Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill

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

Volume 3

Technical submissions on the new tax rules for offshore portfolio investment in shares

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Technical submissions on the new tax rules for offshore portfolio investment in shares

OVERVIEW

This volume of the officials' report deals with technical submissions on the new tax rules for offshore portfolio investment in shares. The bill, as introduced, contained proposals to change the tax rules for investments of less than 10% in foreign companies. The objective of these changes was to tax portfolio investments in offshore companies more consistently, regardless of whether the investment was made through a managed fund, or made directly, and regardless of where the investment was located. It was also considered important to have offshore tax rules that did not bias investment away from New Zealand. The fundamental principle underlying tax reform is that a reasonable level of tax should be payable on New Zealanders' income, irrespective of whether the income is earned in New Zealand or offshore.

The original proposals suggested taxing offshore portfolio share investments on 85% of any gain in value, with this limited to 5% of the opening value (with any excess gain being carried forward). We were forwarded over 1,400 submissions on the bill proposals, with the vast majority opposing them on the basis that they would introduce a capital gains tax and were excessively complex.

In response to these concerns, and the suggestions in a number of submissions that a deemed rate of return be considered, the government invited the Finance and Expenditure Committee to consider a fair dividend rate method for taxing offshore portfolio share investments. This would involve taxing investors on 5% of the opening market value of shares held at the start of a year. However, individuals investing directly and via family trusts would be able to pay tax on their actual return, if this was lower than 5%, with no tax payable when returns are negative.

The fair dividend rate method was considered preferable to the bill proposals, both on the grounds of simplicity and fairness, as it would tax something approximating a reasonable dividend yield rather than targeting capital gains.

The Finance and Expenditure Committee released an interim report outlining the government's fair dividend rate proposal (attaching draft legislation) and invited comment from stakeholders representing individual investors, financial advisors, managed funds and tax and legal professionals. Many of the submissions on this new proposal stated that their first preference was for the current offshore tax rules to remain, with certain modifications such as expansion of the grey list and extension of capital account treatment for managed funds. However, submitters did acknowledge that the fair dividend rate was preferred to the proposals currently in the bill. Submissions on the fair dividend rate proposal raised two key policy issues.

The first major policy issue was the level of the fair dividend rate. Submissions were generally unsupportive of the proposed 5% fair dividend rate. They considered a lower fixed rate of between 3 and 4% should apply, as this was more representative of average offshore dividend yields.

The second major concern of submissions was that the proposal did not align the treatment of direct offshore investment and offshore investment via a New Zealand managed fund. That is, investments via a New Zealand managed fund would be taxed on a fixed 5% fair dividend rate, while direct investment would get the benefit of a lower rate (or no tax being payable) depending on actual returns. In particular, submissions were concerned that the difference in treatment could result in New Zealanders investing in offshore managed funds rather than New Zealand managed funds. Submissions saw a reduction in the 5% fair dividend rate as a means of aligning the two tax treatments.

Officials consider that a 5% fair dividend rate is appropriate as this broadly approximates the dividend yield on Australasian equities. Unlike New Zealand and Australia, which have dividend imputation systems, many other countries have tax systems which discourage dividend payment. Low dividend yields on offshore shares is one of the main reasons why reform of the offshore tax rules is necessary.

A lower fair dividend rate based on average offshore dividend yields is not appropriate as the low average offshore dividend rate is the problem and therefore should not be part of the solution.

Officials consider concerns raised that New Zealand managed funds would be put at a competitive disadvantage compared to offshore funds are significantly overstated. They do not take into account that:

- the bill removes the current major tax disadvantages that New Zealand funds face – full tax on capital gains and over-taxation of low rate investors;
- the proposals cap the tax rate on fund investors at 33%, versus 39% for direct investors;
- managed fund investors will not have their social assistance entitlements affected; and
- managed funds will now be exempt on Australasian share gains, whereas individual share traders will continue to be taxed on these gains.

It is important to keep in mind that the New Zealand managed fund industry has survived to date despite the major tax disadvantages it faces. It is, therefore, not credible to suggest that the existence of a relatively minor difference in the fair dividend rate treatment – 5% fixed for managed funds versus 5% variable for individuals investing directly – could be significant.

The submissions on the fair dividend rate proposal raised a number of technical issues, which are discussed in this report and will be taken into account in the drafting of these amendments. Submissions on the bill as introduced also raised a number of technical issues. These issues are discussed in this report, although a number of these would no longer be applicable if the recommendation to replace the market value and smoothed market value methods currently in the bill with the fair dividend rate method is accepted.

OFFSHORE PROPOSALS SHOULD NOT PROCEED

Submissions

597a – PricewaterhouseCoopers, 12a – NZ Funds, 578 – NZICA, 569 – ING, 594 – NZLS, 591 – Duncan Cotterill, 555 – Forsyth Barr, 596 – ISI, 588 – Trustees Corporation Association, 592 – Tower, 594 – NZLS, 581 – Russell McVeagh, 556 – AMP, 585 – NZ Exchange listed UK Investment Trust Companies, 560 – Institute of Financial Advisers, 565 – NZBio, 566, 936 – ABN AMRO Craigs, 568 – Corporate Taxpayers Group, 570 – Richard Entwistle, 571 – Dr Kelvin Duncan, 575 – Direct Broking, 997W – Grosvenor, 881, 1138 – Perpetual Trust Limited, 1142 – Carter Holt Harvey Employee Benefits Plan and Retirement Plan, 573 – Guinness Peat Group, 1141 – MCA NZ, 1146 – General Electric, 936 – ABN AMRO Craigs, 1221 – Ernst & Young, 965, 1226 – Deloitte, 1239W – Blackmore Virtue & Owens, 1347W – Northplan Financial Services / Swain Investment Services/ Colin Strang Financial Planning, 1382W – Equity Investment Advisers & Sharebrokers, 460 – Securities Industry Association, 468W – Platinum Asset Management, 492, 880 – First NZ Capital, 496W – Fundsource, 510 – Liontamer, 603 – Goldman Sachs JBWere, 1221 – Ernst & Young for Maunsell, 613W – Phillips Fox, 615 – Business NZ, 734 – Todd Corporation, 988 – American Chamber of Commerce in NZ, 574 – Staples Rodway, 674W – Waterfront Industry Superannuation Fund, 1131 – David Patterson (MinterEllisonRuddWatt), 657W – Sothertons, 682W – Private Trust Company, 503W – Anonymous, 478W – Anonymous, 471W – David Sissons, 467W – M.D. Macfarlane, 415W – Andrew Reid, 462W – Stuart Scott, 194W – Phillipa Williams, 70W – Howard Cedric Zingel, 87W – Howard and Glenys Baker, 882W – Lee Stevens, 926 – Associate Professor Martin Young & Professor Lawrence C. Rose, 1333P – G C Gould, 631 – R P Deeble, 559 – ABN AMRO New Zealand, 976 – William Stevens (ABN AMRO Craigs), 1148 – Frank Aldridge (ABN AMRO Craigs), 1133 – Stuart + Carlyon

The offshore tax proposals in the bill, as introduced, were not supported for a number of reasons. In particular, submissions commented that:

- The proposals are too complex and will result in significant compliance costs for qualifying funds and investors (which will result in inadvertent and deliberate non-compliance).

- A capital gains tax on unrealised gains is the harshest possible form of tax treatment and will give rise to cash-flow issues.

- The proposals encourage New Zealanders to leave and discourage new immigrants from coming to New Zealand and expatriates from returning. The proposals conflict with other policy objectives such as the recently enacted exemptions for new migrants and returning New Zealanders.

- Informed investors are aware they should have a diversified portfolio and the proposals discourage investment into non-Australasian shares and therefore provide a disincentive against having a diversified portfolio. The proposals would leave New Zealand investors dangerously over-exposed to local assets.

A number of submissions suggested alternatives to the proposals currently in the bill, including:

- Offshore portfolio equity investments should be taxed based on an expanded grey list which would include all countries that broadly meet the criteria set out in the Tax Reform Consultative Committee report and the *Taxing Income Across International Borders* discussion document. Investments in the expanded grey list should be given capital account treatment (that is, not taxed on capital gains).

- Alternatively, investments in an expanded grey list should be taxable on the higher of actual distributions or a minimum return percentage, based on average dividend yields to deal with the problem of investment in grey list roll up vehicles.

- Capital gains on equities from countries outside an expanded grey list (so-called "black list" countries) should be fully taxed. Rolled-up income from any expanded grey list vehicles and vehicles that invest into "black list" countries should also be fully taxed. The $50,000 de minimis threshold for individuals' direct holdings should be maintained for investments in "black list" countries.

- The exemptions from the proposed offshore tax rules should be expanded to include countries with high distribution rates such as the United Kingdom.

- Alternatively, the grey list should be maintained and a specific exemption included for managed funds for their trading gains on their grey list investments. This would put direct and indirect grey list investors on the same tax footing. PIEs should be exempt from tax on proceeds from the sale of shares in grey list companies, subject to specific exceptions. If this is not accepted, the capital gains tax on non-Australasian shares should be limited to 5% per annum of the opening value of the shares, so as to (at least) reduce the distortion that would disincentivise investment in non-Australasian shares.

- Any concerns with specific grey list vehicles (for example with UK Investment Trusts) should be addressed independently, with the grey list retained. The grey list, while not perfect, is far less distortionary than the current proposals in the bill.

- The requirement to pay tax on unrealised gains should be removed. If a capital gains tax has to be levied on offshore portfolio investments in shares, then it should be based on 50% of the capital gains at the time of disposal. Alternatively, gains should be taxed on a realised basis only.

- A broad "active business" exemption (such as in Australia) should be introduced. This proposal was supported by the Tax Review 2001 ("McLeod") Committee as an area warranting further investigation.

Comment

As noted in our response to the non-technical submissions in the bill (Volume 2 of the officials' report), the proposed changes to the taxation of investment income were introduced to remove a number of distortions in the current tax rules for offshore portfolio investments. These include the difference in tax treatment when investing in offshore shares directly and via a managed fund and also when the investment is made in a grey list country versus a non-grey list country. The offshore tax proposals are designed to create a more level playing field by applying broadly the same tax rules for direct investors and managed funds and for investments in the current grey list and non-grey list countries. The tax changes are also designed to ensure that investment in offshore shares is not tax-advantaged compared to investment in New Zealand companies.

The fair dividend rate method, if accepted as an alternative to the current offshore tax proposals in the bill, should achieve the above objectives while addressing the key concerns raised in relation to the bill proposals. These concerns were the complexity and perceived unfairness of the market value and smoothed market value methods in the bill.

The alternative suggestions put forward in submissions of retaining or expanding the current list of eight grey list countries and applying capital account treatment to investments in those countries (for both individual and managed fund investors) would not achieve the objective of having tax rules that do not favour offshore investment. This is because New Zealanders would still have incentives to invest in vehicles that pay little or no tax in foreign jurisdictions (there are a number of such vehicles in the current grey list) and pay little or no dividends. Increasing the number of countries that would be eligible for grey list treatment would simply exacerbate this issue.

Dealing with specific concerns in the grey list independently is not feasible, as it would be difficult for Inland Revenue to constantly monitor effective tax rates in other countries and to close down the use of tax-advantaged vehicles in these countries (e.g. by "black listing" them). The proliferation of such vehicles and efficient international tax planning would mean that such an approach would always be "two steps" behind the latest schemes. A "black list" approach generally for all countries other than those in an expanded grey list would be arbitrary, and therefore undesirable.

Officials also do not consider that an active business exemption is viable for portfolio share investments (i.e. investments of less than 10% in foreign companies) as, in order to apply such rules, investors would need to work out whether the underlying investments are "active" or not. This would be difficult for portfolio investors to comply with.

Recommendation

That the submission to tax non-Australasian shares at 5% of the investment's opening value each year be accepted. This concept has been incorporated in the proposed fair dividend rate method, which should address a number of concerns raised by submitters in relation to the complexity and perceived unfairness of the current bill proposals. The remaining submissions should be declined.

TIMING OF THE INTRODUCTION OF THE NEW RULES

Issue: General deferral of introduction of new offshore tax rules

Submissions
(591 – Duncan Cotterill, 555 – Forsyth Barr, 1142 – Carter Holt Harvey Employee Benefits Plan and Retirement Plan, 1382W – Equity Investments Advisers and Sharebrokers, 615W – Business NZ, 611 – New Zealand Assets Management Limited)

If the proposals in the bill are to proceed, implementation should be deferred for five years to allow affected investors time to adjust, for example by realising assets that would otherwise be double taxed.

Contrary to views expressed by government and officials, there is no need to have the overseas tax changes implemented by 1 April 2007 for KiwiSaver, particularly as they result in higher tax liabilities and lower diversification. The commencement date of the offshore tax rules should be deferred until 1 April 2009.

The proposed changes for the taxation of offshore portfolio investment should be postponed for at least 12 months or longer.

The government should proceed with the changes to managed funds, however it should defer the proposed rules for offshore investment until the full consequences have been debated, understood and accepted.

The Committee should consider deferring the offshore proposals so that additional work can be undertaken on the deemed rate of return approach to taxation of international investments.

