuals, or a demonstration that the investor had a subjective dominant purpose of resale when the investment was purchased.
- 4.3 In contrast, the tests can be met more easily by a managed fund, because the fund will often, unambiguously, be in the business of trading in equities, and conservative trustees often err on the side of caution when deciding whether share gains should be returned for tax purposes. This difference in treatments creates clear disincentives, both anecdotally and practically, to use a managed fund to invest in shares.

Changes to the capital/revenue boundary for domestic share gains derived via QCIVs

- 4.4 Most savings vehicles that would qualify as QCIVs pay tax on domestic share gains – largely because they are treated as a separate entity from their underlying investors and because of uncertainty over the application of the capital/revenue boundary.
- 4.5 One effect of this uncertainty is that trustees of QCIVs do not know during the life of the investment whether the investment is taxable on realisation. They must treat it as if it were taxable to ensure that investors present at the time of realisation are not treated less favourably (by having to pay the tax) than investors who have already departed.
- 4.6 In terms of the capital/revenue boundary, sections CA 1(2), CB 1, CB 2, CB 3 and 4 of the Income Tax Act 2004 (sections CD 3, 4 and 5 of the Income Tax Act 1994) apply in determining whether share gains are taxable on realisation.

- 4.7 Section CB 1 of the 2004 Act (section CD 3 of the 1994 Act) deems the gross income of any person to include any amount derived from any business. For savings vehicles, it is very likely that section CB 1 will apply as such a vehicle is in the business of making investments – that is, buying and selling shares in order to make share gains. This provision, combined with the conservative nature of fund trustees, means that it is very likely that it would apply to tax share profits derived through QCIVs.
- 4.8 One option considered was removing the application of the “business” test for QCIVs. However, this alone would not deal with the issue of domestic share gains derived via QCIVs being taxable, as sections CB 2, 3 and 4 of the 2004 Act (sections CD 4 and 5 of the 1994 Act) could also apply to tax them.
- 4.9 Section CB 3 (the second limb of section CD 4 of the 1994 Act) taxes any gains from the sale of personal property such as shares if the property was acquired for the purpose of selling or otherwise disposing of it. This is what is known as the “purpose” test.
- 4.10 The “purpose” test is subjective, requiring consideration of the state of mind of the purchaser at the time of acquisition. If there is more than one purpose, then, typically, the test is whether the dominant purpose at the time of acquisition is one of sale or other disposition. There is a significant risk that even if domestic share gains derived via a QCIV are not taxable under the “business” test they would be taxed, in most instances, under the “purpose” test. Depending on the QCIV’s pattern of investment, conservative trustees of funds are likely to want to avoid situations where Inland Revenue could challenge (perhaps in later years) that an investment had not been purchased with a dominant purpose of resale. This risk may well result in trustees returning such profits for tax purposes. Consequently, an amendment is proposed to ensure that section CB 3 does not apply to tax realised gains on domestic equity derived via a QCIV.
- 4.11 Sections CB 2 and CB 4 (the first and third limbs of CD 4 of the 1994 Act) tax the profits from shares if the person’s business comprises dealing in shares, and when the profits of shares relate to the carrying on of an undertaking or scheme devised for the purpose of making a profit. Section CA 1(2) (CD 5 of the 1994 Act) taxes share gains if those gains are “income under ordinary concepts”.
- 4.12 For similar reasons to those described earlier, there is a risk that trustees of funds could return, for tax purposes, gains on domestic shares as a result of the application of these provisions. Therefore these provisions should not apply to domestic equity gains derived via a QCIV.
- 4.13 This does not mean that certain domestic equity gains derived via QCIVs would not be subject to tax. It is proposed to continue to tax certain equity gains derived via QCIVs, that are akin to debt.

Gains on equity investment that would still be taxable

- 4.14 While the government proposes to exempt gains from equity investment from taxation the current debt treatment for such funds would be maintained. That is because the QCIV model is designed to proxy the tax treatment of individuals. With debt, there is currently no difference in the tax treatment between individuals and managed funds, as all taxpayers are subject to the financial arrangement rules relating to debt instruments.³
- 4.15 The capital gains exemption is also intended to apply only when the QCIV has full equity risk associated with the investment. The nature of equity risk is that the return is uncertain. While there may be a capital gain over time, there is also a real possibility of capital loss.
- 4.16 The government is concerned that in exempting capital gains for equity to proxy the tax outcomes for direct individual investors, this exemption becomes effectively extended to debt substitutes or to situations where the equity risk is removed through the use of derivatives.
- 4.17 One option is to broaden the dividend rules to include situations where a taxable return such as a dividend is converted into a non-taxable return – a capital gain. Examples include situations where dividends are deferred until redemption or a share is sold before a dividend is paid.
- 4.18 To ensure that any rules in this area are as clear and certain as possible, fixed rate shares, and shares that provide no dividend and are redeemable for a set price – provided that the price is equal to or greater than the cost to the QCIV of acquiring the share – would be treated as revenue account property by the QCIV. Strengthening the dividend rules to deal with debt substitutes held through QCIVs would not appear to give the necessary certainty to QCIVs or the government. However, submissions on this point are welcomed.
- 4.19 To ensure that capital gains are exempted only to the extent the QCIV was subject to the underlying equity risk, all costs relating to derivatives that would reduce equity risk generally would not be deductible. This ensures that only the portion of the return that reflects the equity risk is not subject to tax and reflects the tax treatment of an individual who holds shares on revenue account buying an equity option.

³ It is accepted, however, that there is a timing difference and individuals may be cash-basis holders and so not return any discounts or deduct any premiums until the instrument matures or is sold.

Other assessable income and treatment of tax credits and deductibility of expenses

- 4.20 The new definition of “assessable income” for QCIVs would continue to include dividends, interest, and other returns, which are currently taxable. The only changes will be to the taxation of domestic share gains and the definition of “assessable income” in relation to portfolio investment in offshore shares by QCIVs. The latter is discussed in more detail in the next chapter. Tax credits such as imputation credits attached to dividends and resident withholding tax deducted on interest would continue to be available for use. The use of these credits is discussed further in the following section, on the proposed flow-through tax treatment for QCIVs.
- 4.21 Fees incurred by investors in investing via a QCIV will be able to be deducted against assessable income derived via a QCIV. Fees incurred that relate to the purchase of domestic shares will be deductible in the same way as if they had been incurred directly by an individual passive investor. Inland Revenue’s Interpretation Statement IS0044 – *Financial planning fees: income tax deductibility* is helpful in providing guidance on the circumstances when such fees are deductible. The statement categorises financial planning fees and indicates that administration, monitoring, evaluation, re-planning and switching fees will be deductible for tax purposes.

Key question: would direct active investment in New Zealand shares be tax-disadvantaged relative to investment via a QCIV under the proposed changes?

One of the questions that arises from not taxing domestic share gains made via a QCIV is whether it would create a tax disadvantage for direct investment in New Zealand. That is because the “business” and “purpose” tests would continue to apply to individual investors on their direct holdings. Taxpayers who are share traders, for example, would continue to be taxed on realised share gains, whereas if the investments were via a QCIV, the activities of the QCIV would not render taxable the domestic share gains.

Individual investors would still be subject to tax on any share gains from trading as this is the correct tax base for these taxpayers. Not taxing these gains would create an incentive for taxpayers to substitute other employment activities (when income in the form of salary and wages is taxed) to this type of activity (when what is effectively the income from labour would not be taxed). This would create tax integrity concerns, because a form of labour income – exerted in trading in capital assets – would not be in the tax base.

It should be noted that under the new rules, if investors actively trade their interest in a QCIV, any gains from this activity will be subject to the capital/revenue boundary, as it exists currently. In other words, if an investor owns an interest in a QCIV and actively trades this interest, so that the “purpose” (or “business”) test is met, any gains will continue to be taxable. In this context, the interest in the QCIV will be treated as any other share investment held directly by the individual investor.

The question of the appropriate tax base when a taxpayer invests through a QCIV is different. While the QCIV may actively trade shares on behalf of the taxpayer, under the proposed definition of a QCIV, the taxpayer will effectively give up control over the management of the investment. One of the key principles for qualifying as a QCIV is that the investor has a non-controlled or portfolio investment in the QCIV and the QCIV is itself a portfolio investor. When an investor has given up investment decision-making control, one concern about the substitutability of taxable labour activity with non-taxable activity no longer applies – the substitutability between QCIV income and labour income.

As the investor should not be able to influence the investment strategy of the QCIV, the question is then whether the gains made by the QCIV on the investor's behalf should be taxable as a proxy for the investor. It can be argued that they should not, because the investor pays a fee to the QCIV to undertake investments on his or her behalf. When a QCIV appropriates a higher fee for generating higher return – for example, with certain foreign hedge funds, taxing the fee would be the appropriate tax policy response rather than separately taxing the gain. This should capture the extra value added by the QCIV. In theory, the fee should proxy the implicit salary or wage income an individual share trader would receive from undertaking this activity.

In summary, the key difference between an individual making active direct investments or making them through a QCIV is that in the latter case the individual cedes control over investment decisions to the QCIV. Investing through a QCIV will also result in a fee being paid by the investor, which is taxable to the QCIV. In theory, this should reflect the value added by the QCIV.

Key question: what would occur in relation to passive funds?

“Passive” is the term given to investment funds with a ruling from Inland Revenue that they are not in the “business” of actively trading investments. These funds typically track the movements of foreign indices, such as the Morgan Stanley Capital Index, with buy-sell decisions contingent on these movements and changes to the composition of the index. The effect of the Inland Revenue ruling is to deem these investments to be held on capital account, and they are marketed as such. Anecdotally, it has been suggested that most passive funds track offshore indices, although there is evidence that some track New Zealand indices.

Under the proposed changes, savings vehicles that qualify as QCIVs and actively undertake domestic share investments would not be disadvantaged relative to passive funds that track domestic indices. The rulings that currently give passive funds a more favourable tax treatment are a tax distortion and influence investment behaviour in a particular way. The removal of this distortion for domestic investment should ensure that investment decisions are undertaken for commercial rather than tax reasons and are based on the returns and fees of the QCIV concerned.

Proposal 2: Flowing through assessable income to investors with tax deducted at marginal tax rates

- 4.22 While the definition of income is important, of equal importance is how this income will be taxed. As noted earlier, there is a significant non-alignment between personal and entity tax rates, depending on the savings vehicle being invested into. Changes are proposed to better align the tax treatment of investment via a QCIV with that of a direct investor.
- 4.23 It is proposed that QCIVs electing into the new rules must allocate to investors any assessable income derived in a year that relates to each investor's share of the underlying assets. The allocated income would be deemed to be derived by the investors, and QCIVs will withhold tax at investors' marginal tax rates. The tax would be deducted by the QCIV and remitted to Inland Revenue each year. The obligations on QCIVs would be similar to the current resident withholding tax requirements for banks and other large interest payers.

- 4.24 A key change for QCIVs is that they would act as a tax calculation and withholding tax agent on behalf of their investors. This has been broadly termed as the flow-through tax treatment for QCIVs.

Why is the government allowing QCIVs to flow through income?

- 4.25 Alignment of tax rates is important to ensure that the correct amount of tax is paid by an investor. Under current rules, alignment is limited to those entities that are subject to the company tax rules, such as unit trusts, or the qualifying trust rules, which include, for example, certain group investment funds. Even in these instances alignment can be partial.
- 4.26 One of the key distortions is the myriad of tax results that can arise depending on the entity structure of the QCIV, even though the product on offer may be identical. This can result in investor behaviour being driven by tax considerations. This occurs because there would be an incentive for taxpayers on a marginal tax rate of 39% to invest in superannuation schemes (with the final tax being 33%). Conversely, taxpayers on marginal rates of less than 33% might be discouraged from investing in these vehicles.
- 4.27 The proposed flow-through method is designed to remove many of the tax distinctions between the entities. Some distinctions will still remain, however, as there are certain QCIVs for whom flow-through is not possible for practical reasons. The tax rules will need to make allowances for these products and providers. These entities are likely to be a minority. The flow-through tax rules are designed to ensure that, as far as possible, tax rates do not disadvantage investors from investing via a QCIV rather than on their own account or in different QCIVs.
- 4.28 One of the key issues noted in the Stobo report on applying flow-through tax treatment for QCIVs was the potential cost to New Zealand QCIVs of updating their systems. One of the options considered by the report, was retaining the current entity tax rules for QCIVs but with a mechanism for aligning the QCIV tax rate with investors' marginal tax rates using a tax credit system. This option was later discarded because it would result in significant complexity for QCIVs.
- 4.29 The New Zealand savings industry is broadly supportive of the flow-through option. It also generally recognises that whatever changes are made will involve some cost to the industry resulting from the transition to a system that acts as a proxy for direct investors.