Comment

The key policy objectives of the offshore tax changes is to remove the current distortions between investing directly or through a managed fund and between investing in grey list and non-grey list countries. These distortions should be removed as soon as practicable, particularly given the 2007 application date for KiwiSaver. Therefore, officials recommend that the 1 April 2007 application date for the offshore tax changes, as is currently in the bill, be retained subject to the recommendation under the next issue.

Recommendation

That the submission to defer the application of the new offshore tax rules be declined, subject to our recommendation under the next issue.

Issue: Alignment of new offshore and portfolio investment entity tax rules

Submission

(FDR 5 – PricewaterhouseCoopers, FDR 6 – AMP, FDR 8 – ISI, FDR 15 – Corporate Taxpayers Group)

Entities that will be eligible to qualify as PIEs should be able to elect that the new offshore tax rules do not apply to them until 1 October 2007, or, if the entity elects to become a PIE in its first income year starting on or after 1 April 2007, from the date the election is effective (the current offshore tax rules will continue to apply until that date). One submission on the fair dividend rate proposal suggested that the application date of the new offshore tax rules for individuals should also be delayed for 12-18 months to allow Inland Revenue to publicise the amendments and individuals to consider the impact of the changes.

Comment

The current application date in the bill provides that both the new offshore tax rules and the PIE rules will apply for income years starting on or after 1 April 2007. The Minister of Finance and the Minister of Revenue wrote to the Committee in August this year recommending that the application date for the new PIE tax rules be deferred until 1 October 2007. This deferral was connected to the deferral of the KiwiSaver scheme (the PIE tax rules will be compulsory for KiwiSaver default funds). The deferral to 1 October 2007 also gives savings vehicles more time to prepare for the implementation of the PIE tax rules.

The resulting non-alignment between the application dates for the new offshore tax rules (1 April 2007) and the PIE tax rules (1 October 2007) creates tax timing problems for some savings vehicles that intend to become PIEs from 1 October 2007. These problems can be addressed by allowing entities that will be eligible to be PIEs to elect that the new offshore tax rules will apply to them from 1 October 2007, or, if the entity elects to become a PIE in its first income year starting on or after 1 October 2007, from the date that the PIE election is effective. The current offshore tax rules would continue to apply until that date.

The proposed offshore tax rules should continue to apply from 1 April 2007 for individuals and other non-PIE investors as a 1 October 2007 application date would mean that these investors would be subject to different sets of tax rules in their 2007-08 income year. That is, the current offshore tax rules would apply for six months until 30 September 2007, with the fair dividend rate method (if implemented) applying from 1 October 2007. This would result in unnecessary complexity. We also do not support delaying the offshore tax rules for individuals until 1 April 2008, as this would be arbitrary. Individuals will have until 1 April 2007 to consider their affairs, prior to the new rules applying.

Recommendation

That the submissions that PIEs should be able to defer the application date of the new offshore tax rules until 1 October 2007 be accepted.

ALTERNATIVE FIF CALCULATION METHOD – TAXING A DEEMED RETURN

Submissions

(597 – PricewaterhouseCoopers, 581 – Russell McVeagh, 579 – Macquarie, 585 – NZX, 555 – Forsyth Barr, 556 – AMP, 585 – NZ Exchange listed UK Investment Trust Companies, 1146 – General Electric, 936 – ABN AMRO Craigs, 1347W – Northplan Financial Services / Swain Investment Services / Colin Strang Financial Planning, 460 – Securities Industry Association, 492, 880 – First NZ Capital, 496W – Fundsource, 603 – Goldman Sachs JBWere, 611 – New Zealand Assets Management Limited, 1131 – David Patterson (MinterEllisonRuddWatt), 657W – Sothertons, 559 – ABN AMRO New Zealand, 976 – William Stevens (ABN AMRO Craigs), 1148 – Frank Aldridge (ABN AMRO Craigs), 1133 – Stuart + Carlyon)

Investors should have the option of applying a modified smooth market value method which would cap tax paid on PIE income to 5% over time, with no wash-up for tax on realisation. The method should also include a "fixed return method" where income is determined as a set percentage of the average value of a portfolio in a year. The fixed return should be less than the 5% cap proposed for the smoothed market value method (around 4%).

The capital gains tax on non-Australasian shares should be limited to 5% per annum of the opening value of shares held. The 5% per annum cap should not be available for interests acquired and disposed of within a 12-month period. Rather 85% of the profit or loss on disposal of such interests should be brought to tax.

A deemed rate of return would greatly simplify the tax calculation and would remove the distortions between investment in grey list and other countries. A 3.5% deemed rate on equity investments outside Australasia, which equates to the average yield on the Australian equity market, would fit with the government's implicit assessment that the Australian market returns a "fair" dividend yield.

The risk free return method outlined in the McLeod Tax Review should be introduced. The rate should be based on the average yield of the Australian S&P 2000 index – 3.7%. A 5% tax is too high and would represent over-taxation versus investing into NZ and Australia.

An investor's income should be the lesser of 85% of the increase in value of their investment plus dividends or 5% of the opening value of their investment. Any amounts over and above this cap should not be subject to tax. Such a result would ensure that the New Zealand government in effect taxes offshore investments at a 5% rate of return, but only where there are actual unrealised gains and/or cash flow to support the taxation imposed.

A deemed dividend income approach that would tax 3% of the value of the investment as at 1 April each year should be introduced. The rate of 3% can be reasonably argued as an income tax and not a wealth tax as it roughly approximates the long run dividend yield of world equity markets, excluding New Zealand and Australia. At 5% there is the argument of a wealth tax rather than an income tax.

A deemed rate of return on all foreign investments within a range of 2-3% should be introduced. This approximates the average gross dividend yield on a globally diversified share portfolio.

A standard return rate which would equate to the New Zealand government five-year bond rate multiplied by the average capital value of offshore investments held with credits given for income received from these investments should be introduced.

An earnings per share based model could be used to assess tax on offshore portfolio investment.

Comment

Officials note that these submissions, which broadly advocate a deemed rate of return approach, have been taken into account as part of the government's decision to recommend the fair dividend rate method to the Finance and Expenditure Committee. The fair dividend rate method is based on taxing deemed income, with actual income that exceeds the deemed amount not taxed. The 5% fair dividend rate method recommended by officials is not out of line with what many of the submitters are suggesting – particularly given that individuals would not be taxed in years where they make a loss (making the effective fair dividend rate about 3.5%). The detailed design of the fair dividend rate method is outlined in the next section.

Recommendation

That the submissions to replace the market value and smoothed market value methods with a deemed rate of return method be noted.

FAIR DIVIDEND RATE METHOD

Overview

A number of submissions on the bill suggested that the market value method (which would tax 85% of offshore share gains each year) and the smoothed market value method (which would limit the tax on 85% of the gains to 5% of the opening value in a given year, with the excess carried forward) should be replaced with a deemed rate of return. The key concerns raised were the complexity of the smoothed market value method – in particular the need to carry forward gains in excess of the 5% cap – and the perceived unfairness of both methods.

In response to these concerns and the suggestions that a deemed return approach be considered, the government wrote to the Finance and Expenditure Committee suggesting a fair dividend rate method for taxing New Zealanders' offshore portfolio share investments. The Committee released an interim report attaching an issues paper on the detailed design of a fair dividend rate method, and draft legislation containing the proposal. Submissions from 20 stakeholders representing managed funds, investment advisors, individual shareholders and tax and legal professionals were sought on the new proposal. This section outlines the key issues raised in those submissions and officials' comments in respect of them.

Issue: Reaction to the fair dividend rate

Submissions
(FDR 1 – Securities Industry Association, FDR 2 – Bruce Raymond Sheppard, FDR 3- Craig Stobo, FDR 4 – NZ Assets Management, FDR 5 – PricewaterhouseCoopers, FDR 6 – AMP, FDR 7 – First NZ Capital, FDR 8 – ISI, FDR 9 – ABN AMRO, FDR 10 – NZICA, FDR 11 – Robert McLeod, FDR 12 – NZ Funds, FDR 13 – New Zealand Law Society, FDR 14 – Staples Rodway, FDR 15 – Corporate Taxpayers Group, FDR 16 – GPG, FDR 17 – Brook Asset Management, FDR 18 – Saxe-Coburg, FDR 19 – Minter Ellison Rudd Watts)

A number of submissions commented that the preferred solution would be to keep the current grey list for offshore portfolio investments. Some of the submissions reiterated earlier suggestions that the grey list should be extended and managed funds be given capital account treatment on their grey list equities. These submissions commented that specific avoidance concerns should be dealt with separately.

The submissions did, however, generally comment that the fair dividend rate proposal was preferable to the proposals currently in the bill. One submission supported the fair dividend rate method as an interim measure.

A few submissions commented that the fair dividend rate proposal should not proceed as it was a wealth tax, had a number of inadequacies which were incurable and fundamental, and would result in incentives for tax haven investing. A few submissions also objected to the fair dividend rate proposals on the basis of the compressed time-frames and lack of public consultation. These submissions were concerned that any resulting legislation would contain unintended anomalies and problems which would be difficult to fix.

Submissions were also received suggesting, on principle, that the grey list exemption should be removed. One submission on this issue suggested, however, that such a proposal should be subject to a full consultation process.

Another submission suggested that the final design of the tax rules for offshore portfolio investment should ideally be determined by the design of the tax rules for foreign direct investment (currently under review). However, if this suggestion was not accepted the fair dividend rate was supported subject to concerns around interest deductibility being addressed.

Comment

For the reasons outlined earlier we do not consider that retaining or expanding the current grey list and applying capital account treatment to investments in these countries is viable. We therefore recommend that these submissions be declined. Officials note some support for removal of the grey list exemption for offshore portfolio investments.

On the issue of the timeframes for consulting more fully on the fair dividend rate proposals, it should be noted that a number of submissions on the bill as introduced suggested that a deemed rate of return approach be considered. We also consider that the fair dividend rate proposal is similar in effect to the smoothed market value method originally proposed. The key differences are the removal of the need to carry forward gains in excess of 5% and the ability to claim losses. Therefore, it is not correct to say that the fair dividend rate proposal is a complete change in tax policy direction which requires further consultation. Furthermore, the limited consultation on the fair dividend rate proposal suggests a general acceptance that the fair dividend rate proposal is preferable to the current bill proposals and the feedback on the detailed design has suggested that the technical issues with the fair dividend rate method can be addressed.

We do not consider it desirable to delay reform of the tax rules for offshore portfolio investments to align with the outcome of the review into the controlled foreign company rules, as this would prolong the current tax distortions that favour direct offshore portfolio investment over investment via managed funds. The review of the CFC rules will take into account the proposed reform of the tax rules for portfolio investment (that is less than 10% interests) in foreign companies.

Recommendation

That the submissions recommending the grey list be maintained or extended to other countries (and investments in these countries be afforded capital account treatment) be declined. Submissions recommending deferral of the offshore portfolio tax changes should also be declined.

Issue: The appropriate fair dividend rate

Submissions

(FDR 1 – Securities Industry Association, FDR 2 – Bruce Raymond Sheppard, FDR 3- Craig Stobo, FDR 4 – NZ Assets Management, FDR 5 – PricewaterhouseCoopers, FDR 6 – AMP, FDR 7 – First NZ Capital, FDR 8 – ISI, FDR 9 – ABN AMRO, FDR 10 – NZICA, FDR 12 – NZ Funds, FDR 13 – New Zealand Law Society, FDR 15 – Corporate Taxpayers Group, FDR 17 – Brook Asset Management, FDR 18 – Saxe-Coburg, FDR 19 – Minter Ellison Rudd Watts)

Submissions commented that a 5% fair dividend rate was too high and should be lowered to between 3 and 4% (with no reduction in this rate in loss years).

A 3-3.5% rate was considered a more appropriate representation of average offshore dividend yields (although one submission suggested 2.6% as the appropriate benchmark based on MSCI World Index yields). A 4% yield was considered appropriate as this was considered the average dividend yield on Australasian equities. One submission commented that 5% was an appropriate compromise, in so far as, both individuals and managed funds received the same treatment. Submissions also commented that the fair dividend rate need not be set in stone (for example, it could be set by Order in Council).

Comment

The fair dividend rate method is aimed at taxing a reasonable dividend yield on offshore portfolio share investments. What is reasonable should be measured against the dividend payout rates by New Zealand companies, which due to dividend imputation, can be expected to pay out a large proportion of their earnings to shareholders – around 6.5% inclusive of imputation credits. The average dividend yield on Australian shares, whose tax system is the closest comparator to the New Zealand one, is also high at around 4.5% (net of Australian franking credits).

Most other countries have tax systems that discourage companies distributing dividends, with the result that income can be rolled-up in the company, and realised as a tax-free capital gain to the New Zealand shareholder. Low dividend yields from offshore shares is one of the main reasons why it is not sustainable to maintain rules that only tax actual dividends from offshore investments. Such rules create a tax distortion in favour of investing offshore rather than in New Zealand companies. Submissions that the fair dividend rate should be set at the average dividend yield on offshore equity investment in the US and UK, for example, do not address the policy concern that offshore dividend yields are generally low.

A fair dividend rate of around 5% does not seem unreasonable compared to average dividend yields of around 6.5% (gross) for New Zealand companies and around 4.5% (net) for Australian companies. A 5% fair dividend rate is also significantly lower than the historical returns on world equity investments, which have averaged around 9% over the last 20 years.

A 3-4% fair dividend rate would also put pressure on the boundary between what is a genuine offshore equity investment (and therefore subject to equity risk) and an investment in an offshore company that invests in high-yield debt (effectively generating “guaranteed returns” in excess of the fair dividend rate). If these offshore debt investments were made directly, they would be fully taxable. We therefore recommend later in this report that investments that generate so-called “guaranteed returns” – that is, investments akin to debt – should be excluded from the fair dividend rate method. However, it is worth noting that under a 5% fair dividend rate, the incentives to use roll-up offshore vehicles to access debt returns is likely to be significantly less than if the fair dividend rate were 3%. Consequently, the need for more complex anti-avoidance rules should be mitigated under a 5% fair dividend rate.

Officials also note that one submission has suggested that the interest deductibility rules should be tightened under a fair dividend rate method, as otherwise investors could borrow money to make the investment and receive a tax deduction for the full interest cost even though the full return is not being taxed under the fair dividend rate. However, investors can currently receive a full interest deduction for money borrowed to invest in grey list companies most of which are likely to pay very low or no dividends. Officials, therefore, do not propose changing the interest deductibility rules for investors.

Recommendation

That the fair dividend rate be set at 5%.

Issue: Different method for individuals and managed fund investors

Submissions
(FDR 1 – Securities Industry Association, FDR 2 – Bruce Raymond Sheppard, FDR 3 – Craig Stobo, FDR 4 – NZ Assets Management, FDR 5 – PricewaterhouseCoopers, FDR 6 – AMP, FDR 7 – First NZ Capital, FDR 8 – ISI, FDR 9 – ABN AMRO, FDR 10 – NZICA, FDR 12 – NZ Funds, FDR 13 – New Zealand Law Society, FDR 15 – Corporate Taxpayers Group, FDR 17 – Brook Asset Management, FDR 18 – Saxe-Coburg, FDR 19 – Minter Ellison Rudd Watts)

Submissions broadly suggested that the same fair dividend rate methodology should apply to individual (and family trust investors) and managed funds. These submissions did not consider that the benefits conferred by the PIE tax rules would be a sufficient offset to the tax difference for managed funds from having a fixed 5% fair dividend rate apply, even in loss years.

Some submissions suggested that “loss protection” for individuals could be accommodated by providing managed funds investing in offshore portfolio shares with a lower fixed fair dividend rate, at 3-4%, while allowing individuals and family trusts the benefit of a variable, 0-5%, fair dividend rate methodology. A variant of this was allowing a variable fair dividend rate to individuals and family trusts as a once-and-for all election. One submission suggested the variable fair dividend rate should be extended to trustees of employee share purchase schemes.

Other submissions commented that alignment of treatment between individuals investing directly and via New Zealand managed funds could best be achieved by having a lower fair dividend rate across the board – that is, a rate that applied equally to managed funds, other non-individuals, natural persons and family trusts.

Comment

As noted in response to submissions on the appropriate fair dividend rate, officials consider that the correct starting point for analysis of the fair dividend rate proposal is a 5% fair dividend rate as, in the main, this represents a reasonable dividend yield. For individuals investing in offshore portfolio shares directly and via family trusts, it was considered that taxing a 5% return in years in which offshore shares made negative returns could result in cash-flow difficulties and be perceived as inequitable. The government therefore proposed allowing individuals and family trusts to elect to be taxed on the lower of 5% of the opening market value of shares held and the actual return on those shares, under the fair dividend rate method.

Such a concession was not considered appropriate for larger investors, such as managed funds, as they would generally be in a better position to manage the volatility associated with investing in offshore equities (they currently have to manage both share market and exchange rate volatility). Furthermore, a fixed fair dividend rate for PIEs, and managed funds generally, would have a considerable simplicity benefit compared to a variable fair dividend rate. This is because, under the PIE tax rules, PIEs would generally allocate investment income to investors daily and pay tax on this income at investors' tax rates each quarter. There is also a fiscal concern with allowing managed funds a lower fixed fair dividend rate of around 3.5%. The extra fiscal cost would be around $65 million per annum.

New Zealand managed funds versus offshore managed funds

The concerns put forward by New Zealand managed funds are that allowing individuals who invest offshore directly to pay no tax when offshore equities make losses would incentivise investment in offshore managed funds (such as Australian unit trusts or United Kingdom investment trusts) to the detriment of the New Zealand managed funds industry. This is because no tax would be payable under the fair dividend rate when the value of the offshore managed fund falls (due to losses being made on the underlying equities), whereas an investment via a New Zealand managed fund holding the same offshore equities would be taxable on 5% even if losses are made. Two potential options to correct this anomaly are discussed below.

<u>Option 1: Fixed 5% fair dividend rate for investment in offshore managed funds</u>

The first option is to subject individuals and family trusts investing in offshore managed funds to a 5% fair dividend rate (without variation), to align with the tax treatment of an investment offshore via a New Zealand managed fund.

This option would ensure that offshore investment through either an offshore managed fund or a New Zealand managed funds are treated similarly for tax purposes. However, this would result in tax being payable by an individual or family trust investor on a 5% deemed return even where an investment in an offshore managed fund has fallen in value. This compares with the treatment of a direct portfolio investment in an offshore company, like Microsoft, which would receive the benefit of loss-protection.

Option 2: High dividend yield Australian unit trust investments taxed on dividends

The second option would be to include investments in Australian unit trusts in the proposed Australian FIF exemption. These unit trusts generally turn over a reasonable proportion of their investments and distribute any returns to investors (as the failure to distribute results in a significant tax penalty in Australia). The dividend yield on Australian unit trusts that turn over investments regularly should therefore be comparable to a 5% fair dividend rate, thereby removing the incentive to use Australian unit trusts as a tax-effective alternative to New Zealand managed funds. Investments in Australian unit trusts that do not turn over a higher proportion of their investments and consequently do not pay high dividends, should not be subject to the exemption.

This option would require investors to know the underlying turnover of investments held by an Australian unit trust. This option would also not address the issue of investments in other offshore managed funds, which receive tax preferences, such as United Kingdom investment trusts.

Fixed 5% fair dividend rate not a significant disadvantage for New Zealand funds

In considering whether the fair dividend rate proposals put managed funds at a tax disadvantage compared to direct portfolio investments offshore, it is important to bear in mind that managed funds have had far worse tax treatment compared to direct investment historically.

Historically, managed funds have been taxed on dividends plus realised gains while individuals have been taxed on dividends only. To quantify this, over the last 10 years or so total international share returns have been about 9% per year and dividend yields about 3% per year. This means active managed funds have been taxed at the equivalent of a 9% return rate and individuals at the equivalent of a 3% return rate, a differential of 6 percentage points. Under the fair dividend rate proposal, managed funds would be taxed at a 5% rate and individuals at an approximate 3.5% effective rate over the long term, a differential of 1.5 percentage points. Given that the tax disadvantage faced by funds is reducing so dramatically, it seems very unlikely that investors would abandon New Zealand managed funds and switch to investing through offshore managed funds directly under the fair dividend rate method.

The reduction in the tax disincentive is supported by industry commentary, which suggests that for actively managed funds, the application of a fixed 5% fair dividend rate should be a significant improvement over the current taxation treatment. Research undertaken by AON Consulting suggests that for the period 2002-2006, when global returns averaged 8.3%, managed fund investors on the 33% tax rate would have been

30 basis points better off under the fair dividend rate method compared to the current tax rules while investors on the 19.5% tax rate would have been 130 basis points better off.[1]

Officials also consider that the fair dividend rate method proposed for funds should not be viewed in isolation. The impact of the other tax proposals in the bill – that is, the PIE tax rules – as well as KiwiSaver should also be taken into account. Managed fund investors would receive a number of benefits that are not available to individual direct investors. These benefits are not immaterial and include:

- having the tax rate on investment income capped at 33% (versus 39% for direct investors);
- investment income not counting towards family assistance entitlements under *Working for Families* or affecting student loan repayment or child support payment obligations;
- investors in PIEs receiving Australasian share gains free of tax, whereas individual share traders would continue to be taxable on these gains; and
- not having employer contributions to KiwiSaver funds subject to tax.

The total value of the tax changes for managed funds in the bill (as measured in terms of the revenue cost of the PIE tax rules) is in excess of $100 million per annum. While this is not of itself an argument for treating individual direct investors and investors using New Zealand managed funds differently, given the other policy objectives, it is not obviously clear that applying a fixed 5% fair dividend rate would result in a significant tax disadvantage for investors in managed funds, compared to investing directly in offshore shares.

Recommendation

Submissions suggesting a 3-4% fixed fair dividend rate method for both managed funds and individual direct investors should be declined.

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[1] AON investment update October 2006.

Issue: The fair dividend rate method to replace the current bill proposals

Submission

(Matter raised by officials)

Subject to our comments in respect of the appropriate fair dividend rate and methodology, we recommend the following fair dividend rate methods for taxing offshore portfolio shareholdings replace the market value and smoothed market value methods in the bill:

- Individual investors and family trusts should be taxed on a maximum of 5% of the opening market value of their offshore portfolio share investments at the start of an income year. If these investors can show that their actual return is less than 5%, they would be taxed on this lower amount with no tax payable when the total return is negative.

- Non-natural persons (other than family trusts) should be taxed on 5% of the value of shares held each year. There would be no variation to this rate in years where the investor earns less than 5%.

Comment

Officials recommend that the fair dividend rate to replace the market value and smoothed market value methods in the bill should:

- tax 5% of the market value of offshore shares held at the start of an income year;

- apply only to portfolio investments in offshore shares – that is an interest of less than 10% in a foreign company – that have market values, with the current FIF rules continuing to apply to interests of 10% or more;

- work on a pooled approach, rather than on an investment-by-investment approach for assets that qualify (this pooled approach would not apply to those assets for which a different income calculation method is used);

- ignore purchases and sales of shares during a year (except where the shares are bought and sold in the same year – separate “quick sale” rules are proposed for these).

- would not tax dividends separately. (Although foreign withholding tax deducted from dividends would still be available as a foreign tax credit under section LC 1(1) and (4) of the Income Tax Act 2004.)

For individual investors and family trusts, a variation to the fair dividend rate approach outlined above should be allowed. Under this variation if investors can show that their total return on all their offshore shares, for which the fair dividend rate method is allowed to be used, is less than 5% of the opening market value they would be taxable on the actual return. If the total return for the year is negative, no tax would be payable. The total return would be calculated by reference to the following formula:

(closing market value of shares held + total sales proceeds + dividends received) – (opening market value of shares held + total value of purchases)

For New Zealand managed funds, including portfolio investment entities, and non-natural persons, other than family trusts, the variation outlined above should not apply. This would mean that tax would be payable on a fixed 5% return irrespective of how investments perform. The 5% fair dividend rate would apply to the average value of the entity's offshore portfolio share investments for the year. That is, for investment vehicles, such as unit trusts and superannuation funds, that calculate the value of their investments on a regular basis, the taxable income for each valuation period (which could range from a day to a quarter) would be calculated using the following formula:

$$5\% \times \text{market value of investments at start of period} \times \frac{\text{the number of days in the period}}{\text{number of days in the income year.}}$$

Recommendation

That the submission be accepted.

Issue: Rule for assets that are bought and sold in the same income year ("quick sales")

Submissions
(Matter raised by officials)

If the fair dividend rate method is accepted, shares that are purchased after the start of the income year and then sold before the end of the same income year should be taxed on 5% of the cost of the purchase.

(FDR 5 – PricewaterhouseCoopers, FDR 6 – AMP, FDR 8 – ISI, FDR 9 – ABN AMRO, FDR 12 – NZ Funds, FDR 13 – New Zealand Law Society, FDR 17 – Brook Asset Management, FDR 19 – Minter Ellison Rudd Watts)

Submissions suggested that the application of the fair dividend rate method should be pro-rated for the number of days the investment was held during the year. Alternatively, they suggested that the proposed rules should be modified so that they tax the lesser of 5% of the cost or the actual gains when a "quick sale" is made.

One submission suggested that the proposed “quick sale” rules should be removed altogether and a general anti-avoidance rule be drafted instead to capture those who buy and sell within a year to defeat the application of the fair dividend rate method. Two submissions commented that the “quick sale” rules as presently drafted were unworkable.

Comment

We consider that a rule is needed to tax shares that are bought and sold within the same income year – that is, shares that are purchased after 1 April and sold before the following 31 March. Shares that are bought and sold within an income year would otherwise escape tax under a fair dividend rate method as they would not be reflected in the value of shares held at the start of the year or the start of the next year.

We consider that the appropriate way to deal with shares that are bought and sold in the same income year, under a fair dividend rate method, would be to tax 5% of the average cost of offshore shares purchased during a year that are sold before the end of the year. These are described as “quick sales” in the draft legislation. The average cost is necessary as different parcels of shares may be purchased during the year at different prices. Taking the average cost of all such share parcels purchased in a year should be easier than requiring investors to track the cost of each share that is subsequently sold.

Under the proposed variation to the fair dividend rate method for individual investors and family trusts, individuals would only be taxable on 5% of the average cost of any offshore shares that are bought and sold within the year, if their portfolio as a whole has made a total return of 5% or greater. For example, if their portfolio has made a return of only 3%, the investor would only be taxed at 3% of the average cost in relation to the “quick sale”.