Background

- 4.30 The concept of mechanisms to align entity and investor tax rates is not new. In the context of managed funds, it was considered by the Taxation of Life Insurance and Superannuation (TOLIS) Review in the late 1990s. TOLIS recommended a tax-credit system for managed funds, a proposal that was not implemented because of technology and cost concerns at the time.

- 4.31 The current tax rules also contain various alignment mechanisms, most notably imputation rules applying to companies which allow a wash-up at investors' marginal tax rates on distributions from companies. Another is the tax treatment of qualifying trusts, where distributions of income within six months of the end of the tax year in which the income is derived are taxed at the marginal tax rates of beneficiaries.
- 4.32 As part of his consultation process, Craig Stobo considered a tax treatment for QCIVs that would remove the entity tax model and would push income derived via a QCIV into the hands of the ultimate beneficiaries – investors, to be taxed at their marginal tax rates. This flow-through approach was considered to have several benefits. They included a closer tax rate alignment than would happen under a tax-credit system and reduced risks for QCIVs because they would no longer be a taxpayer in respect of income derived on behalf of their investors. It was also considered that the issues that affected TOLIS were not as significant in the current environment because of advances in technology.
- 4.33 A flow-through model would generally apply to investment vehicles that elect to be QCIVs. There will be certain exceptions, which are discussed later.
- 4.34 It is recognised that not all QCIVs will be in a position to flow through income to their investors on 1 April 2007. Those entities will still be able to use the existing entity tax treatment until they are in a position to make the transition to the new rules. It should be noted, however, that the new definition of “assessable income” for a QCIV would (with the exception of defined benefit superannuation schemes) be tied to its ability to administer the flow-through model. In other words, if the existing rules apply for tax being paid at the entity level, the current definition of “income” for a QCIV would also apply.

How the flow-through model would work in practice

- 4.35 It is envisaged that the flow-through model would be feasible for a majority of vehicles that qualify as QCIVs. Vehicles such as widely held unit trusts (for example, qualifying unit trusts) and defined contribution superannuation schemes or other vehicles where the underlying investments can be allocated to investors in proportion to their contributions should be in a position to consider flow-through. The treatment for situations where it is not possible for investment income to be allocated to individual investors (for example, defined benefit superannuation schemes) is discussed later.
- 4.36 For the flow-through model to work, QCIVs would generally need to operate a system of accounts for each investor whereby the investor's share of assessable income is recorded and updated regularly. The account would also record the investor's share of any tax credits and tax deductible investment-management fees. Unit trusts will have unit registry systems for recording investor-specific information, although modifications are likely to be needed. For superannuation schemes that are defined contribution

schemes, it is also likely that some system of investor accounts will exist. Again, modifications to these systems may be needed.

- 4.37 How a flow-through model would operate in practice would depend on the commercial arrangements surrounding the relevant QCIV. For example, a QCIV may wish to allocate income to investors' accounts on a regular basis or less frequently depending on how its systems operate. Allocations of income from which tax is deducted (attributions) may be less frequent.
- 4.38 An attribution would not require a physical distribution of income to investors, but rather just a record that the income is derived by a particular investor. Instead, investment income would typically be reinvested in the QCIV to generate further returns for investors. Under such an attribution event, there would be a requirement for tax to be withheld from assessable income and remitted to Inland Revenue. The post-tax return would be available to be re-invested by the QCIV, if that was desired by individual investors. The aim of this exercise is that the investors will continue to be largely unaffected by what occurs within an investment vehicle, subject to the election of correct withholding tax rates, which is discussed later in this document.
- 4.39 The payment of tax by the QCIV on behalf of investors may require the cancellation of some of an investor's interest in a QCIV – such as units in a unit trust. Such a cancellation may be contrary to the current trust deeds of funds. If this is the case, it may be necessary to introduce legislation that would validate certain cancellations that are inconsistent with trust deeds. The government invites submissions on whether such legislative enablement is necessary.
- 4.40 The key for the new tax rules is that there is at least one attribution of income each year to investors' accounts (an allocation from which tax is deducted), as well as an attribution when an investor exits a fund.
- 4.41 An attribution on exit will include instances where only part of an investment in a QCIV is realised – for example, when a few units in a unit trust are redeemed. The attribution would be for the exiting investor's share of the income derived by the QCIV up to the date of exit, and would include all forms of assessable income, including dividends, interest, income from offshore investments and any gains that may still be taxable. This may also necessitate the QCIV having to deduct the exiting investor's share of the tax on any unrealised gains that, on realisation, would be taxable.
- 4.42 Example 1 outlines how the flow-through process would work in a situation where a QCIV does an annual attribution to all investors with separate attributions on exit.

Example 1: Flow-through on annual and exit attributions

John and Emma invest in a widely held unit trust that is a QCIV. They contribute \$10,000 each, with John electing a 19.5% tax rate and Emma a 39% tax rate. The QCIV has 98 other investors who have each contributed \$10,000. The total funds under management is \$1,000,000 and John and Emma's interest in the QCIV is 1% each. They enter the QCIV on 1 April 2007. John leaves the QCIV on 1 October 2007 while Emma stays for the duration of the year. On John's exit, a new investor enters the QCIV, so the existing investors' ownership levels are unaffected. The general attribution date is 31 March 2008.

During the year the investment gains derived via the QCIV comprise dividends of \$50,000 (no imputation credits) paid on 1 June 2007, interest of \$40,000 (no resident withholding tax deducted) paid on 1 November 2007 and a gain on the sale of New Zealand shares of \$10,000 on 1 January 2008.

If the QCIV were to attribute income annually to all investors with separate attributions on exit, John's share of the income would be 1% of \$50,000 = \$500. On his exit, he would pay tax on \$500 at 19.5% = \$97.50, which would be deducted by the QCIV on his behalf.

Emma's share of the income would be 1% of \$100,000 = \$1,000, as she remains for the duration of the year. However, her assessable income would be only \$900 (her share of the \$50,000 dividend + \$40,000 interest). She would pay tax on \$900 at 39% = \$351 at the yearly attribution date, which again would be deducted by the QCIV on her behalf.

- 4.43 From a tax administration viewpoint, an attribution on exit is required to prevent incorrect taxation (including over-taxation) and abuse of the rules. In other words, if a general attribution occurs only yearly, and there are no specific attributions when an investor cashes-out, there will be incentives for investors to leave the QCIV just before to the general attribution date to avoid paying tax altogether. Alternatively, QCIVs could be structured in such a way that the only investors on the attribution date are tax-exempt entities such as charities or other low-tax rate investors. While it is unlikely that such abuse would occur in practice, the exit of investors before attribution date would, without an attribution on exit, result in investor-equity concerns.
- 4.44 While an attribution on exit would assist in minimising opportunities for avoidance and would ensure a level of investor equity, alternatively, if there were regular enough attributions during the year to all investors, this too would address the concerns raised. If a QCIV were unable to attribute income to investors on exit (or partial exit) from the QCIV, quarterly attributions of income to all investors would be required. Under this approach, income allocated to investors' accounts in a quarter would be cleared out on the attribution date for that quarter.
- 4.45 This option would be less precise than having an attribution on exit, particularly as it could result in taxpayers other than those who have derived the assessable income having to pay the tax (for example, if an investor leaves between attribution dates). Example 2 outlines how the flow-through model would work when a QCIV makes quarterly attributions to all investors, although there are several ways that funds could do this in practice.

Example 2: Flow-through on quarterly attributions

Gary and Jane invest in a widely held unit trust that is a QCIV. They contribute \$20,000 each, with Gary electing a 19.5% tax rate and Jane a 39% tax rate. The QCIV has 98 other investors who have contributed \$20,000 each. The total funds under management are \$2,000,000, and Gary and Jane's interest in the QCIV is 1% each. They enter the QCIV on 1 April 2007. Gary sells his entire interest in the QCIV on 5 September 2007, while Jane stays for the duration of the year. On Gary's exit, a new investor enters the QCIV, so the existing investors' ownership levels are unaffected. The quarterly attribution dates are 30 June, 30 September, 31 December and 31 March.

During the year the investment gains derived via the QCIV are dividends of \$25,000 (no imputation credits) paid on 1 June 2007, interest of \$60,000 (no resident withholding tax deducted) paid on 1 September 2007, further dividends of \$35,000 (no credits) paid on 1 February 2008 and a gain on the sale of New Zealand shares of \$25,000 on 1 March 2008.

If the QCIV were to attribute income quarterly to all investors, the attributions at the end of each quarter would be:

<i>Period</i>	<i>Gary</i>	<i>Jane</i>
1 April – 30 June	1% x \$25,000 = \$250	1% x \$25,000 = \$250
1 July – 30 Sept	-	1% x \$60,000 = \$600
1 Oct – 31 Dec	-	1% x \$35,000 = \$350
1 Jan – 31 March	-	1% x \$25,000 = \$250

As Gary is only present on the first attribution date, his assessable income would be only \$250. Tax on this (\$250 at 19.5% = \$48.75) would be deducted on the first attribution date (30 June). However, Gary would still receive his share of the \$60,000 of interest when he exits the QCIV (by way of a higher unit price) even though he will not end up paying any tax on it. That is because Gary would not be present on the next attribution date of 30 September. Consequently, if no adjustment is made to the price Gary receives on exit from the QCIV, to reflect the share of the tax owing on the income derived in the period, investors who will be present on the next attribution date will be required to make up the shortfall. Should Gary continue to enter and exit the fund, however, his interest in the fund may be on revenue account.

For Jane, who remains in the fund for the duration of the year, tax of \$97.50 (\$250 at 39%) would be deducted at the first attribution date; tax of \$234 (\$600 at 39%) at the second date; tax of \$136.50 (\$350 at 39%) at the third date; and no tax would be deducted on the last attribution date because the income is a tax free gain.

4.46 QCIVs that chose to do quarterly (or more regular) attributions would need to manage investor equity concerns. In principle, quarterly attributions to all investors would seem to reduce incentives for taxpayers to exit an investment in a QCIV just before to a general attribution date and enter after the attribution.

4.47 The government therefore considers that QCIVs should have the choice of making:

- a single attribution to all investors at the end of an income year, together with attributions when investors sell their interest, or part of their interest, in a QCIV; or
- an attribution to all investors each quarter – for example, at the end of June, September, December and March.

Who can invest in a QCIV?

- 4.48 The government considers that the opportunity to invest in a QCIV should not be limited to individuals. Therefore entities such as companies and other types of taxpayers such as partnerships and trusts should be allowed to invest in a QCIV. If a company invests in a QCIV and the QCIV derives tax-free capital gains on the company's behalf, these gains would, like other capital gains, be available to the company to be distributed tax-free on liquidation, as under the current rules.

Payment of tax withheld by QCIVs to Inland Revenue

- 4.49 Depending on the frequency of attributions – whether a yearly attribution to all investors in the QCIV and attributions on exit, or quarterly attributions to all investors – the profile of tax payments to Inland Revenue will change.
- 4.50 When a QCIV chooses to do an annual general attribution and attributions on investor redemption, the tax deducted would need to be remitted to Inland Revenue by the 20th of the following month. Therefore if the annual attribution is on 31 March, the tax would need to be paid to Inland Revenue by 20 April. Similarly, for attributions when interests in a QCIV are redeemed, the tax would need to be remitted by the 20th of the month following the month in which the interest or part of the interest was cashed-out. For quarterly or more regular attributions, similar rules would apply.
- 4.51 At the end of the year the QCIV would, for reconciliation purposes, need to provide Inland Revenue electronically with a statement outlining each investor who was present in the fund during the year, the investor's share of investment income, tax deducted, tax deductible expenses and tax credits. This would be similar to the reconciliation requirements for interest payers and, as will be discussed later, is necessary for the matching of investor information.
- 4.52 The proposed process for remitting the tax withheld will have use-of-money implications for both the government and QCIVs. Currently, QCIVs are provisional taxpayers, meaning that they pay tax in three instalments during the year. Under an attribution on exit approach, there is likely to be a single tax payment at the end of the year, with smaller tax payments through the year when some investors exit. Under such an approach, the government would be adversely affected, as it would receive tax revenue later than it otherwise would. Under a quarterly attribution approach, the frequency of tax payments to Inland Revenue would increase, which would mean that QCIVs would be negatively affected as they would be required to remit tax revenue earlier than they otherwise would.
- 4.53 The options put forward are not driven by use-of-money concerns associated with tax payments. The aim of the flow-through model is to ensure that, broadly, the correct amount of tax is paid, by the correct investor. The level of precision will depend on the approach adopted by QCIVs for various reasons, such as investor equity.