Managed funds that value their offshore investments daily, such as unit trusts would not need to apply this rule, as income would be calculated daily under the fair dividend rate method. However, where the valuation period is longer than a day, for example a quarter, this “quick sale” rule should apply to any shares that are bought after the start of the quarter and are sold before the end of the quarter.

Submissions have however raised valid concerns in relation to instances where an investor purchases shares (in say A Co) during a year and sells these shares before the end of the year, and then uses the proceeds to buy shares in another company (B Co) which are sold before the end of the year. Under the “quick sale” rules as currently proposed these investors would be subject to tax on 5% of the cost of each lot of A Co and B Co shares bought and sold during the year. This could be irrespective of the profit (or loss) made on these “quick sales” as investors other than individuals and family trusts would not be able to pay tax based on the actual return if this is less than 5%. Therefore, a superannuation fund that is not a daily valuer may be caught by these rules in respect of their offshore trading activities. In these instances, we consider that investors should be able to pay tax based on the lower of 5% of the cost or the actual gains made on any “quick sales”.

Rules are also required to deal with situations where an investor buys and sells shares during an income year and there is a share split between when the shares were purchased and when they were sold. This is described as a "share re-organisation" in the draft legislation. Investors would need to work out the average cost of the "equivalent interest" that is sold for the purposes of applying the fair dividend rate.

Recommendation

That the officials' submission be accepted, subject to our comments about amending the "quick sale" rules for investors (other than daily valuers) to allow them to pay tax based on the lower of 5% of the cost or the actual gains made on any "quick sales".

Issue: Offshore investments for which the fair dividend rate would not apply

Submission
(Matter raised by officials)

The fair dividend rate method should not apply to investments which have an effectively non-contingent obligation, directly or through an arrangement, to return an amount to the investor that exceeds the issue price of the investment. These investments, which are akin to debt, should be subject to the comparative value method in the foreign investment fund rules.

Further, there should be discretion for the Commissioner of Inland Revenue to issue a determination that:

- an investment that did not meet the definition outlined above, but was still substantially debt in nature, would be treated as a non-qualifying investment and therefore subject to taxation under the comparative value method; and

- an investment that did meet the definition but was not substantially debt in nature would not be treated as a non-qualifying investment and therefore remain subject to the fair dividend rate method.

Investments in foreign companies in the form of fixed-rate shares (as defined in section LF 2(3) of the Income Tax Act 2004) and non-participating redeemable shares (as defined in section CD 14(9)) should specifically not qualify for the fair dividend rate method. As a further safe-guard, investments in offshore entities whose assets comprise 80% or greater New Zealand dollar denominated financial arrangements (i.e. debt instruments) should also not qualify for the fair dividend rate method.

(FDR 6 – AMP, FDR 8 – ISI, FDR 10 – NZICA, FDR 12 – NZ Funds, FDR 15 – Corporate Taxpayers Group, FDR 19 – Minter Ellison Rudd Watts)

Submissions suggested that:

- As a matter of practicality, managed funds be allowed to elect (via notification to Inland Revenue) that a particular investment be treated as debt.

- The proposed "guaranteed return" rules were too wide and should be made more specific. Alternatively, a submission suggested that a public binding ruling should be issued on the application of this section at least two months prior to its application date for managed funds.

- Any resulting Commissioner determination should be on a prospective basis, unless the taxpayer is subject to the tax penalties rules (for example, for taking an abusive tax position) in respect of the investment that is subject to the determination.

- The proposed Commissioner determination process should allow fund managers to obtain a determination in a timely and cost effective fashion.

Comment

Officials consider that the fair dividend rate method should not apply in the case of certain offshore portfolio share investments, which effectively offer New Zealand investors "guaranteed returns" in excess of the fair dividend rate. For example, a portfolio investment in a company resident in a low-tax jurisdiction that invests in high-yield debt or other guaranteed return instruments (with rates of return greater than 5%) would be taxable on a maximum return of 5% under the fair dividend rate whereas if they had invested directly in these instruments they would be taxable on the full return. The fair dividend rate should therefore not apply to such investments.

Officials consider that the Australian "economic substance" test for determining whether an instrument is debt or equity, would be useful in determining investments for which the fair dividend rate method should not apply. That is, an investment which has an effectively non-contingent obligation, directly or through an arrangement, to return an amount to the investor that exceeds the issue price of the investment should not be subject to the fair dividend rate, as such an investment would in essence be debt. Contingencies that are immaterially remote would be ignored for the purposes of this rule (guidelines issued by the Australian Tax Office should provide guidance on understanding what an "immaterially remote contingency" is). Investments that are carved out of the fair dividend rate method should be subject to the comparative value method under the foreign investment fund rules.

Officials also consider that the Commissioner of Inland Revenue should be able to issue a determination:

- that an investment that did not meet the definition of "debt" outlined above, but was still substantially debt in nature, would be treated as a non-qualifying investment and therefore subject to taxation under the comparative value method; and

- that an investment that met the definition but was not substantially "debt" in nature would not be treated as a non-qualifying investment and therefore remain subject to the fair dividend rate method.

This determination process should provide sufficient flexibility to deal with cases close to the boundary.

We do not consider that the Commissioner determination process should apply in the case of investments in foreign companies in the form of fixed-rate shares (as defined in section LF 2(3) of the Income Tax Act 2004) and non-participating redeemable shares (as defined in section CD 14(9)). These investments, which offer "guaranteed return", should automatically be subject to the comparative value method.

As a further safe-guard, investments in offshore entities whose assets comprise 80% or greater New Zealand dollar denominated financial arrangements (i.e. debt instruments) should also not qualify for the fair dividend rate method. This is necessary, as the rules proposed above may not be effective in instances where the investment is in a foreign bond fund that invests back into New Zealand government debt. This is because the obligation to provide a return in excess of the issue price would apply in respect of the foreign fund holding the NZ debt, not between the NZ investor and the fund. We consider the scope of such a rule could be limited to offshore entities holding New Zealand dollar-denominated debt, given the exchange rate volatility (and therefore risk) associated with debt instruments denoted in other currencies. Also, foreign debt is generally unlikely to yield a risk-free return that is higher than 5%.

In relation to the points raised in submissions, we consider that managed funds should apply the objective rules proposed earlier when determining whether an offshore investment should be subject to the fair dividend rate method or the comparative value method (rather than simply electing that an investment is in substance debt). On the issue of the proposed so-called "guaranteed return" rules being more targeted, officials have attempted to draw a reasonable debt/equity distinction (based on what is used by the Australia tax system) with a Commissioner determination to deal with issues close to the boundary. Objective tests of this kind are inherently difficult, but are needed as otherwise there would be significant scope for abuse of the fair dividend rate method. We do, however, agree with submissions that any determinations should be on a prospective basis, unless the taxpayer is subject to the tax penalties rules (for example, for taking an abusive tax position) in respect of the investment that is subject to the determination. We are also currently working through the practical issues with the Commissioner determination process. Inland Revenue will endeavour to ensure that this process operates effectively.

Recommendation

That the officials' submission and the submission that any Commissioner determinations be on a prospective basis, unless the taxpayer is subject to the tax penalties rules (for example, for taking an abusive tax position) in respect of the investment that is subject to the determination, be accepted. Other submissions should be declined.

Issue: Interests greater than 10%

Submissions
(FDR 5 – PricewaterhouseCoopers, FDR 6 – AMP, FDR 8 – ISI, FDR 10 – NZICA, FDR 11 – Robert McLeod, FDR 12 – NZ Funds, FDR 15 – Corporate Taxpayers Group, FDR 17 – Brook Asset Management)

Submissions suggested that the fair dividend rate method should be able to be applied in respect of 10% or greater interests in foreign investment vehicles that are held by managed funds. Another submission commented that the fair dividend rate should be able to be used in respect of interests greater than 10% if the New Zealand investor is not able to control or influence the distribution policies of a foreign entity.

A submission also commented that the fair dividend rate method should be available for interests of greater than 10% in non-grey list countries.

Comment

As noted earlier, the new offshore tax rules would generally apply only to portfolio investments (that is, interests of less than 10%) in foreign companies. However, managed funds and PIEs would be subject to the proposed offshore tax rules in respect of all their non-controlling offshore share investments (which due to the widely-held nature of these funds can be viewed, as in substance, being portfolio investment). The current bill proposals would have applied the market value method for interests greater than 10% in offshore companies held by PIEs and other managed funds that were not CFCs.

PIEs, any entity eligible to become a PIE (such as a superannuation fund that does not elect), or a life insurance company holding a 10% or greater interest in a foreign investment vehicle, as defined for the purposes of the PIE rules, should be allowed to apply the fair dividend rate method in respect of these investments. This should largely address the concerns raised in submissions. The proposed definition of foreign investment vehicle (which is similar in nature to that of a PIE) should mean that there is sufficient independence of control.

In the case of individuals and non-PIE investors, the current tax rules would continue to apply to interests of 10% and greater in foreign companies. This would include the grey list exemption and the existing FIF rules. The appropriate tax treatment of non-controlled offshore investments of 10% or greater is relevant to the current review of the CFC rules. Officials therefore do not recommend any changes in this area as part of this reform.

Recommendation

PIEs, any entity eligible to become a PIE (such as a superannuation fund that does not elect), or a life insurance company holding a 10% or greater interest in a foreign investment vehicle, as defined for the purposes of the PIE rules, should be allowed to apply the fair dividend rate method in respect of these investments. The other submissions should be declined.

Issue: Treatment of portfolio investments for which market values are not available – new cost-based method

Submission
(Matter raised by officials)

A cost-based method should be available for offshore portfolio investments for which it is not possible or practical to obtain market values (that is, investments for which the fair dividend rate method is not practical). This method, which would replace the cost method currently in the bill, would tax 5% of the cost of a person's investments, with the cost base increased by 5% each year to proxy for an increase in the value of the investment.

(FDR 2 – Bruce Raymond Sheppard, FDR 5 – PricewaterhouseCoopers, FDR 9 – ABN AMRO, FDR 10 – NZICA, FDR 15 – Corporate Taxpayers Group, FDR 19 – Minter Ellison Rudd Watts)

Submissions commented that:

- The proposed rules should not apply in respect of investments in private companies or shares acquired through employee share purchase schemes.
- A "wash-up" should be allowed under the proposed cost method, if an investor elects to do one.
- Where shares are not listed on a recognised exchange, investors should have the ability to use an independent valuation as the initial cost base for the investment.
- Taxpayers should be allowed to use the cost method in respect of any of their offshore portfolio investments, not just those subject to the FIF rules.
- The cost method should be permitted where the shares are in a company that is not listed on a recognised exchange.

Comment

The bill currently contains an income calculation method for offshore portfolio investments for which it is not possible or practical to obtain a market value. Under the bill proposal, these investments would be taxed on 5% of the cost, each year, with this base increased by 5% per annum. When the investment is sold, there would be a wash-up calculation to ensure any gains not already taxed or any losses that have not been deducted are brought to account.

The fair dividend rate method does not contain a wash-up calculation. Consequently, a variation of the fair dividend rate method is needed for investments which do not have market values. These investments would include interests in unlisted foreign companies as well as non-exempt interests in foreign superannuation schemes and foreign life insurance policies, for which the fair dividend rate method is not practical.

A cost-based version of the fair dividend rate is proposed with the following features:

- It would tax 5% of the cost of the portfolio investment each year plus an up-lift of 5% to account for investment growth.

- No tax would be payable in the year in which the investment is made (as there would be no cost base at the start of the year).

- The cost base for each subsequent year (denoted as the "opening value" in the draft legislation) would be adjusted by any sales and purchases in the previous year and increased by the FIF income for the previous year (5% of the "opening value" in the previous year), to account for investment growth.

- Any dividends derived would not be taxed separately and would not be subtracted from the opening value in the next year. This is because 5% deemed growth is likely, on average, to underestimate the actual increase in the value of the investment.

- The rules for shares bought and sold within the same income year ("quick sales") would apply to portfolio investments for which this new cost method is used.

Submissions have suggested that a wash-up calculation is desirable to allow investors who have made a gain of less than 5% (or potentially a loss) to square-up. Having a wash-up provision, as per the cost-based proposal currently in the bill, would add considerable complexity and in years where the investment has increased by more than 5% would amount to a capital gains tax. Officials therefore do not recommend that a wash-up provision be added to the proposed cost method. As noted earlier, 5% growth each year is likely to underestimate the performance of such investments (given historical equity returns of around 9%); consequently, the lack of a wash-up mechanism should not give rise to significant issues.

However, we consider that investors should have the ability to re-value their interests in companies subject to the cost-method (for example, through an independent valuation) and adjust their opening value accordingly. This should allow investors to lower their cost base if the capital value of their investment has decreased.

We do not consider that portfolio investments in private offshore companies (which are likely to be subject to the proposed cost method) or shares acquired through employment should be exempt from the new rules. This would provide a tax preference to certain offshore investments and not others.

We agree with the submission that investors should have the ability to use an independent valuation as the initial cost base if there is no available market value for the investment (e.g. the company is not listed). This would be a one-off valuation requirement to allow these investments to access the proposed cost-method.

The cost method should not be allowed as a general option under the new offshore tax rules for portfolio investments. This method is intended as a back-up, if use of the fair dividend rate method is not practical due to the absence of market values. Allowing use of the cost method in situations where market values are available does not make sense, as the fair dividend rate would be the more accurate method. We consider that the cost method would be permitted where the shares are in a company that is not listed on a recognised exchange and a market value is therefore not available.

Recommendation

That the officials' submission be accepted. Investors should also have the ability to use an independent valuation as the initial cost base if it is not practical to obtain a market value for the investment (for example, the company is not listed) with a further ability to update their opening value through independent valuations.

Issue: NZD$50,000 de minimis exemption from new offshore tax rules

Submission
(Matter raised by officials)

We recommend that the NZD$50,000 threshold for application of the new offshore tax rules to individual investors should remain if the recommendation to replace the current bill proposals with the fair dividend rate method is accepted. Investments below the NZD$50,000 threshold would continue to be taxed as at present.

(FDR 3 – Craig Stobo, FDR 4 – NZ Assets Management, FDR 5 – PricewaterhouseCoopers, FDR 6 – AMP, FDR 10 – NZICA, FDR 12 – NZ Funds, FDR 13 – New Zealand Law Society, FDR 15 – Corporate Taxpayers Group, FDR 17 – Brook Asset Management, FDR 18 – Saxe-Coburg)

A number of submitters recommended removing the NZD$50,000 de minimis threshold if a low fixed fair dividend rate method was implemented. Some suggested that the de minimis threshold could be made elective, with taxpayers able to waive the de minimis on a once-and-for-all basis.

One submission, that did not support the fair dividend rate proposal, recommended that the NZD$50,000 de minimis threshold should be raised to $100,000 and be extended to family trusts that met certain criteria.

Comment

The NZD$50,000 threshold for individual direct investments in offshore companies (outside Australia and New Zealand) was designed to limit the application of more complex tax rules to individuals with moderate to large offshore share portfolios. The threshold represents a trade-off between accuracy and simplicity for individual investors with small amounts invested offshore and recognises that any additional accuracy gained from imposing more complex tax rules is likely to be more than offset by the compliance costs involved. Under the exemption, individuals would generally pay tax on dividends only, if the total cost of their offshore investments is NZD$50,000 or less.

The fair dividend rate method would be significantly simpler for individuals to apply than the current bill proposals. Therefore, there is an argument to remove the NZD$50,000 de minimis threshold on simplicity grounds. Removing the threshold would also better align the tax treatment of direct investment in offshore portfolio shares with the treatment of investors that invest offshore using managed funds (who currently do not receive the benefit of the NZD$50,000 exemption). A number of submissions on the fair dividend rate proposal have advocated removing the de minimis exemption on these grounds.

On balance, however, officials consider that the NZD$50,000 threshold should be retained as dividend-only taxation, under the exemption, may be simpler for smaller investors to understand and the tax difference is not likely to be significant (given the size of the portfolios involved). We also do not agree with submissions that taxpayers should have the ability to waive the de minimis exemption on a once-and-for-all basis. While there is some justification for such an approach, it would add further complexity to the offshore tax rules.

The submissions that the de minimis threshold be raised and apply to offshore portfolio share investments held through family trusts have been considered later in this report.

Recommendation

That the officials' submission be accepted. The other submissions should be declined.

Issue: Exemption for investments in Australian-resident listed companies

Submission

(Matter raised by officials)

We recommend that the proposed exemption for investments in Australian resident listed companies be retained if the recommendation to replace the current bill proposals with the fair dividend rate method is accepted. Investments in these companies by individuals and non-PIE entity investors would continue to be taxable as at present. Investment in Australian-resident listed companies by PIEs would be taxable only on dividends.

(FDR 3 – Craig Stobo, FDR 4 – NZ Assets Management, FDR 7 – First NZ Capital, FDR 10 – NZICA, FDR 12 – NZ Funds, FDR 15 – Corporate Taxpayers Group, FDR 18 – Saxe-Coburg)

Submissions were generally of the view that the proposed exemption for investments in Australian-resident listed companies should also be removed (or at the least be made elective). Some submissions commented that if the Australian exemption was retained, it should also encompass interests in listed Australian unit trusts and shares in unlisted widely held Australian companies acquired through employee share purchase schemes.

Comment

The bill currently contains an exemption from the new offshore tax rules for investments in companies that are Australian tax-resident and are listed on the Australian Stock Exchange. The rationale for this exemption is that the franking credit rules in the Australian tax system (like the New Zealand imputation model) create incentives for Australian companies to pay out a significant portion of their earnings as dividends. As a result, dividend yields from New Zealand and Australian companies are significantly higher (at around 4.5% net of tax credits) than dividend yields from companies resident in other countries, such as the United States, where average dividend yields are around 2%. Therefore, taxing primarily dividends from investments in Australian companies was considered a reasonable approach given the relative simplicity of such a regime. For PIEs, it was proposed that realised share gains on qualifying Australian investments should not be taxed, to align with the general tax treatment of direct investors.

As noted earlier, the fair dividend rate method would be much simpler to apply than the offshore tax proposals currently in the bill. If applied to Australian-resident listed companies, it would tax individuals and family trusts on a 5% return in most years. This should be broadly similar to the tax these investors would pay on a dividend-only taxation basis. Given this, there is an argument for retaining the exemption as most direct investors would be more familiar with dividend taxation compared to the fair dividend rate method. At a lower flat fair dividend rate (of around 3%), investors would generally be better off under a fair dividend rate method than dividend taxation, due to Australian dividend yields being, on average, around 4.5%. Support for removal of the Australian exemption is largely conditional on a lower than 5% fair dividend rate applying. Officials have recommended that the fair dividend rate be set at 5%.

Removal of the Australian exemption would eliminate the boundary between investments in Australian-resident listed companies and non-listed equity investments, such as Australian unit trusts. Under the proposals in the bill, Australian unit trusts would not be subject to the proposed exemption because they could be used to derive income in the form of unrealised capital gains that are not taxable in either New Zealand or Australia. This rationale is still valid and, therefore, officials do not consider that Australian unit trusts should generally be part of the Australian exemption. However, later in this report we recommend that investments in certain Australian unit trusts that turn over a high proportion of their investments and have a New Zealand proxy that withholds tax on behalf of investors be able to access the Australian exemption. The issue of shares acquired through employee shares schemes is discussed later in this report.

The key reason for retaining the exemption for Australian-resident listed companies, is that moving from a regime that explicitly taxes Australian dividends to a regime that approximates a reasonable dividend yield (under the fair dividend rate) could raise issues in relation to trans-Tasman recognition of imputation credits. The proposed Australian exemption would, to the extent it applies generally, preserve the status-quo, which is important as officials have not had time to consult with the Australian Treasury on trans-Tasman credit recognition issues. We therefore do not support removing this exemption or making it elective.

Recommendation

That the officials' submission be accepted. The other submissions should be declined.

Issue: Exemption for investments in certain grey list companies

Submission
(Matter raised by officials)

If the recommendation to replace the current bill proposals with the fair dividend rate method is accepted, the proposed temporary exemption (outlined in Supplementary Order Paper No. 44) for investments in certain companies, like GPG, should be retained, as the policy rationale for such an exemption has not changed. Investors in a company like GPG would be taxed under current rules. If this exemption is retained:

- Institutional investors (PIEs and other managed funds) should be taxed on their GPG investments under the fair dividend rate method, as otherwise tax would be payable on realised share gains.
- A two-year exemption from the offshore tax rules should be allowed for investments in the New Zealand Investment Trust (a UK based investment trust that invests predominantly in New Zealand and Australian companies).

(FDR 3 – Craig Stobo, FDR 4 – NZ Assets Management, FDR 6 – AMP, FDR 10 – NZICA, FDR 12 – NZ Funds, FDR 16 – GPG)

Submissions were generally of the view that this exemption should also be removed under the fair dividend rate method. One submission recommended that the exemption remain and be amended so that all shareholders of GPG (particularly institutional investors) were treated as if they held shares in a New Zealand company for the duration of the exemption.

Comment

Under this temporary exemption, investments in companies that meet certain criteria would continue to be taxable under current tax rules for a period of five years. To qualify, the investment must be in a company that is resident in a grey list country, is liable to tax in that country, is listed on a recognised stock exchange and the majority of its shareholders in both number and by proportion of shares held are New Zealanders. Officials are not aware of investments in any foreign companies, other than GPG (a UK-resident company), which will meet this criteria.

The rationale for the temporary exemption was to allow time for completion of the government's review of the controlled foreign company tax rules. Pending the outcome of this review, which will include consideration of whether the controlled foreign company rules should exempt income from active investment (e.g. investment in factories) while continuing to tax income from passive investment (e.g. investment in securities), GPG may consider relocating to New Zealand. If this were the case, the new offshore tax rules for portfolio investments would not apply to investments in GPG. The outcome of this review would be important for GPG in its consideration of whether or not to relocate, as its primary investment would likely be an active investment in a controlled foreign company.

On the one hand the fair dividend rate method would be relatively simple for investors to apply on their shares in GPG and would result in a more reasonable level of New Zealand tax being payable on investments in GPG. However, the rationale for this exemption – to allow time for GPG to make a decision regarding relocation to New Zealand pending completion of the CFC review – has not changed since the proposal was announced by Ministers earlier this year. Therefore, notwithstanding the submissions on this issue we recommend that the exemption be retained, if the fair dividend rate method is accepted as a replacement for the offshore tax proposals currently in the bill.

If this exemption is retained, we consider that institutional investors (that is, PIEs and other managed funds) should be taxed on their GPG investments using the fair dividend rate method. Under the current offshore tax rules, institutional investors would generally hold these investments on revenue account, and would be taxable on any gains that are realised. In many cases, the fair dividend rate method would result in a lower tax liability for such investors. A fair dividend rate method would also be easier for managed funds to apply under the PIE tax rules. We do not consider that institutional investors should be exempt on their GPG holdings for reasons discussed later in this report.

We also consider that a temporary exemption would be justified for investments in New Zealand Investment Trust (NZIT), a UK-based investment trust, which has the majority of its assets invested in New Zealand and Australian-resident companies. Officials consider that this particular investment trust would benefit from relocating to New Zealand and becoming a PIE. Under the PIE tax rules, NZIT would benefit from not having their capital gains from trading Australasian shares taxed (a benefit that is currently procured through the UK tax rules) but would also be eligible to pass through the imputation credits attached to NZ dividends to investors (this is currently not allowed as NZIT is a UK entity).

Therefore, if the temporary exemption for investments in GPG was retained an exemption of two years for investments in the NZIT, to allow time for it to relocate and become a PIE, would be justified. A two-year exemption would not give NZIT a competitive advantage over New Zealand PIEs as NZ PIEs would also not be taxable on realised gains from Australasian equities. The detail of how such an exemption should be drafted is discussed later in this report.

Recommendation

That the officials' submission be accepted. The other submissions should be declined.

Issue: Exemption for investments in New Zealand start-up companies (venture capital)

Submissions
(Matter raised by officials)

An exemption for investments in New Zealand start-up companies that migrate offshore to gain access to finance should be included in the new offshore rules, even if the recommendation to replace the current bill proposals with the fair dividend rate method is accepted.

(FDR 5 – PricewaterhouseCoopers)

The exemption for New Zealand venture capital-type investments should remain under the fair dividend rate method.

Comment

This exemption would carve out from the proposed offshore tax rules investments in New Zealand start-up companies that migrate offshore to gain access to finance (venture capital or private equity investment). As a result of offshore capital raising, New Zealand investors typically end up holding portfolio interests in the migrated company.

Officials consider that applying comprehensive tax rules to such investments may result in a large tax liability arising when there is no underlying income stream, as start-ups will typically be making losses even though their share value, in anticipation of future earnings, is increasing. Therefore, even the application of the fair dividend rate (which would tax a maximum of 5% of the value of the investment) could result in cash-flow issues for investors in such companies.

Importantly, the new tax rules for offshore portfolio share investments are designed to create a level playing field between investing directly and via a managed fund. As direct investment in start-up companies does not compete with investment via managed funds, venture capital investment is not the target of the proposed tax rules.

For the reasons outlined above, officials consider that an exemption to cater for this situation should be included in the offshore tax rules. The criteria for application of this exemption is discussed later in this report.

Recommendation

That the submissions be accepted.

Issue: Availability of other FIF calculation methods

Submission
(Matter raised by officials)

In addition to the proposed fair dividend rate and cost-based methods, investors with portfolio investments should be able to use the branch equivalent and accounting profits methods.

The default FIF calculation method for offshore portfolio investments should be the fair dividend rate method, with the cost method available if use of the fair dividend rate method is not practical due to the unavailability of market values.

The comparative value method should apply for interests for which the fair dividend rate method is not allowed to be used, with the deemed rate of return method available for these interests if use of the comparative value method is not practical (due to unavailability of market values).

Comment

The current bill allows investors the option of continuing to apply the branch equivalent and accounting profits methods (under the current FIF rules). This should continue if the fair dividend rate method is accepted as an alternative to the market value and smoothed market value methods currently in the bill.