Anti-avoidance rules

- 4.54 It will be necessary to develop certain rules that guard against tax-driven behaviour. One such rule is a “wash-sale” provision, which would effectively deem a sale and subsequent re-purchase of an interest in a QCIV to give rise to a taxable event (the sale) if the two parts of this transaction are carried out within, say, 30 days of each other. This is on the basis that such an arrangement is likely to have little commercial rationale. It is more likely to be tax-driven with the purpose of minimising tax payable. An instance where such a rule would be useful is if an investor in a QCIV who holds that interest on capital account were able to sell the interest to a revenue account investor just before the attribution of income by the QCIV (for example, payment of a dividend to the QCIV by a New Zealand company) and re-acquire it after the attribution is made.
- 4.55 In this scenario, the sale price would be the pre-attribution price. The revenue account investor would have tax deducted on attributed income, with the value of the investment falling to reflect the attribution. The revenue account investor would then sell the interest back to the capital account investor at the post-attribution price. The revenue account investor would receive a deductible loss on the transaction (to offset the tax payable on the attribution by the QCIV), while the capital account investor would receive a real gain (on the difference between what the investor sold the interest for and the price at which it was reacquired). In this scenario, the arrangement is structured in such a way that no tax is payable on the dividend.
- 4.56 Such an arrangement could also work if the QCIV sells an interest in a New Zealand company, before the company pays a dividend, to a revenue account taxpayer and re-purchases the interest after the dividend is paid. The QCIV would not be taxable on the sale because of the domestic capital gains carve-out.
- 4.57 A “wash-sale” rule would cover both scenarios by taxing any gains made by the capital account investor on the sale of the interest in the QCIV and taxing the QCIV on the sale of the interest in the New Zealand company.

When the flow-through model may not be feasible

- 4.58 There will be some funds that cannot allocate all of their income to their investors because the underlying value of their assets cannot be linked to contributions by or for specific individuals.
- 4.59 In defined benefit superannuation schemes, the benefits that are ultimately payable cannot readily be linked to what investors have contributed. That makes it difficult to determine, at any given point in time, what each investor’s share of the underlying assets is. Also, defined benefit schemes have certain triggering events for payment of benefits, such as payment after a certain age or event. When a contributor exits a scheme, there may be a forfeiture of contributions or repayment of these contributions, but at a significant discount (calculated actuarially).

- 4.60 Furthermore, defined benefit superannuation schemes typically require a top-up to investor contributions to make up any shortfalls between contributions and eventual payouts. This makes it difficult to allocate fund assets to investors if contributions are being “topped up” by the scheme or employers in the case of employer-based defined benefit superannuation schemes. Defined benefit schemes represent a significant, though declining, part of the superannuation and savings landscape.
- 4.61 Schemes that offer a capital guarantee may also be unable to allocate all income to investors. It may be prudent to leave some income unallocated so that, if the scheme generates poor returns in the future, the unallocated income can then be used to provide the promised minimum rate of return.
- 4.62 Another instance when income cannot be fully allocated arises with “unvested” amounts. Unvested amounts can arise in the context of both defined contribution and defined benefit schemes when an employer, for example, matches or “tops up” contributions made by an investor. A key feature of the employer contributions is that unless certain criteria are met, such as length of service, the amounts do not vest with the employee. Unvested amounts typically flow back into the schemes and are redistributed among remaining policyholders, or can revert back to the employer. As vesting periods can, in certain cases be significant, in instances where there are unvested amounts it can be difficult to tax income relating to these amounts at the marginal tax rates of investors to whom these amounts may or may not eventually belong.
- 4.63 A fund that cannot completely allocate income to individuals would be unable to fully apply flow-through tax treatment. As such, unless a special provision were designed, such funds would be denied access to the proposed tax treatment of domestic capital gains. This would motivate a significant shift in investment away from such funds, which would represent a tax-generated distortion of investment behaviour. Consequently, special rules are required to deal with these types of funds.
- 4.64 Schemes with “unallocated” amounts should still have the option of electing into the new rules and receiving the benefit of the exemption on domestic share gains. There are three options to achieve this. The final approach taken by the government will take consideration of views expressed in submissions.
- 4.65 The first option is to continue to tax unallocated amounts at 33%. This approach would create incentives for funds managed on behalf of 39% rate taxpayers not to allocate income.
- 4.66 The second option would also tax unallocated income at 33%. It would involve a fund with unallocated income being allowed to access the proposed tax treatment for domestic capital gains only if it is a registered superannuation scheme operating as a defined benefit scheme as of 27 June 2005. This mechanism would discourage the establishment of new registered superannuation schemes with unallocated amounts. This

limitation could be revisited if required. There may also be difficulties in appropriately defining “defined benefit” schemes.

- 4.67 Both options would allow schemes with unallocated amounts to obtain the same tax treatment of capital gains as other funds, but they limit the ability of such funds to access a valuable aspect of the reform, the ability to attribute the correct tax rate to their members. However, the requirement to apply marginal tax rates would apply only to the extent they are practically able to attribute income.
- 4.68 The third option would allow schemes to attribute income earned by the fund, when possible, to participating savers so that earnings so attributed could be taxed at their correct marginal rate. This would be allowed to the extent possible, with remaining earnings that could not be allocated taxed at 33%. The attribution could be based on current filing requirements to the Government Actuary, who reviews the filings of each registered superannuation scheme every three years. The reporting requirements would attempt to limit changes required from current reporting when possible. Funds could be allowed to attribute, or required to make a best effort to attribute at correct marginal rates when possible. Individuals would elect their marginal rates in the same manner as with other schemes.
- 4.69 To the extent that marginal tax rates can be applied, the income would be taxed at the fund level and not to the individual investors. This is because in the case of, say, unvested amounts, the employer contribution to which the income relates does not belong to the investor, so, technically, neither does the income until the amount is vested. Consequently, it would be inequitable for the income to be deemed to have been derived by investors, as this could trigger other obligations.
- 4.70 This approach would limit unallocated amounts within a scheme to an acceptable reserve level. It would also seek to ensure that attribution to lower rate taxpayers was made on an actuarially appropriate basis. It would provide a practical limit on vesting, capital protection reserves and general reserves of such schemes.
- 4.71 Excess amounts allocated to taxpayers on rates below 39% or excess reserves could be taxed at 39% at the discretion of the Commissioner of Inland Revenue. This approach would place additional requirements on the Government Actuary, and on Inland Revenue. Further, it could increase compliance costs for funds. It would provide funds with members having marginal tax rates of less than 33% a valuable advantage however. The government would welcome submissions indicating whether an approach such as the third option is considered valuable enough to justify incurring these costs.

Flowing through income, tax credits and losses

- 4.72 All assessable income will need to be flowed through to investors. Equally, any tax credits such as imputation credits and resident withholding tax on New Zealand interest and any foreign tax credits such as foreign non-resident withholding tax on dividends will need to be flowed through in proportion to each person's investment in the QCIV. These tax credits can be used to offset the tax that is deducted by the QCIV on behalf of individual investors. Similarly, tax deductible investment expenses can be offset against assessable income derived via the QCIV. Tax losses, for example, from any realised revenue account assets will also be available for use.
- 4.73 The ability of QCIVs to flow through foreign tax credits for non-resident withholding tax provides greater consistency with the treatment for direct non-controlled investment in offshore shares. Currently an investor in a managed fund such as a unit trust would not gain the benefit of the foreign tax credit if the fund pays a dividend because the foreign tax credit would have been used to offset assessable income at the fund level.
- 4.74 The availability of credits, expenses and losses raises the issue of the correct treatment of excess amounts, whether excess credits or losses. This would arise when the deductions or credits available exceed the assessable income in the QCIV. It could arise, for example, when a QCIV derives only fully imputed dividend income and has tax deductible expenses or investors on the lower marginal tax rates. Should these amounts be refundable, available to be claimed as a loss in the current year against non-QCIV income, or carried forward within the QCIV?
- 4.75 As a general rule, under imputation, excess imputation credits are not refunded, although excess resident withholding tax is. Theoretically, under a flow-through model, the different credits and income to which those credits relate should retain their character. This means that excess imputation credits available should be carried forward, while resident withholding tax credits should be refundable. This would provide better consistency with the tax treatment of an individual direct investor. The ability of investors in QCIVs to get value for these credits is discussed below.
- 4.76 It should be noted that as QCIVs are not flow-through entities at present – it is the QCIV and not the investors who explicitly receive tax credits. A similar situation arises relating to tax losses and deductible expenses. Consequently, excess tax losses or credits are generally quarantined at the fund level, with excess credits carried forward and offset against future fund income.
- 4.77 One method that would give investors value for excess tax losses and credits would be for QCIVs to flow them through to individual investors each year, as part of the general annual attribution to all investors. However, to gain the benefit of such excess losses or credits, investors would need to file a tax return. This would result in a large number of investors who have no other reason to file a tax return having to do so or risk losing the credits. The

compliance cost of requiring investors to file a return to get value for their credits would, however, be onerous, especially if the value of any excess losses or credits is small and the return triggers other obligations. The broader implications for investors are discussed in more detail later.

- 4.78 A better mechanism for providing investors with value for excess tax credits, tax losses and expenses that cannot be used is for QCIVs to carry forward these amounts to be offset against the future assessable income of the investor, to be derived via the QCIV. This would preclude the need for investors having to file a return automatically each year to claim any excess amounts. It is likely that technology solutions are available to achieve this, which is the approach favoured by the government.
- 4.79 When investors redeem their interest (or part of their interest) in a QCIV during a year, they should have the option of filing a return to get the benefit of excess tax credits or losses in proportion to the amount realised. Claiming excess tax losses and credits in this way could result, however, in other obligations arising. These are discussed in greater detail later.
- 4.80 Alternatively, QCIVs could offset any tax losses and tax credits against assessable income before allocating income to investors' individual accounts. Under this arrangement, net income would be allocated to investors rather than gross income and tax losses and credits. Any excess tax losses or tax credits would be carried forward in the value of the QCIV. That approach is similar to what happens in managed funds today – where a fund has excess tax losses, they may be provided for in the fund's price by way of a higher unit price. While not as accurate as carrying forward the excess in individual accounts, it may result in less complexity for certain QCIVs. Therefore the government also considers that it would be an acceptable approach for dealing with excess losses and credits and envisions that the new rules would include both options.
- 4.81 One of the key issues is the ability of QCIVs to determine accurately what percentage of their tax losses are likely to be useable going forward, and therefore able to be included in the fund's price on the balance sheet. This issue would remain if tax losses were able to be offset on a gross income basis, with any excess losses carried forward in a fund's unit price. However, it would allow QCIVs to give value to investors for excess tax losses and credits via a higher price which is redeemable on exit from the QCIV.

Implications for investors in QCIVs

- 4.82 The tax rate applied by QCIVs when assessable income is attributed to investors will be the tax rate elected by the investor. Taxpayers will be able to elect a rate based on their marginal tax rate of 19.5%, 33% or 39%. Investors would need to provide this tax rate at the start of the year or when they enter a QCIV for the first time. If an investor fails to elect a rate, the QCIV will be required to deduct tax at the highest marginal tax rate of 39%.