We consider that the default FIF calculation method for offshore portfolio investments should be the fair dividend rate method. The default method would apply if a person fails to elect a FIF calculation method. It is needed to ensure that the Commissioner of Inland Revenue has a basis for assessing an investor's income if no tax return is filed. In cases where market values for offshore portfolio investments are unavailable, the proposed cost-based variant of the fair dividend rate method should apply.

We also consider that the comparative value and deemed rate of return methods (also under the current FIF rules) should apply for portfolio investments for which the fair dividend rate method is not allowed to be used. As noted in a matter raised by officials, there would be certain offshore portfolio investments for which the fair dividend rate would not be applicable (for example, where so-called "guaranteed returns" are made). While the comparative value method would need to be used in these circumstances, the deemed rate of return, which is currently used for FIF interests which do not have market values should also be available if use of the comparative value method is not practical. The comparative value and deemed rate of return methods should not, however, be generally available – that is, they should only be applicable for offshore portfolio investments for which the fair dividend rate and cost-based methods are not allowed to be used.

Recommendation

That the submissions be accepted.

Issue: Other technical issues raised in submissions on the fair dividend rate method

Submission
(FDR 8 – ISI, FDR 10 – NZICA, FDR 12 – NZ Funds, FDR 15 – Corporate Taxpayers Group)

A number of technical submissions were made in relation to the fair dividend rate method. These include:

1. Section EX 38 needs modification to include the fair dividend rate and cost methods and to drop the market value and smoothed market value methods.

2. Sections EX 40(4) and EX 44 need reinstatement.

3. Section EX 44C needs to be removed from the bill.

4. Section EX 44(7) could be redrafted more simply.

5. Section EX 44B(1)(b) – add "whether or not vested" after "assigns each investor an interest".

6. Section EX 44B(4) – replace "FIF loss" with "any FIF loss".

7. Section EX 44B(15)(a) – given the frequency of seven-day pricing and monthly pricing, seven days or monthly should be substituted in the quick sales formula to accommodate normal practice. If the submission is not accepted, there will be the need to discuss precisely what information can be sourced from offshore managers where daily pricing is not used.

8. Section EX 44B(16) – average weighted cost should be used instead of average cost in the quick sale rules.

9. The suggestion that LIFO be used to determine quick sales is inconsistent with the software used by most managed funds, which is based on FIFO.

10. Section EX 45B(7) – references in sub-paragraphs (a)-(c) should be to "FIF income in the preceding year".

11. The comparative value method in the bill should be the market value method in section EX 44B.

12. Section EX 40(5)(a) – the fair dividend rate method should be an option for interests of 10% or greater in widely held foreign investment vehicles, even for those that would otherwise constitute controlled foreign companies (CFCs). If CFC investments cannot be reported using the fair dividend rate method, then the comparative value method should remain the default.

13. Section EX 44(6) – the fair dividend rate method should apply in respect of 10% or greater interests in foreign companies held by PIEs. Interests of less than 10% that are subject to comparative value (i.e. debt) should be able to claim losses.

14. The NZ IFRS requirements for distinguishing between debt and equity could be used an as alternative for the Australian economic substance test.

15. Determination under section EX 40(5)(b)(iii), (iv) should be for borderline products only. Determinations should be issued by the Financial Sector Corporates Desk with a benchmark turnaround time of 30 days at no charge (if a charge is deemed necessary it should be a fixed fee).

16. For Australian unit trusts investing in debt, the RWT proxy mechanism should be retained with application of the comparative value method under the proxy for those who hold interests of greater than NZD$50,000 in these vehicles.

17. If the submission that a flat 3.5% fair dividend rate without variation is not accepted, then managed funds (especially PIEs) should be permitted to switch to comparative value from the fair dividend rate method.

18. Section EX 51 should be amended to accommodate swapping from the fair dividend rate method to the cost method or comparative value method.

19. The foreign dividend withholding payment rules should not apply under the fair dividend rate method as it is not a dividend.

20. Where investors use the fair dividend rate or cost methods, the market value should be the opening value. If comparative value was being used, the higher of cost or market value would be appropriate.

21. It would be desirable to confirm that investment expenses incurred in deriving fair dividend rare income are deductible.

22. The rules should allow people to move between the cost and other methods when circumstances dictate.

23. The cost of gifted or inherited shares and shares acquired through an employee share purchase plan should be clarified.

24. The rule in section EX 40(5) should be drafted as a stand-alone provision

25. Losses in respect of FIF interests correctly determined under the comparative value method should be offset against taxpayers' other assessable income.

26. The legislative approach needs to clearly reflect the policy as to whether the fair dividend rate method is a true pooling regime.

27. There should be no difference in outcome between grey list and non-grey list equities (under section EX 40(5) and EX 40(9))

28. The ability to use the fair dividend rate method should be available if the FIF interest is held through a CFC.

29. Section EX 44(6C) should apply only to an investment that has been subject to the fair dividend rate method. The variable component of the fair dividend rate method should be drafted as part of the standard method.

30. Sections EX 40(5) and (6) should be redrafted to reduce the complexity caused by having multiple provisions considered "in the absence of" various other provisions.

31. "Market value" should be defined for the purposes of the fair dividend rate method as including fair value under the New Zealand international financial reporting standards.

32. Managed funds should have the option of using a fair dividend rate formula that minimises the effect of compounding which arises under the proposed daily calculation for funds that unit price daily.

33. Where an interest in a foreign company falls below 10% during a year, no fair dividend rate income should arise in the year (or alternatively a more accurate income calculation method should be made available).

Comment

Officials will take the various technical submissions outlined above into account in drafting the fair dividend rate legislation.

Recommendation

It should be noted that officials will take into account the technical submissions outlined above when drafting the fair dividend rate legislation.

MARKET VALUE METHOD

Clause 58

Issue: Including dividends in the market value formula

Submission
(597 – PricewaterhouseCoopers, 12a – NZ Funds, 578 – NZICA, 589 – KPMG, 965, 1226 – Deloitte, 415W – Andrew Reid)

The market value method formula in section EE 44B(1) should be amended to include dividends. This would address the issue of double taxation of revenue account investors who hold FIF interests under the market value method. Consequentially, the amendment to section EX 47(2) should be omitted. Section CD 26 should also be repealed or alternatively, the reference to "market value method" be omitted from section CD 26.

Comment

Officials would agree with this submission in part, if the market value method were retained – that is, the market value method should be amended to include dividends in the formula and the amendment to section EX 47(2) should not proceed.

However, officials consider that this issue would not need to be addressed if the recommendation to replace the market value method with the fair dividend rate method is accepted.

Recommendation

Officials have recommended that the market value method be replaced with the fair dividend rate method. If this recommendation is accepted the issue in this submission will no longer be applicable.

SMOOTHED MARKET VALUE METHOD

Clause 58

Issue: Rollover relief

Submissions
(12a – NZ Funds, 594 – NZLS, 734 – Todd Corporation)

That rollover relief under the smoothed market value method should apply only to family trusts if they have offshore portfolio share investments of $50,000 or less. (Rollover relief would continue to apply to natural persons.)

Rollover relief should also be extended to closely held companies, with appropriate measures to avoid exploitation of this provision.

All investors should qualify for rollover relief.

The formula should allow for rollover relief to span a tax balance date when the prior investment is realised close to the balance date but the replacement is not made until after balance date.

Comment

Officials consider that this issue would not need to be addressed if the recommendation to replace the smoothed market value method with the fair dividend rate method is accepted. This is because there is no wash-up under the fair dividend rate method when shares are sold, so no rollover relief is necessary.

Recommendation

Officials have recommended that the smoothed market value method be replaced with the fair dividend rate method. If this recommendation is accepted the issue in this submission will no longer be applicable.

Issue: Opening value

Submission
(12a – NZ Funds)

The definition of "opening value" under the smoothed market value method should be amended to allow cost to be used as the opening value only in the first year that an interest becomes subject to the FIF rules.

Comment

The submission raises a valid issue with the smoothed market value method in the bill. However, officials consider that this issue would not need to be addressed if the recommendation to replace the smoothed market value method with the fair dividend rate method is accepted.

Recommendation

Officials have recommended that the smoothed market value method be replaced with the fair dividend rate method. If this recommendation is accepted the issue in this submission will no longer be applicable.

Issue: Clarifying application of method

Submission
(589 – KPMG)

The wording in section EX 44C should be clarified to make it clear that the section applies only to those FIF interests where the person has elected to use the smoothed market value method.

Comment

Officials consider that this issue would not need to be addressed if the recommendation to replace the smoothed market value method with the fair dividend rate method is accepted.

Recommendation

Officials have recommended that the smoothed market value method be replaced with the fair dividend rate method. If this recommendation is accepted this submission will no longer be applicable.

Issue: Allocation of cost to sale proceeds

Submission
(1221 – Ernst & Young)

The formula in the proposed section EX 44C(6)(a) for calculating a person's FIF income for an income year includes all amounts derived during the year from holding or disposing of shares less expenditure incurred during the year in acquiring further offshore shares.

This formula unfairly penalises investors by not effectively allowing a deduction for the cost base of investments sold against gross proceeds derived from the sale of investments. This is because the formula fully taxes gross proceeds on sale but does not permit a pro-rata deduction for the cost of shares sold against those proceeds. This disadvantages those investors who wish to realise some of the gains derived from shares that have risen in value by taxing them on the full amount of that gain without allowing them a deduction for the cost of the shares sold.

Comment

Officials consider this is not an issue under the smoothed market value method as the opening value of any shares held at the beginning of the year would be allowed as a deduction. In any event, officials consider that this issue is not applicable if the recommendation to replace the smoothed market value method with the fair dividend rate method is accepted.

Recommendation

Officials have recommended that the smoothed market value method be replaced with the fair dividend rate method. If this recommendation is accepted this submission will no longer be applicable.

Issue: Application of FIF income limit

Submission
(1221 – Ernst & Young)

There appears to be an anomaly in the smoothed market value method in an income year where there is no opening value and expenditure is incurred in acquiring FIF interests during that income year.

Comment

Officials consider that this issue would not need to be addressed if the recommendation to replace the smoothed market value method with the fair dividend rate method is accepted.

Recommendation

Officials have recommended that the smoothed market value method be replaced with the fair dividend rate method. If this recommendation is accepted the issue in this submission will no longer be applicable.

Issue: Pooling FIF interests

Submission

(734 – Todd Corporation)

All investors should be able to apply the regime on a pooled basis. This is currently restricted to individuals and trusts.

Comment

Officials consider that this issue would not need to be addressed if the recommendation to replace the smoothed market value method with the fair dividend rate method is accepted.

It should be noted that officials have earlier recommended that investors should be required to pool their offshore portfolio investments when applying the fair dividend rate method.

Recommendation

Officials have recommended that the smoothed market value method be replaced with the fair dividend rate method. If this recommendation is accepted this submission will no longer be applicable. The fair dividend rate method would apply on a pooled basis.

DISCOUNT ON MARKET VALUE METHODS

Clause 58

Issue: Level of discount

Submission

(597a – PricewaterhouseCoopers, 596 – ISI, 12a – NZ Funds, 578 – NZICA, 589 – KPMG, 588 – Trustees Corporation Association, 595 – AXA, 582 – NPF, 579 – Macquarie, 586 – Promina, 585 – NZX, 555 – Forsyth Barr, 556 – AMP, 557 – AllianceBernstein, 560 – Institute of Financial Advisers, 568 – Corporate Taxpayers Group, 572 – NZ Fire Service Super Scheme, 577 – ASB Group, 997W – Grosvenor, 965, 1226 – Deloitte, 1484 – Mercer Investment Consulting, 460 – Securities Industry Association, 603 – Goldman Sachs JBWere, 604W – Meat Industry Superannuation Scheme, 734 – Todd Corporation, 966 – NZ Harbours Superannuation Scheme, 618W – The Retire Fund, 657W – Sothertons, 682W – Private Trust Company, 467W – M.D. Macfarlane, 415W – Andrew Reid)

Submissions commented that if the market value methods were to proceed, a lower level of tax on offshore investments (than taxation on 85% of gains) should apply. Submissions suggested that the level of discount on the market value methods should be increased, with suggestions ranging from taxing 15% of gains to 70%. Most technical submissions considered a discount of around 50% was more reasonable.

Comment

Officials consider this issue does not need to be addressed if the recommendation to replace the market and smoothed market value methods currently in the bill with the fair dividend rate method is accepted. The level of discount is not relevant under the fair dividend rate method.

Recommendation

Officials have recommended that the market value and smoothed market value methods be replaced with the fair dividend rate method. If this recommendation is accepted this issue would not be applicable.

Issue: Applying a discount to dividends

Submission

(597 – PricewaterhouseCoopers, 556 – AMP)

Dividends should be taxed on the same basis as market value movements (that is, the discount should apply to dividends).

Comment

Dividends would not be separately taxed under the fair dividend rate method. Therefore, this submission would no longer be relevant, if the fair dividend rate recommendation is accepted.

Recommendation

Officials have recommended that the market value and smoothed market value methods be replaced with the fair dividend rate method. If this recommendation is accepted the issue in this submission will no longer be applicable.

Issue: Claw-back of discount

Submissions
(597 – PricewaterhouseCoopers, 596 – ISI, 608 – ING, 595 – AXA, 556 – AMP, 557 – AllianceBernstein, 568 – Corporate Taxpayers Group)

Distributions by non-PIE entities to their shareholders should not be subject to claw-back of the 15% discount allowed under the market value and smoothed market value FIF methods. An alternative is that the new international regime applies only to PIEs and the status quo is maintained for all non-electing entities.

The taxation of life insurers' policyholder base should be amended to exempt claw-back of the 15% discount.

Comment

Officials have earlier recommended that the market value and smoothed market value methods be replaced by the fair dividend rate method, which would make the issue of the discount irrelevant.

We note that a design feature of the New Zealand imputation system is that preferences that are received at the company level are effectively clawed back at the shareholder level. Under the current offshore tax rules, offshore portfolio share investments in grey list countries that are held on capital account by a company would be fully taxable when the gains are realised and distributed to investors (as there would be insufficient imputation credits to fully offset the tax payable on the dividend). This claw-back of preferences for companies should continue if the fair dividend rate method is adopted – that is, gains in excess of the 5% fair dividend rate would become taxable if the shares are sold and the proceeds distributed to shareholders. It should be noted that offshore portfolio share investment via PIEs would not result in individual investors being taxed on more than 5% of the value of their investments, as the PIE rules are designed to put managed fund investors on a similar footing to investing directly.

In relation to the taxation of life insurers' policyholder base, officials note that the government has announced a review of the tax rules for life insurance and the issue raised in this submission would be more suitably addressed under that review.

Recommendation

Officials have recommended that the market value and smoothed market value methods be replaced with the fair dividend rate method. If this recommendation is accepted the issue in this submission will no longer be applicable

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Issue: Applying the discount to currency hedges

Submissions
(608 – ING, 593 – BT Funds)

The currency hedge on international shares (outside those in Australian-resident listed companies) should be treated in the same way as the gain or loss on shares – only 85% of the gain or loss on the hedge should be taxable.

The currency hedge on shares in Australian-resident listed companies should be excluded income. Currency hedges held by a PIE, either in relation to Australian or other offshore investments, should only be taxable to the extent that currency movements on the underlying assets are taxable.

Comment

Officials do not consider that the currency hedge on international shares should be taxable using the fair dividend rate method – the financial arrangement rules should continue to apply to tax the gains and losses on these instruments. Similarly, in the context of investments in Australian-resident listed companies by PIEs, if the exemption is retained for these investments, we do not consider that gains on currency hedges should excluded income (to mirror the treatment of the underlying share gains for PIEs). Officials note that similar situations arise where there are exchange losses for which there is a deduction while the underlying asset has increased in value. This is an inherent feature of the financial arrangement rules.

Recommendation

Officials have recommended that the market value and smoothed market value methods be replaced with the fair dividend rate method. If this recommendation is accepted the issue in this submission will no longer be applicable

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Issue: Increasing the discount on long term investment

Submission
(510 – Liontamer)

Long-term investment should be rewarded by means of an increasing scale on the level of the discount. For instance, for investments held for less than five years tax could be imposed on 85% of the gains and for those held for more than five years this could be reduced to a tax on 50% of the gains and for investments over 10 years, 25% of the gains would become taxable.

Comment

Taxing gains on offshore portfolio investments on a sliding scale would not be relevant if the fair dividend rate recommendation is accepted (as the fair dividend rate does not target capital gains, but rather something approximating a reasonable dividend yield).

Recommendation

Officials have recommended that the market value and smoothed market value methods be replaced with the fair dividend rate method. If this recommendation is accepted the issue in this submission will no longer be applicable.

COST METHOD

Clause 60

Issue: Carried forward FIF income

Submission
(597 – PricewaterhouseCoopers)

The concession for deferred tax on the death of an investor under the smoothed market value method should also be available to persons under the cost method.

Comment

This issue no longer applies in light of the recommendation to replace the cost method that is currently in the bill with a new cost method that is based on the fair dividend rate concept. The new cost method would not contain a wash-up when an investment is sold. Therefore, the submission to defer the tax on gains arising on wash-up is not relevant.

Recommendation

Officials have recommended that the cost method in the bill be replaced with a new cost method that is based on the fair dividend rate concept. If this recommendation is accepted this submission will no longer be applicable.

Issue: Opening value definition

Submissions
(12a – NZ Funds, 608 – ING, 965, 1226 – Deloitte)

The reference in section EX 45B(4)(b)(ii) should be to "FIF income from that interest", not "FIF income" generally. The reference in section EX 45B(4)(b)(ii) to "subsection (1)(a)" should be to "subsection (1)(a)(i)".

Clarification is needed on the definition of FIF income in the definitions of "opening value" and "commencing value" in section EX 45B.

Comment

Officials agree with the first submission. We consider that this suggested change would address the issue raised in submission two. It should be noted, however, that the recommendation to replace the cost method that is currently in the bill with a new cost method that is based on the fair dividend rate concept should address this issue.

Recommendation

It should be noted that the recommendation to replace the cost method that is currently in the bill with a new cost method that is based on the fair dividend rate concept should address the issues raised.

Issue: Cost method "wash-up" rule

Submissions
(578 – NZICA, 603 – Goldman Sachs JBWere)

The proposed "wash-up" rule (where an investor sells their interest) under the cost method option is very difficult to follow and should be redrafted. The rule seems to be similar to a base price adjustment for a financial arrangement and should be drafted as such to make the legislation easier for users.

The draft legislation should be amended to ensure that under the cost method, a taxpayer gets a deduction for the cost of acquiring a FIF interest that is disposed of in the same income year (for the purposes of the wash-up rule).

The taxation of disposal proceeds under the cost method is unnecessary. In essence since the deemed rate of return would tax expected earnings, it would not bias investment decisions even if ex-post the return ended up higher or lower than expected.

Comment

These submissions no longer apply in light of the recommendation to replace the cost method that is currently in the bill with a new cost method that is based on the fair dividend rate concept. As noted earlier, the new cost method would not contain a wash-up when an investment is sold.

Recommendation

Officials have recommended that the cost method in the bill be replaced with a cost method that is based on the fair dividend rate concept. If this recommendation is accepted, submissions on this issue will no longer be applicable.

FIF LOSSES AND FOREIGN TAX CREDITS

Clauses 58 and 60

Issue: Carrying-back FIF losses

Submission

(597 – PricewaterhouseCoopers, 556 – AMP, 567 – Mercer Human Resource Consulting)

Losses arising under the new FIF rules should be capable of being offset against all income (including non-FIF income) from previous income years. At a minimum, losses should be able to be offset against FIF income arising in previous years.

Comment

The recommended replacement of the market value and smoothed market value methods with the fair dividend rate method should remove this issue for a majority of investors, as under the fair dividend rate no FIF losses would arise.

Investors would need to use the comparative value method for offshore portfolio investments for which the fair dividend rate is not allowed (that is, investments that generate "guaranteed returns", akin to debt). We do not consider that application of the comparative value method, in this instance, should give rise to the ability to carry back FIF losses. This would be inconsistent with the general tax loss rules which allow losses to be carried forward but not carried-back. It would also create significant administrative costs for Inland Revenue from having to reopen past assessments and would create uncertainty for government revenue flows.

Recommendation

That the submission be declined. It should be noted that the recommended replacement of the market value and smoothed market value methods with the fair dividend rate method should remove this issue for a majority of investors, as under the fair dividend rate no FIF losses would arise.

Issue: Carrying-back foreign tax credits

Submission
(578 – NZICA, 591 – Duncan Cotterill, 965, 1226 – Deloitte)

There needs to be an allowance in the foreign tax credit rules for New Zealand residents to be able to claim a full credit for the foreign tax paid when the investment is realised against the total New Zealand tax paid in relation to that investment (not just the amount reported in the New Zealand return for that particular year). Subpart LC should be amended to allow foreign tax credits to be carried back to earlier years for tax paid in foreign jurisdictions on the realisation of an interest in a FIF.

Comment

This was an issue under the offshore tax proposals originally contained in the bill. However, because the new fair dividend rate proposal does not seek to tax capital gains (but rather approximates a reasonable dividend yield on offshore shares) no credit should be allowed for foreign capital gains taxes. Credits for foreign tax paid on any dividends received would continue to be allowed under the fair dividend rate method.

Recommendation

That the submission be declined, as the fair dividend rate method does not seek to tax capital gains. Therefore no credit should be allowed for foreign capital gains taxes.

GREY LIST ISSUES

Clause 51

Issue: Schedule 4 approach to addressing base maintenance concerns

Submission
(594 – NZLS)

If the current grey list exemption from the FIF rules is maintained and PIEs are made exempt on their grey list share gains, base maintenance concerns should be addressed by excluding certain problematic entities. This could be achieved by listing them in schedule 4 of the Income Tax Act 2004. The type of entities that could be so listed are those known to enjoy favourable tax treatment in the relevant grey list country.

Comment

Officials do not consider that a schedule approach to dealing with specific tax avoidance concerns is sustainable due to the significant resources that would need to be expended in monitoring potential tax-preferred offshore entities and "black listing" them. Tax systems and tax planning structures are dynamic and change frequently. It is for this reason that officials consider reform of the offshore tax rules is necessary to ensure that a reasonable level of tax is payable on offshore portfolio share investments.

Recommendation

That the submission be declined.

Issue: Listed company limitation to address base maintenance concerns

Submission
(594 – NZLS)

If the schedule 4 approach is not considered sufficient to address base maintenance concerns, a more comprehensive limitation would be to restrict the exemption so it would apply only to listed companies not themselves operating as investment vehicles. The intent of this limitation would be to restrict the grey list exemption to listed companies carrying on an active business.

Comment

This approach would require monitoring of the activities of offshore companies which is likely to require a significant resource commitment and be less certain for taxpayers. As noted in the response to the previous submission, we consider that more wide-ranging reform of the offshore tax rules is necessary.

Recommendation

That the submission be declined.

Issue: Extension of Australian exemption to include other countries

Submission
(575 – Direct Broking, 1146 – General Electric, 471W – David Sissons, 301W – Canada New Zealand Business Association)

The present exemption for Australian-listed entities should be extended to include all entities listed on the UK and US stock markets. The exemption should also apply to investments in Canadian companies.

Comment

Extending the proposed exemption from the new offshore tax rules to investments in Canada, the United Kingdom and the United States is not feasible. Firstly, unlike Australia and New Zealand, the tax systems in these counties do not generally encourage companies to pay out a reasonable portion of their earnings as dividends (consequently gross dividend yields in these countries are around 2-3% compared to net dividend yields of around 4-5% in NZ and Australia). Second, the Australian exemption can also be justified on the basis of the Closer Economic Relationship between the two countries and the benefits of treating both economies as a single investment market. Third, the New Zealand Inland Revenue has a close working relationship with the Australian Tax Office, which should facilitate quickly shutting down structures set up to exploit the Australian exemption. It would be exponentially more difficult to monitor and clamp down on investments in structures that are set up and marketed to New Zealanders to reduce their tax liabilities, if the Australian exemption were extended to investments in Canadian, UK and US entities.

Recommendation

That the submissions be declined.

VENTURE CAPITAL

Clause 51

Submissions
(597 – PricewaterhouseCoopers, 589 – KPMG, 576 – NZ Venture Capital Association, 583 – NZ Venture Investment Fund, 563 – No 8 Ventures Management, 662 – Simon Earl Wilkinson, 664 – Richard Francis Locke)

Section EX 33(1)(c)(iv) should be amended so that, provided the other criteria are satisfied, investors that are not widely held can still claim the exemption notwithstanding that the investee company also has widely held investors.

The qualifying criteria in section EX 33(1)(c)(iv) should be deleted and an additional exemption should be available for investors in venture capital funds who cease to qualify because of expansion into foreign markets and/or investment by offshore investors. That is, a further exemption for investments in a Qualifying Venture Investment Company (QVIC) should be introduced. To qualify to be a QVIC the following criteria must be met:

- At the time of the initial capital investment, the company, whether incorporated in New Zealand or not, must be unlisted and have a majority of its assets or employees in New Zealand.

- The company must have been in operation for a minimum of one year before the company migrates from New Zealand (although Inland Revenue could waive this requirement if they were satisfied the company was genuine venture capital).

- The investee company must maintain a permanent establishment in New Zealand.

- Unlisted foreign companies that control companies that satisfy the above requirements should be treated as QVICs.

Investments in a QVIC by New Zealand investors should be eligible for the exemption, notwithstanding that the investment may be made after the company migrates from New Zealand. Investors should be able to claim the benefit of the exemption until the earlier of the company ceasing to have operations in NZ or ten years from the date of initial investment. Investors should have a grace period of six months following the company losing QVIC status to exit their investments. The exemption should also apply to investments made prior to 1 April 2007.

Other submissions commented that New Zealand investors in New Zealand-born and bred companies that migrate offshore should be exempt from the proposed tax for a period of 5 to 7 years following migration.

Comment

Officials support an exemption from the offshore tax rules for investments in NZ start-up companies that migrate offshore to gain access to finance. We consider that such an exemption is justified on the basis that venture capital investments do not compete with investment via New Zealand managed funds.