- 4.83 Under the proposed flow-through model for QCIVs, any income derived via a QCIV will be treated in the same way as an investor's, if income from direct investments forms part of a direct holder's assessable income in a year. Currently, if an investor is a direct holder, any income including dividends and taxable equity gains must be returned each year, by filing a tax return, if the amount of assessable income is greater than \$200. The time requirement applies at present to investments in managed funds such as unit trusts if the fund pays a dividend greater than \$200 or if any gain on the sale of an interest in the fund is taxable. However, if any gains made by the fund are not distributed, or if an investor holding an investment on revenue account does not realise the interest in the QCIV, no taxable event is triggered for the investor. Consequently, a tax return is usually not required to be filed.
- 4.84 The flow-through model aims, as much as possible, to put investors who invest via a QCIV on a similar footing to individuals who invest directly. Absolute consistency between investors in a QCIV and direct investors would mean that to the extent individual direct investors are required to return income each year on their investments, the same rule should apply to investors in a QCIV. However, for investors in QCIVs this would impose compliance costs above the current level.
- 4.85 In particular, it should be noted that the proposed KiwiSaver scheme announced in this year's Budget will result, over time, in a large number of taxpayers having investments in vehicles that may qualify as QCIVs. The requirement for these taxpayers to file tax returns each year, when they currently are not required to, would result in significant compliance costs.
- 4.86 More importantly, the requirement for investors in a QCIV to file a return would also affect a number of social policy initiatives that are delivered or collected through the tax system. They include:
- payment of family assistance;
 - collection of child support payments (from liable parents); and
 - student loan repayments (from borrowers).
- 4.87 Currently, a taxpayer's assessable income generally determines entitlements and payment obligations. Under the proposed flow-through model for QCIVs, investment income derived via a QCIV would be the income of the individual investor, which in the absence of any changes to the contrary, would affect that person's entitlement to family assistance and payment obligations for child support and student loans.
- 4.88 Requiring taxpayers to declare investment income derived via a QCIV would affect entitlements under the Working for Families scheme. The package can result in access to assistance for families with fairly significant income levels, and there is a risk that those benefits might be clawed back in cases where a family saves via a QCIV. That would be inconsistent with both the aim of the Working for Families scheme and the broader intention to encourage more saving by New Zealanders.

- 4.89 Under the current rules, depending on the entity being invested into, investment income derived through that entity may not affect family assistance and other social policy initiatives. For example, for investments made via a registered superannuation scheme, a claw-back of family assistance would be a significant change to the existing tax treatment as the investment is taxed at the scheme level of 33% and does not affect family assistance, child support or student loans. An investment in a unit trust would claw-back family assistance only when the unit trust makes a taxable distribution such as a dividend over \$200 or on the realisation of the investment for a revenue account taxpayer.
- 4.90 Given the current rules and the fact that for certain investments such as superannuation schemes investments may be locked in, it would not be appropriate to require claw-back of family assistance. Different problems arise in relation to the impact of investment income on any liability to pay child support, however. Investment income derived via a QCIV should not affect a liable parent's child support obligations if it reduces the level of child support received by the custodial parent.
- 4.91 That can occur at present if a liable parent invests through a registered superannuation scheme. Importantly, there are administrative mechanisms for dealing with this "excluded" income for child support purposes. Even if investment income derived via a QCIV is excluded from a taxpayer's gross income figure for the year, custodial parents can still apply for an administrative review for consideration of whether the excluded amount should be included in the calculation of a liable parent's capacity to pay child support. Consequently, it is proposed that income flowed through to investors in a QCIV would not give rise to re-assessments of child support obligations.
- 4.92 To prevent income derived by an investor via a QCIV requiring a tax return to be filed, and affecting family assistance entitlements, child support and student loan repayment obligations of investors, tax on investment income derived via a QCIV and deducted and paid by the QCIV on an investor's behalf would be a final withholding tax for most investors.
- 4.93 Here a distinction is being drawn between individuals and non-individuals (such as companies) who are investors in QCIVs. The tax deducted by the QCIV would be a final withholding tax for individuals, unless certain criteria were breached. It would not be a final withholding tax for non-individual investors. That is because a key reason for deeming tax withheld by a QCIV to be a final withholding tax is to prevent investors having to file returns when they otherwise would not have to. Non-individual investors such as companies are already required to file returns, so there is no need for the tax withheld by a QCIV to be a final tax. This distinction is discussed in more detail later.

Individuals investing in QCIVs

- 4.94 For individuals, a final withholding tax would operate based on the rate that is elected by the investor at the start of the year or when an investor enters a QCIV for the first time. Individual investors would elect the relevant marginal tax rate based on their previous year's income. Such a model would work as follows:
- If total assessable income from all sources in the previous year is below \$48,000, an investor must elect a rate not lower than 19.5%.
 - If total assessable income from all sources in the previous year is between \$48,000 and \$70,000, the investor must elect a rate not lower than 33%.
 - If total assessable income from all sources in the previous year is greater than \$70,000, the investor must elect a rate of 39%.
- 4.95 Under these rules, taxpayers would not be required to file a return in respect of QCIV income, or include this income in the return if they are required to file for other reasons. The thresholds above are greater than the thresholds for income tax to reflect the fact that investment income derived via a QCIV may result in a higher tax rate applying at the margin.
- 4.96 For example, if a taxpayer derived \$35,000 of wage and salary income in the previous income year and \$5,000 of QCIV income, the marginal tax rate on the next dollar of income would be 33%. However, strictly speaking, only \$2,000 of the QCIV income should be taxed at 33%, with \$3,000 taxed at 21%. In the following year, assuming that salary and wage income is not subject to significant inflation, electing a 33% tax rate on QCIV income would result in over-taxation. While it would be possible to require some apportionment based on different tax rates, such a mechanism would be difficult to apply in practice for individuals and QCIVs. Consequently, the government proposes to build in a \$10,000 buffer into the income thresholds to ensure that investment income derived through a QCIV is not over-taxed. While this could result in certain income derived via a QCIV being under-taxed – for example, when salary and wage income is \$38,000 and QCIV income is \$5,000, the marginal rate on the QCIV income should be 33% – the proposed approach should result in the right outcome for most individual investors without imposing undue compliance costs.
- 4.97 The approach outlined here would impose a statutory requirement on taxpayers to elect a tax rate based on the previous year's income. To ensure compliance with these rules, Inland Revenue would undertake selected matching of the tax rates elected. If a taxpayer did not elect the correct rate based on the previous year's income, together with the thresholds discussed earlier, Inland Revenue would collect any shortfall plus use-of-money interest and penalties.

- 4.98 Taxpayers who have elected too high a tax rate on their QCIV income for the current year would be able to file a return to receive a refund. However, that would require including income derived via a QCIV in an investor's tax return, which would trigger the claw-back of any family assistance and child support and student loan obligations.
- 4.99 An additional rule would require individuals who have significant QCIV income of over \$15,000 a year to file a tax return if the tax rate they have elected (based on the previous year's total assessable income from all sources) is incorrect for the current year. That is necessary because when an individual derives a significant level of QCIV income that results in a higher marginal tax rate for the current year than the previous year, an election based on the previous year's income is clearly not the correct result. In such cases, taxpayers would be required to reconcile their tax rate on the QCIV income at the end of the year by filing a tax return. While this would result in QCIV income counting towards family assistance, child support and student loans, taxpayers would have the option of electing a higher rate at the start of a year. The thresholds discussed earlier specify a minimum tax rate that must be applied. Electing a higher rate would remove them from the application of the reconciliation rule.
- 4.100 A number of questions arise in relation to using the previous year's total assessable income from all sources as the method for electing the tax rate on QCIV income in the current year.
- 4.101 First, there is a timing question relating to when investors know their total income for the previous year. For those earning salary and wages, the necessary information should be available before 1 April. If they also have investment income such as interest or QCIV income in the previous year, notification of total income earned will take longer. This would make it difficult for investors to elect a tax rate and provide it to a QCIV at the start of an income year. In turn, not having a valid tax rate could affect a QCIV's ability to make attributions to its investors.
- 4.102 For QCIVs that choose to make a general attribution at the end of the year, with smaller attributions on investor redemption, not having a tax rate election at the start of the year should not generally be a problem. For QCIVs that choose quarterly or more frequent attributions, the first attribution may be affected. When a valid tax rate is not received by the QCIV before an attribution date, the QCIV should use the tax rate elected by the investor for the previous year. Or, if the investor is new to the QCIV, the 39% rate should be used, with a square-up on future attribution dates.
- 4.103 A second question concerns the information that must be provided to investors in relation to their QCIV income. Under the proposed final withholding tax approach, QCIVs would need to provide investors with notification of the level of QCIV income and tax deducted (after credits and losses) for an income year so that investors can elect the correct tax rate for the next income year. As the income year for individual investors is 1 April to 31 March, this information would need to be provided promptly after the

end of an income year. This means that QCIVs with non-standard balance dates would need to move to a standard income year for their withholding tax obligations. That would allow QCIVs to provide income and tax withholding details to investors for a standard income year. Under a flow-through model for QCIVs, balance dates should not be a significant issue, although submissions are welcomed on the issue.

- 4.104 Another question that arises concerns the income measure in the previous year that should apply to individual investors that have business income such as self-employed taxpayers or other non-wage and salary taxpayers. They may not have the requisite income information if, for example, the return for a previous year has not yet been filed. In this case, it may be possible to require taxpayers to base their rate elections for the current year on total assessable income from all sources from two years ago (for which the information should be available). Submissions are invited on this issue.

Non-individual investors investing in a QCIV

- 4.105 The statutory rule for non-individual investors in QCIVs would generally be the withholding rate. (Investors holding an RWT exemption certificate would qualify for withholding at the appropriate rate.) This would be irrespective of the income of the investor in the previous year. Non-individual investors would also be required to return QCIV income in their tax return at the end of a year, which would allow any losses or excess tax credits allocated to the company by the QCIV to be claimed. It would also reconcile investors' tax position in respect of QCIV income with their other business income.
- 4.106 Tax-exempt entities with a resident withholding tax exemption certificate would be able to elect a 0% withholding tax rate.

Summary of a QCIV's withholding obligations

- Step 1: Investor provides withholding rate to QCIV. If no rate is provided, a default rate of 39% will be used.
- Step 2: The QCIV calculates assessable investment income for the investor. If this is negative, the result is an investor net loss, which is carried forward by the QCIV.
- Step 3: The QCIV deducts expenses from assessable investment income for the investor. This results in investment income after expenses.
- Step 4: Investment income after expenses is reduced by the:
- (a) investor's share of the QCIV's transitional net loss carry forward, if any. This loss could have arisen only before the new tax rules for QCIVs applied and on the deemed wind-up on transition;
 - (b) investor's net loss carried forward from prior years, if any.
- The result is net investment income.
- If the investor has a net loss and is redeeming some or all of the interest in the QCIV, the investor net loss (or a portion thereof if only a partial redemption is made) flows through to the investor and may be claimed on a tax return.

Step 5:	Net investment income multiplied by the investor's selected withholding tax rate is the investor's gross tax liability.
Step 6:	<p>The investor's gross tax liability is reduced by the investor's share of available foreign tax credits. The result is the investor's adjusted tax liability.</p> <p>The investor's share of available foreign tax credits is the lesser of:</p> <ul style="list-style-type: none"> (a) the investor's share of foreign taxes paid by the QCIV (generally NRWT withheld on interest and dividends paid to the QCIV); (b) the investor's gross tax liability; or (c) the investor's share of net foreign-sourced income multiplied by their withholding tax rate. <p>As under current law, excess foreign tax credits are not carried forward or refunded.</p>
Step 7:	<p>The investor's adjusted tax liability is reduced by the investor's allocated share of imputation credits, received or carried forward by the QCIV. This results in the investor's net tax liability.</p> <p>To the extent that an investor's share of imputation credits exceeds the adjusted tax liability, they are carried forward and may reduce tax deducted on behalf of the investor in future years.</p> <p>In the year an investor redeems the interest in a QCIV, any excess imputation credits (in proportion to the share of the interest that is redeemed) may be claimed if the investor elects to file a tax return.</p>
Step 8:	<p>The investor's net tax liability is reduced by the allocated share of source RWT on interest and dividends paid to the QCIV.</p> <p>QCIVs should generally be able to get an RWT exemption certificate, so there should be minimal source RWT deducted.</p> <p>To the extent source RWT exceeds an investor's net tax liability, the QCIV may have this refunded and paid out to (or included in the account of) the investor.</p> <p>To the extent an investor's net tax liability exceeds source RWT, the QCIV must deduct and pay additional withholding tax to Inland Revenue in satisfaction of the investor's net tax liability.</p>

Non-resident investors in a QCIV

- 4.107 If an investor in a QCIV is a non-resident, the QCIV would withhold tax on any income derived via the QCIV at the rate that would have applied if the investor had invested directly. For example, if the assessable income relates to a dividend received from a New Zealand company – and the investor is resident in a country with which New Zealand has a double tax agreement – a 15% withholding rate would apply.
- 4.108 To the extent that a QCIV derives fully imputed dividend income, no tax would need to be deducted on attribution to non-resident investors. Such income would effectively be exempt. This approximates the result that would have occurred under the foreign investor tax credit rules if the non-resident investor had received the dividend directly from the New Zealand company.
- 4.109 This approach maintains the flow-through treatment in relation to non-resident investors and requires QCIVs to track different types of income for their non-resident investors and withhold tax at the applicable rate.

- 4.110 The government welcomes submissions on whether any problems arise as a result of this approach.

Flow-through when a QCIV invests in another QCIV

- 4.111 One of the key questions is how the flow-through model would operate in an environment where a QCIV invests in another QCIV that may then on-invest into another QCIV.
- 4.112 An example is a retail QCIV that invests in a wholesale QCIV, which is a common investment structure in the financial services industry. At present, the retail and wholesale QCIVs are treated as taxpayers in their own right. Under the flow-through model, the wholesale QCIV would effectively need to pass through income (in a notional sense) to the retail QCIV, which in turn would need to attribute the income to their investors. In practice, this will typically mean that on attribution date, the retail QCIV will need to know what income has been derived in the attribution period from the wholesale QCIV and withhold tax, at investors' marginal tax rates, based on that amount. This may require the retail QCIV either to realise some of its assets in the wholesale QCIV or maintain a pool of cash to fund any liability.
- 4.113 To the extent the wholesale QCIV can provide the information to the retail QCIV, the wholesale QCIV will be exempt from deducting tax on behalf of the retail fund. This is not to say that the wholesale fund will be altogether exempt from the withholding obligations. For example, if the wholesale QCIV has another retail client that is not a QCIV – for example, an individual who has a large interest – it will still be required to withhold tax. This would be similar to the resident withholding tax exemption certificate rules when there are multiple tiers of investors.

Key question: should the top withholding tax rate be capped at 33% under a flow-through model to encourage saving?

It is possible that some high-income taxpayers may view as unfavourable the prospect of being taxed at 39% on investment income derived through a QCIV, given that they may currently be taxed at a lower rate on certain investments (for example, 33% for investment in a registered superannuation scheme). To these taxpayers a flow-through model could be seen as disadvantageous. Capping the withholding tax rate applying to income derived via a QCIV at 33% (regardless of the investor's actual marginal tax rate) is a possible option to address this issue.

Such an approach would, however, effectively constitute a tax incentive to invest through a QCIV, rather than as a direct investment. This is because a direct investor would be taxed at their correct marginal tax rate while investment in a QCIV would be taxed at a maximum rate of 33%. This would retain a key distortion which the flow-through proposal is designed to remove.

Also, it is not clear that removal of the 6% differential would result in investors on the highest marginal tax rate being worse off. This is because the benefits of not having New Zealand share gains taxed, when investing via a QCIV should, in most cases, outweigh the benefit of the current tax rate differential for high income taxpayers.

Points for submission

The government welcomes submissions on any points raised in the discussion document, with specific comment welcomed on the following:

- Whether the suggested scope of the equity gains that would remain taxable under the new rules is appropriate.
- Whether legislation is required to allow QCIVs to cancel units in certain situations to allow tax to be paid.
- Whether the rules governing when a QCIV should make attributions to investors give QCIVs the appropriate choice of methods, and whether these methods would be workable.
- Whether the options proposed for defined benefit schemes are workable.
- Whether the proposed rules for carrying forward and offsetting tax losses and tax credits are appropriate.
- Whether the non-alignment of withholding tax obligations and income years for QCIVs would cause significant compliance costs.
- Whether the assessable income measure for establishing a withholding tax rate that should apply to self-employed individual taxpayers or other non-wage and salary taxpayers could be based on the assessable income from all sources from two years ago.
- Whether the flow-through model which requires QCIVs to track different types of income and apply the correct withholding rate for their non-resident investors is a workable approach.

Chapter 5

NEW TAX RULES FOR OFFSHORE PORTFOLIO INVESTMENT IN SHARES

- 5.1 The government proposes to update and modify the foreign investment fund (FIF) rules so that income attributable to investment in foreign portfolio equity is appropriately taxed. In doing so, it is important that the rules have regard to the level of tax levied on an equivalent New Zealand investment. Practical limitations and a lack of information prevent this from being done perfectly, however, so a proxy measure of the underlying income attributable to the interest must be used.
- 5.2 One objective of the reform is to align the taxation of investment in domestic assets and foreign assets. This is one of several competing objectives, however, and must be weighed against other objectives, such as ensuring that the underlying income from foreign investments in which New Zealanders invest is subject to New Zealand tax.
- 5.3 Taxpayers have raised concerns about the current FIF calculations and, in particular, that the income recognised could be highly volatile, especially when there are large fluctuations in the exchange rate. They may also have a tax liability without the cashflow (distribution of income) to satisfy the liability. A new FIF calculation method is therefore proposed, one that achieves the underlying objectives while dealing with volatility and cashflow concerns.
- 5.4 Other objectives of the reform include:
- neutralising the differences in taxation of foreign portfolio equity held directly or through a QCIV;
 - ensuring there is no tax incentive to invest offshore instead of in New Zealand; and
 - ensuring there is no tax incentive or disincentive to invest in different countries.

Practical constraints to offshore options

- 5.5 The proposals described in this chapter have been developed in light of a number of key constraints. Given that the majority of QCIVs will be taxed under a flow-through model, any calculation method for offshore income must allow QCIVs that use the flow-through model to attribute assessable income to their investors on a regular basis. The practical reality of flow-through, therefore, would rule out any option for taxing offshore income on a realisation basis. That is because it would be extremely difficult to allocate accurately, and track over time, each investor's share of unrealised assessable

gains. Also, for individuals with reasonably sized portfolios, a realisation-based system is too open to abuse and quickly becomes complicated.

- 5.6 Given this constraint, just two options appear feasible for taxing QCIVs using the flow-through model on their offshore income. The first of these would be to exempt QCIVs on their offshore equity income. As is discussed later, this option is not favoured as it is inconsistent with New Zealand's interests. The second option is to tax QCIVs on their offshore income on an accrued basis. The government proposes the latter approach.
- 5.7 It is also necessary to ensure that people who invest directly offshore are taxed in a manner that is broadly similar to the way they would be taxed if they invested via a QCIV. That is to ensure that the tax rules do not create incentives to invest offshore in one form over another. Therefore the rules proposed for individuals investing offshore are designed to be as similar as possible to the rules for QCIVs, taking into account their ability to manage investment risks.

Background

Foreign investment fund rules

- 5.8 Investment in offshore portfolio equity outside countries included in the grey list is generally subject to the FIF rules. That provides a number of income calculation options, but the method most commonly used is comparative value (CV). It generally treats as income the increase in market value of the interest, plus any dividends paid. If the market value of the interest cannot be determined, the taxpayer can use the deemed rate of return method, which calculates assessable income by multiplying the opening book value of the interest by a deemed rate of return.
- 5.9 Taxpayers who have access to sufficient information are also allowed to use the branch-equivalent method. It is a more exact calculation of a company's assessable income using New Zealand tax rules.
- 5.10 Another calculation option that is less accurate than the branch-equivalent method, but potentially more accurate than the comparative value method, is the accounting profits method. It calculates the investor's assessable income by taking the after-foreign tax accounting income of the foreign entity and apportioning it by the investor's ownership interest.
- 5.11 Taxpayers have complained about some of the practical implications of the calculation methods. In particular, under the CV method, the assessable income may be highly volatile, especially when there are large fluctuations in the exchange rate. Also, because an increase in value of the interest may result in a tax liability, even when the interest has not paid much in dividends, the taxpayer may have insufficient cashflow to fund the tax.

Grey list and foreign investment fund rules

5.12 A significant exception to application of the FIF rules is the grey list exemption. Taxpayers are not subject to the FIF rules for investments in companies resident in a grey list country: Australia, Canada, Germany, Japan, Norway, the United Kingdom and the United States. Over 70% of outbound portfolio investment goes into grey list resident entities, so the FIF rules do not apply to a significant amount of foreign investment. The assessable income of individual direct portfolio investors in foreign companies resident in grey list countries would generally equal the dividends paid to them.

Minimum threshold

5.13 A minimum threshold exemption also applies to individuals. Individuals are subject to FIF rules only if the cost of all of their FIF interests (which do not include equity in grey list resident companies) exceeds \$50,000.

Collective investment vehicles

5.14 QCIVs are subject to the FIF rules as all resident taxpayers are. That applies to the tax treatment of QCIVs and individuals investing directly in countries outside of the grey list. However, for investments made in grey list countries, QCIVs are generally taxable on their trading income, while individuals are not (unless they are dealers in shares). This results in a disincentive for investors to invest in grey list entities through a QCIV.

Economic and policy issues

Economic efficiency

5.15 The primary policy objective behind taxing income from offshore investments is economic efficiency. Ideally, investments that maximise New Zealanders' personal returns should also maximise the return to New Zealand. The return to New Zealand consists of both the return to the resident investor and the return to the New Zealand government as tax revenue. Thus investors should consider the post-foreign tax return of a foreign investment on an equivalent basis as the pre-New Zealand tax return of a domestic investment. This can be illustrated by the example in table 1 of returns from a domestic and foreign investment, assuming the foreign investment is not subject to New Zealand tax.

Table 1: Domestic and foreign investment returns

	<i>Domestic</i>	<i>Foreign</i>
Pre-all tax return	10%	12%
Foreign tax (33%)	-	(4%)
Pre-NZ tax return	10%	8%
NZ tax (33%)	(3.3%)	EXEMPT
Return to investor	6.7%	8%
Return to NZ	10%	8%

- 5.16 In the example in table 1, the investor would choose the foreign investment because it yields the higher return to the individual (8%). However, New Zealand as a whole would be better off if the investment were made domestically.
- 5.17 The example in table 2 illustrates how the incentives change if New Zealand taxes the post-foreign tax return.

Table 2: Tax on foreign investment returns

	<i>Domestic</i>	<i>Foreign</i>
Pre-all tax return	10%	12%
Foreign tax (33%)	-	(4%)
Pre-NZ tax return	10%	8%
NZ tax (33%)	(3.3%)	(2.6%)
Return to investor	6.7%	5.4%
Return to NZ	10%	8%

- 5.18 In the table 2 example, the investor would choose the domestic investment because it yields the highest return to the investor and to New Zealand.
- 5.19 Investing offshore may provide benefits for portfolio diversification to reduce the risk associated with a narrow range of investments or investing in just one economy. Some consider that this justifies favourable tax treatment for offshore investments. However, the risk diversification benefit is generally taken into account by investors when they choose their investments. It would therefore be distortionary for the government to provide further incentives for investors to choose offshore investments by providing favourable tax treatments for them.
- 5.20 In the case of domestic investments, New Zealand tax on the income earned by the company is imposed by New Zealand company tax, which is integrated with the investor's tax through the imputation system. New Zealand does not separately tax the capital gain on the increase in share values for domestic companies because tax on the company's income is satisfied by the New Zealand company tax.

- 5.21 New Zealand company tax does not apply to the income earned from investment into non-resident companies. Therefore another mechanism is necessary to ensure that New Zealand tax applies to income earned by non-resident companies in which New Zealand residents invest.
- 5.22 When implementing this framework, a key consideration is that excessive taxes on foreign portfolio equity investment could discourage individuals from migrating to New Zealand or encourage high net-wealth New Zealanders to emigrate. Therefore, particularly for individual investors, it is necessary that this factor is considered when designing tax rules for offshore investment.

The grey list and controlled foreign company rules

- 5.23 The grey list exemption is a New Zealand tax exemption on income accumulated in companies resident in seven countries. The origin of the exemption was an intention to reduce compliance costs under the controlled foreign company (CFC) rules.
- 5.24 The grey list consists of countries with fairly robust tax rules where the government is satisfied that, in most cases, companies resident there will pay a similar level of tax in that country as New Zealand companies do in New Zealand. The exemption was established for the CFC rules because they provide for an underlying foreign tax credit. It was thought that in most cases, application of the foreign tax credit would mean that little or no New Zealand tax would be imposed on CFCs resident in those countries. The grey list exemption was therefore established as a compliance-savings measure. It has also applied to FIFs to extend to them the same exemption as for CFCs.
- 5.25 The rationale for the grey list exemption, however, does not apply to FIFs, as FIFs generally do not qualify for an underlying foreign tax credit. This has resulted in a distortion when investors have an incentive to invest in FIFs in grey list countries (which are generally high-tax), even when that investment does not maximise the return to New Zealand. In other words, investors investing in grey list FIFs face the incentives illustrated in table 1, while investors in non-grey list FIFs face the incentives illustrated in table 2. This has led to an inefficient allocation of offshore investments from New Zealand's perspective.
- 5.26 Some may think it is fair or equitable to give an exemption or foreign tax credit on offshore investments since they have paid foreign tax. However, from a New Zealand perspective, foreign tax is simply another expense of the foreign company, and the expense should not be given special tax treatment, in the same way that there is no special tax treatment for other company expenses such as wages or rent. Further, the international tax environment New Zealand operates in has no expectation that a country must provide an exemption or underlying foreign tax credit for foreign portfolio investments. That is because it is simply not possible to expect portfolio investors to know the foreign tax paid on their investment.

- 5.27 The foreign tax credits granted for direct investment are made in the context of multilateral practice. Most countries give credits for underlying New Zealand tax on direct investment here, and New Zealand also gives credits for taxes on direct investments offshore. However, countries generally do not give credits for underlying New Zealand tax on portfolio investments made here. Giving credits for underlying taxes on portfolio investments may be more feasible under a bilateral arrangement where credit for New Zealand taxes is also granted by another country. That would be done only if it were clearly in New Zealand's interest.
- 5.28 Unlike a foreign tax credit, an exemption for foreign income does not maximise world wealth. Therefore the international tax environment, which generally expects countries to provide underlying foreign tax credits for offshore direct investments, does not encourage countries to exempt foreign portfolio income from taxation.

National welfare maximisation and world welfare maximisation

National welfare maximisation is the idea that policy settings should align investors' interests (the post-all tax return) with the national interest (the post-foreign tax and pre-domestic tax return). That is achieved by providing that domestic tax applies to foreign-sourced income with a deduction and not a credit for foreign taxes.

World welfare maximisation is the idea that policy settings should align investors' interests (the post-all tax return) with the world interest (the pre-all tax return), achieved by providing a credit for foreign taxes. That is the reason foreign tax credits are the norm in the international tax environment and are a standard provision in almost all tax treaties.

The two concepts are illustrated here:

Table 3: Results of deduction, credit and exemption

	<i>Domestic</i>	<i>Foreign with deduction (NWM)</i>	<i>Foreign with credit (WWM)</i>	<i>Foreign with exemption</i>
Pre-all tax return (return to world)	10%	12%	11%	9.5%
Foreign tax (20%)	-	(2.4%)	(2.2%)	(1.9%)
Pre-NZ tax return (return to NZ)	10%	9.6%	8.8%	7.6%
NZ tax (33%)	(3.3%)	(3.2%)	(1.4%)	-
Return to investor	6.7%	6.4%	7.4%	7.6%

World wealth is maximised when investors choose to make investments with the highest returns before all tax (top row). National wealth is maximised when investors choose to make investments that maximise the return before domestic taxes (after deducting foreign taxes). Investors obviously choose to maximise their post-all tax returns.

The table illustrates a combination of different policy settings with different pre-tax rates of return and how the ultimate return to investors is distorted. In this example, the investor would choose the 9.5% pre-all tax return with an exemption for foreign income, even though this would provide the lowest return to the world and to New Zealand. A foreign income exemption is neither national welfare-maximising nor world welfare-maximising.

5.29 Another major problem with the grey list is that it assumes that a level of tax is paid in the grey list country that is broadly equivalent to that paid if the entity were resident in New Zealand. This is not so for a number of offshore vehicles resident in grey list countries. Examples of this include Australian unit trusts and United Kingdom open ended investment companies. As noted in chapter 2, the proliferation of vehicles of this nature is making the grey list unsustainable.

5.30 A further problem with the grey list is determining where companies invested into actually reside. For example, New Zealand investors can purchase an interest in a company on the Australian Stock Exchange that is resident, say, in The Netherlands without knowing that the company is resident outside the grey list. This results in compliance costs and uncertainty for taxpayers.

Accommodating QCIVs that flow through income

5.31 It is necessary that the proposed grey list reforms for QCIVs should reflect how they operate in a flow-through environment. QCIVs that flow through must attribute assessable income to their investors regularly. Therefore it is highly desirable that the calculation of offshore income for QCIVs does not contain a deferred tax liability that must be provisioned for by investors. It suggests strongly that assessable income should be calculated on an accrued basis and rules out a tax based on realisation.

Parity between investing in CIVs and investing directly

5.32 A key objective of the reform to the taxation of investment is to ensure that individual investors are not disadvantaged by investing in a CIV rather than directly. An investment in a CIV has the advantage of providing small savers the benefit of diversification. However, it has had the disadvantage of being taxed on its trading income while most individual savers would not be taxed on income from selling shares.

- 5.33 At present, there is parity between the taxation of direct ownership of foreign equities and ownership through CIVs to the extent those equities are in entities resident outside the grey list. However, most foreign equities in which New Zealanders invest are resident in the grey list. For investment in grey list equities, there is a disadvantage in investing through a CIV compared with investing directly. A CIV is taxed on its trading income, while an individual saver would not be.

Proposal 1: Repeal grey list FIF exemption for portfolio investments

- 5.34 The government proposes to repeal the grey list exemption as it applies to the FIF rules for portfolio investments. The rationale for the grey list exemption as it applies to CFC rules does not apply to the FIF rules, because the FIF rules do not provide an underlying foreign tax credit (unless the branch-equivalent calculation option is selected). This option would remain under the proposed amendments.
- 5.35 The grey list exemption would remain for non-portfolio investments that own more than 10% of the entity invested into. This aligns with accepted world norms, which generally require an underlying foreign tax credit. Therefore applying the high-tax presumption of the grey list is appropriate for these investments.
- 5.36 All offshore investments held by a QCIV, regardless of the size of the holding, will be treated as a FIF and the grey list exemption will not apply. That is because the QCIV would be holding them on behalf of its investors, and the investments would be classed as portfolio from the perspective of the QCIV's investors.
- 5.37 Repealing the grey list exemption would eliminate the current distortion which favours investing in the relatively high-taxed grey list countries over investing in low-tax countries. It would also largely eliminate the tax disadvantage from investing in a grey list country through a QCIV rather than investing directly. This should improve the efficiency of New Zealanders' savings and investments.
- 5.38 An example of the deficiencies of the grey list exemption was recently discussed in an article published in *The New Zealand Herald*.⁴ According to the article, if a New Zealand investor bought shares in Dell 10 years ago, the investment would have multiplied more than 50 times. However, no New Zealand tax would have been payable because Dell has never paid a dividend and is resident in a grey list country.

⁴ Brian Gaynor, *The New Zealand Herald*, 21 May 2005, Business page 2.

Practical problems with the FIF rules

5.39 Application of the FIF rules has raised some problems in practice. The most common income calculation method used is the CV method, which has required income from a FIF interest to be calculated using the following formula:

$$(A + B) - (C + D)$$

Where:

- A is the market value of the interest at the end of the income year;
- B is the aggregate of all gains derived from holding or disposing of the interest during the income year, including any foreign withholding tax that the holder is allowed to credit;
- C is the market value of the interest at the end of the previous income year; and
- D is the total expenditure incurred by the holder during the income year in acquiring or increasing the interest.

5.40 When the variables in the formula are denominated in a foreign currency, they must be translated into New Zealand currency either using the exchange rate on the day of the transaction or valuation, or using a 12-month average exchange rate. Given the high fluctuation of the New Zealand dollar over the last few years, it has made the outcome of this calculation highly volatile.

5.41 Another problem with the CV method is that because tax is imposed on the increase in value of shares and not just on dividends, a tax liability could arise even though the interest has not paid much in dividends and there is little cashflow to pay the tax.

5.42 For FIF interests which do not have a readily ascertainable market value, the deemed rate of return method is available. Assessable income on the interest is calculated by multiplying the cost of the interest by a set rate of return. However, this calculation can be complicated in cases where the interest is acquired or disposed of during the year, as daily apportionment is required. Also, the rate of return that must be used may be higher than the actual rate of return of the interest in some cases.

Proposal 2: FIF calculation method – comparative value

5.43 As stated earlier, it is important that New Zealand investors in foreign equities face an equivalent New Zealand tax impost on the underlying income earned on this investment as they would if investing in domestic equities. It is impossible to determine this directly, so a proxy must be used. The government has considered a number of proxy measures, including a risk-free return method, and a partial comparative value. It considers the best method to be comparative value, with some modifications to alleviate cashflow and income volatility concerns for individual investors.

- 5.44 It is proposed that a comparative value approach with no modification to the income calculation will apply to QCIVs and investments by non-individual investors. This method would apply to offshore portfolio share investments that have a readily verifiable market value. The fact that the comparative value approach taxes on an accrued basis should make it relatively easy to apply for QCIVs that flow through income.
- 5.45 This method should not represent a significant increase in the tax liability for funds that currently trade actively as these vehicles are likely to turn over their offshore share investments regularly and currently pay tax on realised share profits.
- 5.46 Given that income will be taxed on an accrued basis under a comparative value method, it is appropriate to allow a deduction for accrued losses. Accrued losses would be available to be offset against any assessable income derived via the QCIV.

What level of comparative value income should be taxed?

- 5.47 Income earned and retained by a company should affect its share value, as the company would have more net assets. This makes CV a useful proxy for the underlying income. Obviously, other factors affect a company's share price, including the general trend of the sharemarket, the general trend of the industry the company is in, and investors' perceptions of future income and growth prospects for the company.
- 5.48 The effect of this measure would be to capture the "external" capital gain in the share price as income, and not just the underlying income earned by the company. In this way, the taxation of the foreign investment would differ from taxation of the domestic investment when external gains are not taxed. While this is undesirable, the government is not aware of any superior method that captures the underlying income of the company.
- 5.49 It may be possible, for example, to tax a percentage – say, 70% – of a company's change in share price as suggested in the 2003 issues paper *Taxation of non-controlled offshore investment in equity*. The underlying assumption is that 70% of a company's change in share price over a year results from an increase in retained earnings, and 30% from an increase in goodwill (the excess of a company's total share value over its net asset value). However, there is no magic number that provides the right percentage. When there may be such a percentage, it differs wildly from company to company, market to market, and from year to year. Any percentage used would be inherently arbitrary.
- 5.50 In addition, the calculation of assessable income using a percentage of the change in an asset's value is likely to give rise to tax integrity concerns. That could occur if an investment were made in a country that does not impose any tax on the investment. In such cases it would clearly be inappropriate for New Zealand to tax only a percentage of the income derived.

- 5.51 By using the total change in share value as the proxy for the underlying income, it would at least ensure that the income earned at the investor level is taxed. Using a percentage would most likely mean that the amount taxed does not equate to actual underlying income at either the company or the investor level.
- 5.52 Another possible approach would be to give some partial credit for foreign taxes as long as there is a way to measure them or have a good proxy for them. It would be a mid-way approach between world wealth maximisation and national wealth maximisation criteria.

Modified CV with volatility cap

- 5.53 QCIIVs and other commercial operations such as companies should be able to manage the risks associated with the volatility of offshore share investments, be they real or exchange-rate related. The government believes that individual investors are not as well placed to manage these risks – particularly where a large tax liability arises but the investor has no cashflow to meet the liability. For these investors, the government is proposing a modified CV with a volatility cap.
- 5.54 Under the proposed approach for taxing individuals on their offshore portfolio equity investment, before tax is calculated for the income year it would be necessary to determine the amount that is “available to tax”. The “available to tax” amount can be represented as follows:

$$(A + B) - (C + D) + E$$

Where:

- A is the market value of the pool of offshore assets at the end of the income year;
- B is the aggregate cash receipts derived in the income year (from dividends and also any receipts from the sale of any asset in the pool), including foreign tax allowed as a credit and imputation credits attached;
- C is the market value of the pool at the beginning of the income year;
- D is the aggregate of expenditure incurred on acquiring any assets during the income year; and
- E is the “available to tax” amount carried forward (from the previous year).
- 5.55 The amount that is actually taxable (the “deemed taxable” amount) would be the greater of dividends, plus realisations during the year or a deemed percentage (6%) of the total amount that is invested. The “deemed taxable” amount in a year would be capped by the amount that is “available to tax”. Where the “available to tax” amount is greater than the “deemed taxable amount”, the difference would be carried forward to the next income year (and added to the “available to tax” amount calculated for that year).

Pooling of FIF interests

- 5.56 A question arises as to whether taxpayers should be allowed to pool all FIF interests together in applying the formula, or whether a separate calculation should be required for each FIF investment.
- 5.57 Pooling should result in simpler tax compliance. One consequence of pooling, however, would be to allow a de facto rollover of gain when a taxpayer sells FIF interests by investing them into another FIF. In other words, the gain from selling the interest reflected in item B in the formula is offset by a higher item D in the formula when the taxpayer reinvests the proceeds in another FIF. That would allow the taxpayer to defer the income until proceeds from the sale of FIF interests are repatriated rather than reinvested, but could have the negative consequence of discouraging repatriations.
- 5.58 The government considers that the risks of allowing pooling are partly offset by having a higher income cap percentage. It is therefore proposed that the income cap percentage be 6%, with rollover relief so that tax is payable on the sale of offshore assets only on repatriation. The higher the income cap percentage, the lower the tax deferral amounts carrying forward will be and the less likely there would be a “lock-in” effect discouraging repatriations. The government’s willingness to accept the rollover provision is directly related to the 6% rate. Submissions on this question are welcomed.

Treatment of foreign tax credits and imputation credits

- 5.59 Under the proposed approach, foreign non-resident withholding tax (NRWT) deducted on foreign dividends would continue to be allowed as a tax credit. Foreign NRWT credits would be included in the “available to tax” amount calculation (in part B of the formula), as under the comparative value approach used at present. No credit would be allowed on underlying foreign taxes, as the proposed approach deals with portfolio investment. Imputation credits attached to dividends paid by Australian companies would be treated in a similar manner.

Treatment of losses

- 5.60 Losses would be allowed under the proposed approach. A loss would arise if the “available to tax” amount were negative. The government proposes to allow a loss up to the deemed percentage that would have been taxable (again, 6%) if a gain had been made instead. Also, when the proposed approach applies in the context of a pool of offshore assets, and a portion of the assets is realised, any negative “available to tax” amount would be available as a loss in proportion to the ratio of the realisation to the market value of the pool at the time. The full loss would be allowed when the pool is realised.
- 5.61 Example 1 outlines how the proposed method would work. For simplicity, the example assumes that an investor holds only one offshore asset.

Example 1: Readily attainable market value

Jo purchases 100 F Co shares for \$2 per share halfway through income year 1. Later in that same income year she derives a \$10 gross dividend on her interest in F Co. The F Co shares have a market value of \$3.20 per share at the end of income year 1.

Halfway through income year 2 Jo purchases 50 additional F Co shares for \$3.20 per share. Later in that same income year she derives a \$10 gross dividend on her interest in F Co. The F Co shares have a market value of \$3.40 per share at the end of income year 2.

A quarter of the way into income year 3 Jo sells her entire portfolio of F Co shares for \$3.60 per share. Jo does not purchase any other qualifying offshore equity in income year 3.

Assessable income (in NZ dollars):

Year 1

“Available to tax” calculation:

$$(\$320 + \$10) - (\$0 + \$200) = \$130$$

“Deemed assessable income” calculation:

Higher of \$10 (dividend) and \$0 (the deemed 6% tax does not apply as Jo does not hold the interest in F Co at the beginning of the income year) = \$10

“Available to tax” amount carried forward = \$130 – \$10 = \$120

Year 2

“Available to tax” calculation:

$$(\$510 + \$10) - (\$320 + \$160) + \$120 = \$160$$

“Deemed assessable income” calculation:

Higher of \$10 (dividend) or \$19.20 ($\$320 \times 6\%$) = \$19.20

Available to tax carried forward = \$160 – \$19.20 = \$140.80

Year 3

“Available to tax” calculation

$$(\$0 + \$540) - (\$510 + \$0) + \$140.80 = \$170.80$$

“Deemed assessable income” calculation:

Higher of \$170.80 (\$540 gross revenue from sale capped to “available to tax” amount) and \$30.60 ($\$510 \times 6\%$) = \$170.80

“Available to tax” amount carried forward = \$170.80 – \$170.80 = \$0

Investments without a readily attainable market value – simplified standard rate of return

5.62 It will be necessary to provide investors with a method for calculating income on offshore assets for which it is not possible or practical to obtain market values. Currently, the deemed rate of return method in the foreign investment fund rules caters for such assets, although it is very complex to apply and uses a high rate.

5.63 A simplified version of the standard rate of return method has been developed as follows.

Method

5.64 An investor would be taxable on the following two aspects:

- on accrual – the higher of 6% or any dividends derived; and
- on realisation – the difference between the asset’s cost base and the realisation value.

Accrual component

5.65 The first aspect, a simplified standard return approach, would consist of the following components:

- Cost base: the cost base would be an investor’s entry price into the investment. It would also include all subsequent additions to the interest.
- Standard return rate of 6%: this is the deemed rate of return that would apply on the cost base at the start of the year.

5.66 In the year in which the investor enters an investment (for example, part-way through the year), the investor will have no cost base in that year. The investment would become part of the cost base only in the second year. As a general rule, any additions to the investment would be rolled into the cost base only in the following year.

5.67 In the first year of an investment, an investor will have no cost base and therefore the investor’s income under a standard return will be zero. Consequently, in that first year, if the investor receives a dividend from that asset the dividend will be taxable because it would be higher than assessable income under the standard return. Similarly, in the year the investment is fully realised, any dividends received would be taxable.

5.68 In the second year, the investor’s cost base would include any acquisitions in the previous year, plus assessable income for the previous year (in dividends) less any dividends derived in that year. Rolling up assessable income on accrual (at the standard return rate or on dividends) into the cost base in the following year will preclude the need for investors to keep track of how much income has been recognised on a year-by-year basis.

5.69 That is important when considering the implications for the tax wash-up when an asset or portion of an asset is sold. The assessable income in the previous year, when rolled up into the cost base, would also proxy for “investment growth”. So, in the third year, the investor’s cost base would be the cost base in the second year, plus any acquisitions in the second year, plus assessable income recognised in the second year (proxying for “investment growth” in that previous year) and less dividends derived in the second year. This will be the formula for calculating the cost base in each subsequent year.

Wash-up

- 5.70 For investments that are realised in a year, the difference between the cost base-value of those investments and their sale price will be taxable. Because the assessable income each year is rolled up into the cost base, any tax paid in each year before realisation (for example, on the dividend or at the standard return rate) will be available to offset the tax payable on realisation.
- 5.71 If the asset is realised in the first year (the year of purchase), as there will be no cost base, the difference between the purchase price and the sale price will be taxable.
- 5.72 When only a portion of an investment is realised, the cost base will need to be updated. An investor will need first to value the portion of the cost base that the realisation represents. The methods for determining which portion of an interest has been realised include FIFO (first in first out); LIFO (last in first out); and average cost.
- 5.73 It would seem preferable to use an average cost basis for valuing realisations as it does not require investors to keep track of the cost of acquisitions. Instead, the average cost would simply be the cost base value at the start of the year, divided by the number of units of the asset held (pre-realisation). The difference between the sale value and the portion of the cost base realised would be taxable.
- 5.74 Once the portion of the cost base that the realisation represents is valued, the difference between it and the cost base at the start of the year would be the updated cost base in that year (for working out tax paid on accrual) and would also carry over to the following year.
- 5.75 This method for calculating assessable income would result in the following formulas for calculating assessable income:

Year of acquisition (Year 1)

Cost base = 0
Any dividends received taxable

Year 2

Cost base = purchases in Year 1 – distributions derived in Year 1 (for example, dividends) + assessable income in Year 1

Higher of dividends and standard return income taxable
Standard return income in Year 2 = cost base x standard return rate

Year 3

Cost base = cost base in Year 2 – distributions derived in Year 2 (for example, dividends) + assessable income in Year 2

Higher of dividends and standard return income taxable

Standard return income in Year 3 = cost base x standard return rate

Year n

Cost base = cost base in Year n-1 – distributions in Year n-1 + assessable income in Year n-1

Higher of dividends and standard return income taxable

Standard return income in Year n = cost base x standard return rate

Sale of asset (or portion of asset)

Proportion of cost base realised = no of units realised x average cost

Average cost = cost base in year of realisation/no of units held

Gain or loss on realisation (taxable) = sale value – proportion of cost base realised

Updated cost base = cost base in year of realisation – proportion of cost base realised

Assessable income on accrual: higher of dividends or standard return income (standard return income = updated cost base x standard return rate)

Cost base in year post-realisation (n+1) = Updated cost base (year n) – distributions in year n + assessable income in year n

Example 2: No readily attainable market value

- Joe buys 10,000 shares in A Co on the 25th of September, 2007. The cost of these shares is \$1.50 each. On the 29th of January, 2008 he buys 4,000 shares in A Co @ \$1.75.
- In the following year (2008-09) Joe continues to hold 14,000 shares in A Co but purchases another 2,000 shares @ \$1.77 on the 15th of October, 2008.
- In the third year (2009-10), on the 15th of March, 2010 he sells 7,000 shares in A Co @ \$1.80.
- In the fourth year (2010-11), on the 20th of September, 2010 he sells the remaining 9,000 shares @ \$2.00.
- In each year, except the last, on the 1st of February, Joe receives a dividend of \$0.05 per share.

Year 1 (2007-08)

Cost base = \$0

Assessable income is dividend of \$700 (as this is higher than standard return income of \$0)

Year 2 (2008-09)

Cost base = \$15,000 + \$7,000 (acquisitions in year 1) – \$700 (distributions in year 1) + \$700 (assessable income in year 1) = \$22,000

Assessable income is \$1,320 (the standard return of 6% on \$22,000) as this is higher than the dividend of \$700 (the actual dividend received in the current year is \$800 but \$100 of this, relating to the acquisition of 2,000 shares, has been carved out).

Year 3 (2009-10)

Cost base = \$22,000 (cost base in previous year) + \$3,540 (acquisition in previous year) – \$800 (dividend in previous year) + \$1,320 (assessable income in previous year) = \$26,060

Realisation

Assuming average cost is used, average cost of share is \$1.63 (\$26,060/16,000). The cost base for the realisation is \$11,401 (\$1.63 x 7,000).

The value of the realisation is \$12,600. The difference between the value of the realisation and the cost base for the realisation – \$1,199 – is taxable.

The updated cost base is \$26,060 – \$11,401 = \$14,659

Assessable income is \$880 (the standard return of 6% on \$14,659) as this is higher than the dividend of \$800 paid in the year.

Year 4 (2010-11)

Cost base = \$14,659 (updated cost base from previous year) – \$800 (dividend in previous year) + \$880 (assessable income in previous year but not from realisation) = \$14,739

Realisation

The cost base for realisation is \$14,739 (as the interest is realised in full). The value of the realisation is \$18,000. The difference – \$3,261 – is taxable.

No tax is payable on accrual as the interest has been fully realised.

Minimum threshold

5.76 The current FIF rules provide for a minimum threshold of \$50,000 (total cost of FIF interests) before the rules apply to individuals. Here, an investor would generally only be taxed on dividends. With the repeal of the grey list exemption, many more individuals are likely to be subject to FIF rules.

- 5.77 If the minimum threshold remains at \$50,000, moderate savers – say, those who have shares with savings of \$20,000 to \$50,000 – will be disadvantaged by investing in offshore equities through a QCIV rather than investing directly. Reducing the current minimum threshold would reduce this distortion. Keeping the threshold at a high level, however, minimises compliance costs for individuals.
- 5.78 On balance, a minimum threshold of \$50,000 for individuals would seem appropriate as it would minimise compliance costs for small investors without creating significant incentives for investors with more sizeable portfolios to invest offshore directly rather than via a New Zealand-resident managed fund. The government proposes that the \$50,000 minimum threshold should be available only for investments into companies that are listed on a recognised exchange in a country with which New Zealand has a double tax agreement. This should ensure that the vast majority of small investments into foreign companies fall below the threshold. It should also ensure that the minimum threshold cannot be used for tax minimisation rather than minimising compliance costs.
- 5.79 The government invites submissions on the appropriate level of the minimum threshold for individual investors.

Points for submission

The government welcomes submissions on any points raised in this discussion document, with specific comment welcomed on the following:

- Whether the modified comparative value with a volatility cap is a workable proposal for the taxation of individual offshore investments that can be easily valued.
- Whether the 6% income cap is an appropriate rate, given the proposals for rollover relief.
- Whether taxpayers should be allowed to pool foreign investment fund interests together in applying the modified comparative value method, or whether a separate calculation should be required for each investment.
- Whether the proposed treatment of losses in the context of the modified comparative value approach would be a workable solution.
- Whether the method proposed for taxing individuals on investments with no readily attainable market value is an appropriate and workable method.
- Whether the amount of the minimum threshold of \$50,000 for individual investors is set at an appropriate level.

Chapter 6

TRANSITIONAL AND OUTSTANDING POLICY ISSUES

- 6.1 The proposed tax rules for QCIVs and the proposed changes to the taxation of offshore portfolio investment in shares raise several issues in relation to transitioning from the current rules.
- 6.2 For CIVs, the key issues are around moving from rules that may tax domestic share gains to rules that would generally exempt those gains. For investors in offshore shares, be they individual direct investors or a CIV, the key issues are likely to be around removal of the current grey list exemption and movement to rules where tax is based on changes in value. This chapter outlines some of the key transitional issues.
- 6.3 One of the key outstanding policy issues is life insurance. When life insurance companies offer savings products that mirror those offered by other CIVs, such as widely held unit trusts and registered superannuation schemes, similar tax rules should apply to these products.
- 6.4 Nonetheless, the taxation of life insurance is a complex area. While the government agrees that life insurance, as a collective savings vehicle, should get some benefit from the reforms it must consider how such benefit would be delivered within the overall framework of the life insurance rules.
- 6.5 Submissions on how to extend the benefits to life insurance as a savings vehicle are welcomed.

Transitional issues – new tax rules for QCIVs

- 6.6 Currently, most CIVs pay tax on realised domestic share gains as a result of the current capital/revenue boundary. Similarly, revenue account losses are deductible. Under the proposed changes, these gains and losses would generally not be taxable. This creates a problem of how to deal with unrealised revenue account gains and losses under the current rules when a QCIV elects into the new rules on 1 April 2007 or later.
- 6.7 The government considers that transition rules that do not penalise investors or the QCIV, but that also do not give rise to undue windfall gains at the expense of the tax base, are desirable. Broadly, any transitional rules should treat losses and gains symmetrically.

Losses and gains arising under the current tax rules

- 6.8 At present, if a CIV treats domestic share gains on revenue account, on election into the new tax rules for QCIVs (the transition date) there is a question of whether these gains should be taxed. Similarly, if unrealised losses have been made, the issue arises whether these losses should be crystallised and able to be used to offset income under the new tax rules.
- 6.9 Two options have been considered for dealing with this transitional problem. The first would effectively retain the current tax rules for investments made before the transition date. The second would require there to be a notional “wind-up” of the entity on transition into the new rules.
- 6.10 Under the first option, any domestic share investments made by a CIV would remain subject to the current taxation of investment income rules. In other words, if they are currently treated on revenue account they would continue to be taxable on any gains on realisation and, similarly, any losses would be deductible. Investments entered into after the date of transition would instead be subject to the new taxation of investment income rules. This option would principally serve to provide certainty that the transactions entered into under a historical regime remain subject to those rules. It would effectively quarantine any tax losses to existing investments. As a result, tax losses incurred in relation to historical investments could be offset against any gains made on investments entered into before the transition to the new rules (rather than allowing the losses to be carried forward into a system where the gains are no longer taxed).
- 6.11 There are some concerns about such an option. CIVs may, for example, take the opportunity to time their transition to the new rules so that it is in their favour. In this case, a CIV could choose to enter the new tax rules when gains are expected, to avoid a tax liability arising on those gains. Conversely, there would be no such incentive for CIVs to move into the rules when tax losses were being made (to ensure that the losses can be used up before entry).
- 6.12 A more important concern is that this transition rule could result in complexity, because it would result in separate rules applying for QCIVs, depending on when an investment was made, and would require QCIVs to track different investments. Consequently, an option requiring QCIVs to track separately investments made under the current tax rules and the new tax rules (and apply different tax rules for each) is not preferred.
- 6.13 The other option considered was to require a notional “wind-up” of the CIV on entry into the new rules. This wind-up would relate to the CIV’s share investments, both onshore and offshore. Under the notional wind-up option, any unrealised share gains (or for that matter losses) would be crystallised on the date of transition. If there is a gain, and the gain is on revenue account, tax would be payable. Similarly, if a loss is made on revenue account, it would be available to be used against income arising on crystallisation of any

gains, with any excess available to be carried forward and offset against future assessable income (under the new rules).

- 6.14 Requiring a notional wind-up on transition to the new rules would also allow CIVs to time their transition so that there would be an incentive to make the transition when they are making losses. Such incentives would exist because the new rules, while coming into effect on 1 April 2007, would not compel CIVs to enter on this date. This was discussed in chapter 3 and is a practical recognition that certain CIVs may not have the systems to operate fully as a flow-through vehicle by the proposed implementation date. A notional wind-up would preclude the need for separate tax rules to apply to investments made before and after the transition. It is therefore the preferred transition approach.

No reduced tax rate on unrealised gains

- 6.15 The government considered an option that would have applied a reduced tax rate to the taxation of unrealised equity gains on transition. Such an approach may have been justifiable on the basis that, under the current rules, the investments would be taxable only on a realised basis and, therefore, a crystallisation of gains on the date of transition would provide an advantage to the government because it would receive tax revenue earlier than it otherwise would.
- 6.16 Such a reduction is not considered appropriate. Active CIVs are likely to turn over their portfolios fairly regularly, with the result that gains would be brought to tax relatively quickly under the current rules. In addition, the removal of tax on most domestic equity gains represents a major benefit for QCIVs which should more than compensate for any timing disadvantage.

How should any tax losses that enter the new rules be dealt with?

- 6.17 Under the proposed transitional rules, any tax losses arising from periods before the new QCIV rules take effect and on the notional wind-up of the entity that cannot be used to offset other taxable gains could be carried forward and offset against future income that is taxable under the new tax rules. However, these would be strictly quarantined so that they could be used only against QCIV income, since losses arising under the old entity rules should be able to offset only income arising from that entity. For that reason, and to minimise filing obligations and complexity to investors, it is proposed that the transitional losses of a QCIV be carried forward and offset against investor income arising only from that QCIV. Transitional losses should be tracked by the QCIV and taken into account in calculating investors' withholding taxes.

- 6.18 The government recognises that requiring QCIVs to track losses in individual investors' accounts would give rise to compliance costs for QCIVs. Therefore an option whereby the QCIV effectively pools losses and uses these against QCIV income (before such income is allocated to individual investors' accounts) would also be acceptable. This is effectively how losses are dealt with by QCIVs currently, and would result in losses being reflected in the QCIV's unit price.

Treatment of tax credits on notional wind-up

- 6.19 While the discussion so far has focused on tax losses arising on transition to the new tax rules for QCIVs, qualifying vehicles may also have tax credits, such as imputation credits, credits for resident withholding tax paid, foreign non-resident withholding tax and dividend withholding payments, which have yet to be distributed. The options for dealing with these credits are similar to the losses issue – refunding the credits, allowing the credits to be offset against any assessable income of the investor (not just QCIV income) or requiring them to be offset against QCIV income (with any excess to be carried forward and offset against future investment income).
- 6.20 The preferred option is for tax credits that exist on the date of transition being used to offset tax on investment income derived via a QCIV and, if excess credits are available, for them to be carried forward if they would be allowed to be carried forward under normal rules. Such a treatment would necessarily be identical to the treatment of tax losses arising on transition and would also remove the need for taxpayers to file a tax return to get the benefit of these tax credits.
- 6.21 There is, however, a problem in relation to tax credits that, if distributed to individual investors (or if derived directly by individual holders) would be refundable. Credits for resident withholding tax paid and dividend withholding payments should be refunded to the QCIV, as a taxpayer, which could then apportion credits to investors' accounts in the same way that tax credit refunds are made under current rules.

Transitional considerations – new tax rules for offshore portfolio investment in shares

- 6.22 Transitional considerations would also arise in relation to the proposed changes to the taxation of offshore portfolio investment in shares. They would arise for QCIVs and individual direct investors alike.
- 6.23 The key problem is the value at which offshore share holdings enter the new rules. Under the new rules, tax would apply to changes in the value of share holdings – a comparative value basis of taxation.

- 6.24 Under the current tax rules for offshore portfolio investments in shares, when the investment is in a grey list country and the holding is on capital account, investors would not need to respond to the change in value of the shares. That is likely to be the case for most direct holders. For active QCIVs with grey list investments, it is likely that the investments are currently on revenue account and, depending on turnover, that tax is being paid on something close to a comparative value basis.
- 6.25 For QCIVs, given that the current tax treatment is already likely to proxy a comparative value basis of taxation, existing investments should enter the new rules at their market value on 1 April 2007. It would apply for both savings vehicles that enter the new rules for QCIVs and undertake a notional wind-up on 1 April 2007, as well as those vehicles that do not elect into the new rules on this date. It would also apply to non-individual investors, such as companies and trusts with offshore holdings.
- 6.26 For individual investors currently in the grey list, it is more complicated. The issue is whether existing investments should enter the new tax rules at their market value on 1 April 2007, at cost, or at some other value, such as the median between the cost and market value on the transition date. The government considers that for individual investors, the entry value of their grey list interests should be at the higher of cost or the market value on the transition date. This may allow them to realise the benefit of an unrealised loss on interests acquired before they became subject to the new rules, as that would reflect their total economic loss on the investment up to that time. If the investor does not remember or have records of the original cost, the opening value would be the market value on the transition date.

Outstanding policy issues

- 6.27 The proposals outlined in this discussion document are aimed at delivering a reform package that is comprehensive in scope and detail. In particular, the new tax rules for QCIVs are aimed at ensuring that, for investment vehicles generally, tax does not act as a deterrent to owning a diversified portfolio of investments or drive entity form. However, the range of savings vehicles is significant.
- 6.28 While complexity has not specifically precluded consideration of other investment vehicles, and the proposals for reform put forward should be consistent with the treatment of savings via these alternate entities, it has meant that it has not been possible to consider certain detailed design issues for these other vehicles fully. In particular, this has been the case with life insurance companies that offer savings products which, in many cases, can be similar to those offered by unit trusts and superannuation schemes.

- 6.29 The taxation of life insurance is a complex area. Life insurance companies are taxed on two bases. The first, the life office base, is the profits from the life insurance business – premium income, mortality profit and investment returns. The second, the policyholder base, attempts to tax the returns to policy holders, with a credit for tax paid on the life office base. In practice, the tax rules for life insurance companies result in all investments being held on revenue account. Consequently, there are problems associated with changing the tax rules for savings vehicles such as unit trusts and superannuation schemes, while leaving investment income made via life insurance companies taxable under the current life insurance rules. The inequity in treatment is not desirable as the savings products on offer may be equivalent to that offered through a vehicle that does qualify for QCIV treatment (and should therefore be treated the same).
- 6.30 However, there has been insufficient time to consider the implications of moving life insurance companies into the new tax rules for QCIVs, as part of this reform phase. In his review, Craig Stobo noted that life insurance should be included within the scope of any reform of the investment tax rules.
- 6.31 Since the report-back from the Stobo review, the government has been working with key stakeholders to further develop the recommendations for reform put forward. The detailed nature of these discussions, and the desire to get the framework right for the majority of savings vehicles that are likely to use the new rules, has precluded looking in detail at the issue of life insurance companies. The government is, however, committed to ensuring that investments via a life insurance company will not be tax-disadvantaged compared with investments in a superannuation scheme or a unit trust under the new rules for QCIVs and will examine ways to ensure that this does not occur.

Points for submission

The government welcomes submissions on any points raised in this discussion document, with specific comment welcomed on the following:

- Whether the notional wind-up rules proposed for the treatment of historic losses and gains is the appropriate approach.
- Whether the proposal for individuals to bring assets into the new offshore rules at the higher of the asset's cost or market value is appropriate.