Officials recognise the venture capital exemption, as currently drafted in the bill, does not cover the full range of venture capital cases. We have therefore worked with the venture capital industry to develop a new set of criteria, which more appropriately identifies the types of venture capital investments involved. The criteria we have identified, which is generally supported by the industry, is as follows:

- The shares are in a New Zealand-resident company that migrates to a grey list country, but has a fixed establishment in New Zealand, which has at least $1 million of deductible expenditure or capital expenditure (not including interest) each tax year or 10 full time employees or contractors providing services ("significant operations").

- Prior to migrating the company had been tax-resident in New Zealand for a minimum of 12 months and had the majority of its assets or employees in New Zealand for at least a year.

- The exemption would apply to NZ investors who first invest before the company lists on a recognised exchange ("qualifying investors"). Qualifying investors would be able to continue to invest after the company has listed without losing the exemption.

- The exemption would last for 10 years from the date the company migrates.

- Qualifying investors would lose the exemption if a company ceased to have significant operations (as defined above) in New Zealand. The investor would have six months, from the date of cessation, to dispose of the shares prior to the new FIF rules applying.

- The shares would enter the new FIF rules at market value following the lapse of the 10-year period or cessation of significant operations in New Zealand.

- The exemption would also apply to shares in a grey-list company received in exchange for shares in a New Zealand resident company that satisfies the criteria above or shares purchased in an unlisted grey list company that owns a New Zealand company that meets the criteria. The 10-year rule would apply from the time the grey list company acquired a majority of the shares of the NZ company.

A provision incorporating these criteria should replace section EX 33(1)(c) currently in the bill.

Recommendation

That the exemption for venture capital investments currently contained in the tax bill be replaced by the criteria outlined in the officials' comment.

EMPLOYEE SHARE PURCHASE SCHEMES

Submissions

(578 – NZICA, 594 – NZLS, 581 – Russell McVeagh, 554 – NZ Bankers Association, 557 – AllianceBernstein, 559 – ABN AMRO New Zealand, 568 – Corporate Taxpayers Group, 580 – Stratex Networks, 1146 – General Electric, 1221 – Ernst & Young, 965, 1226 – Deloitte, 1239W – Blackmore Virtue & Owens, 1282W – Bell Gully, 1221 – Ernst & Young for Maunsell, 987 – HSBC, 988 – American Chamber of Commerce in NZ, 1131 – David Patterson (MinterEllisonRuddWatt), 494 – Clemenger Communications)

Shares acquired under an employee share purchase agreement (as defined in section CE 7 of the ITA) should be excluded from the new offshore tax rules. If this is not accepted, for the purposes of applying the new FIF rules, the cost of shares obtained under employee share schemes should be the market value at the time the shares were obtained (rather than the cost to the investor). This should also be the case for shares that are gifted or inherited.

Where a taxpayer holds shares in a "grey list" overseas company through their employment, these shares should be exempted from the FIF regime with shareholders continuing to be taxable on dividends as they are received.

Comment

Officials do not consider that shares acquired through employee share purchase schemes should, as a general rule, be exempt from the new offshore tax rules, especially given the replacement of the current bill proposals with the fair dividend rate method. This could result in a New Zealand employee of a foreign company receiving an exemption if they acquire the shares in that company through work, versus acquiring the shares privately. It would also mean that different investors, holding the same shares, could be treated differently for tax purposes depending on how the shares were acquired. A similar issue would arise in relation to exempting offshore portfolio share investments that are gifted or inherited.

A temporary exemption may be justified in cases where shares acquired through an employee share purchase scheme contain restrictions on disposal. We consider that such an exemption should be limited to shares held by a person in a foreign company where:

- the foreign company is resident in a grey list country and is the employer of the employee or owns, directly or indirectly, the New Zealand-resident employer of the employee;

- the shares are acquired through employment; and

- there are restrictions in the share purchase agreement preventing the person disposing of the shares for a period other than on the grounds of serious hardship.

This exemption should apply only for the period that there are restrictions on the disposal of the shares and employees should have six months from the date the restrictions on disposal no longer apply to dispose of their investments. After this period, the shares would enter the new FIF rules (that is, be subject to the fair dividend rate method) at their market value.

Recommendation

The new offshore tax rules should contain a limited exemption for offshore shares acquired through employee share purchase schemes to the extent there are restrictions on disposal of the shares. The exemption should only be valid for the duration of the restrictions.

OFFSHORE INVESTMENT TRUSTS

Issue: Offshore investment trusts should be exempted

Submission

(585 – NZX, 936 – ABN AMRO, 1347W – Northplan Financial Services / Swain Investment Services/ Colin Strang Financial Planning, 503W – Anonymous, 471W – David Sissons)

Shareholders in non-resident investment trusts which are listed on the NZX, as at 1 May 2006, and which can satisfy the criteria as set out in the supplementary order paper, should be granted, like the investors in GPG, a "five-year holiday" from the proposed new rules.

This five-year holiday from the new offshore tax rules would allow Investment Trust Companies and their shareholders time to consider restructuring their affairs and product offerings in a manner which is most appropriate for the new regime. In the long-term, the tax issues will be minimal, but the compliance costs and risks of technical non-compliance (and hence enforcement) would be high if this approach is not taken.

Comment

The reason for granting GPG a five-year holiday was to give it the opportunity to consider relocating to New Zealand pending the outcome of the review of the CFC rules. If the outcome of this review was the introduction of an active business income exemption this would benefit GPG as its principal offshore holding would probably be covered by such an exemption. UK investment trust companies would not have similar incentives to consider re-locating to New Zealand as they are typically portfolio investors (that is, the outcome of the CFC review would not impact on these entities). An exception is the New Zealand Investment Trust (NZIT), which because it invests predominantly in New Zealand and Australian companies, would benefit from re-locating to New Zealand and becoming a PIE. Officials have therefore recommended that investments in NZIT receive a two-year exemption from application of the offshore tax rules to allow NZIT time to relocate.

Recommendation

That the submissions be declined.

Issue: Offshore investment trusts should not be exempted

Submission
(1142 – Carter Holt Harvey Employee Benefits Plan and Retirement Plan)

The Australasian exemption should not apply to overseas-based actively managed products (e.g. UK listed Trusts) that are currently tax-favoured and are inconsistent with the existing tax regime.

Comment

For reasons outlined earlier in this report, and in the submission on this issue, officials do not consider that the proposed Australian FIF exemption should be extended to include these products. Investments in these products should be subject to the proposed fair dividend rate method.

Recommendation

That the submission be noted.

AUSTRALIAN EXEMPTION

Clause 51

Issue: Clarification of criteria

Submissions

(597 – PricewaterhouseCoopers, 12a – NZ Funds, 578 – NZICA, 608 – ING, 589 – KPMG, 593 – BT Funds, 595 – AXA, 581 – Russell McVeagh, 579 – Macquarie, 584 – Smartshares, 557 – AllianceBernstein, 560 – Institute of Financial Advisers, 568 – Corporate Taxpayers Group, 575 – Direct Broking, 1221 – Ernst & Young, 965, 1226 – Deloitte, 510 – Liontamer, 602W – ANZ National, 603 – Goldman Sachs JBWere, 603 – Goldman Sachs JBWere Transtasman Unit Trust, 734 – Todd Corporation, 1131 – David Patterson (MinterEllisonRuddWatt), 657W – Sothertons, 415W – Andrew Reid)

Inland Revenue should be required to publish a definitive and binding list each year of shares that qualify for the Australian exemption. Investors should be able to rely on this list when applying the revised rules until the list changes at which point investors should be given a period to dispose of their interests without application of the FIF rules.

Under the proposed exemption:

1. The "official list of the Australian Stock Exchange" should be defined and applied consistently in section EX 33(1)(a) and section CX 44C(a)(ii).

2. The meaning of "resident in Australia" should be clarified, for example, by reference to New Zealand tax law (section OE 2).

3. The exemption in section EX 33 for investment in Australian-resident listed companies should be amended by deleting new section EX 33(1)(a)(ii) and (iii). Alternatively section EX 33(1)(a)(iii) should be clarified.

4. Section EX 33(1)(a) should be replaced with a requirement that the company is listed on the ASX unless specifically identified by IRD as not qualifying for the Australian exemption.

The proposed exemption should apply to all Australian-listed company shares, including stapled securities with no requirement to ascertain Australian tax liability. The requirement for an Australian company to be liable to Australian tax on its worldwide income should be removed as it would be practically impossible for an investor to work this out. Also, Australian law exempts companies' foreign branch profits and dividends from foreign subsidiaries in most circumstances. As such, the exemption would not seem to apply to investments in Australian companies that have foreign branches.

The exemption test should be restricted to the company being Australian tax-resident, listed and entitled to maintain a franking account.

The exemption should be extended to include Australian-resident companies that are listed on any Australian or New Zealand-based “recognised exchange”.

The exemption requirement to be listed on the Australian Stock Exchange and hold a franking credit account and be liable to income tax on income derived from Australia and not derived from Australia should be removed in favour of an exemption that applies to all Australian-listed companies’ tax-resident in Australia.

The requirement for the exemption should be modified from “resident in Australia” to “registered in Australia” to recognise that several large Australian-listed companies are dual-listed.

All listed entities in NZ and Australia should be exempt from the proposed tax, irrespective of country of residence.

The Australian exemption should be extended to cover all Australian-resident companies (that keep franking credit accounts) be they listed or unlisted companies.

All Australian-resident companies should qualify for grey list status provided their principal business and/or investments are held in Australasia.

Comment

If the exemption from the proposed offshore tax rules for investments in Australian-resident listed companies is retained, we consider that the following technical changes should be made to the exemption, in response to submissions:

- Officials agree that the ASX references in sections EX 33 and CX 44C should be consistent. However, the reference to the ASX should replaced by the “ASX approved list”. The ASX-approved list includes the ASX All Ordinaries, ASX 50 and ASX 200.
- Officials consider that it should be clarified that the “resident in Australia” reference in section EX 33 cross-refers to the definition of a foreign company in section OE 2(3).
- Officials agree that EX 33(1)(a)(iii) should be clarified by replacing it with a provision which excludes Australian-resident companies that tie-break to another country other than New Zealand under an Australian tax treaty. The wording in section ME 1A(1), which serves a similar purpose, could be used as the basis for the drafting of new section EX 33(1)(a)(iii).

In response to other submissions, we do not support the proposal that Inland Revenue be required to publish a binding list of companies that qualify for the Australian FIF exemption. Under the current grey list exemption in the offshore tax rules, investors are required to ascertain whether a foreign company is tax-resident in one of the eight grey list countries. We consider that this self-assessment approach should continue under the proposed Australian exemption. Generally, a New Zealand investor that receives a "franked" dividend from a company that is listed on the ASX will be able to access the proposed exemption.

We do not consider it is feasible to replace the requirement that a company be Australian tax-resident with a requirement simply that it be listed on a recognised Australian exchange. As noted in response to earlier submissions, officials consider that a key justification for exempting investments in Australian companies is on the basis that, on average, these companies pay out a large proportion of their earnings as dividends. This incentive to pay high dividends is created by the application of the Australian tax system (in particular the franking credit rules). A company that is not Australian tax-resident would not necessarily have the same incentives to pay dividends (even though it may be listed on the ASX). Therefore, the requirement that a company is subject to the Australian tax rules is important.

Submissions have indicated that the exemption should apply in respect of any investment in an Australian-resident company, regardless of whether it is listed or not. Officials consider that the exemption for Australian-resident companies should be restricted to companies listed on the official approved list of the ASX which should cater for most of New Zealanders' portfolio investment in Australia. The listing requirement would make it easier for officials to identify vehicles that have been set up to take advantage of the exemption (for example, vehicles that roll-up gains).

We do not consider that an active income exemption is feasible for Australian companies, as this would require investors who hold portfolio (that is, less than 10%) interests in Australian companies to ascertain the nature of the companies' activities. An active business exemption is generally more useful in the context of controlling investments, as investors will have greater access to information.

Recommendation

That the submissions on technical changes to the exemption for Australian-resident listed companies be accepted, subject to officials' comments. The other submissions should be declined.

Issue: Stapled securities

Submission
(597 – PricewaterhouseCoopers, 589 – KPMG, 579 – Macquarie, 553 – Brook Asset Management, 936 – ABN AMRO, 575 – Direct Broking, 1221 – Ernst & Young, 965, 1226 – Deloitte)

The Australian exemption should be extended to include stapled securities listed on the ASX. At present, it is not clear whether the Australasian exemption applies in situations where an otherwise eligible security has other securities stapled to it.

The legislation should ensure that shares in Australian companies are not disqualified from the Australian exemption in the FIF rules where a unit in an Australian unit trust is stapled to the share, provided the unit only provides an entitlement to distributions.

Comment

Officials consider that the Australian exemption should be limited to shares in Australian-resident listed companies without stapled rights. Our understanding of stapled securities is that the Australian security would have "stapled" to it an interest in a foreign company. The exemption should apply only to the Australian security (to the extent it is issued by an Australian-resident listed company); the proposed offshore tax rules should apply to the attached interest in the foreign company. In practice, however, it would seem difficult to separate the two. Therefore, we consider that the appropriate treatment for stapled securities issued by Australian entities should be the application of the fair dividend rate method to such interests.

Recommendation

That the submission be declined. The proposed Australian FIF exemption should be limited to shares in Australian-resident listed companies without stapled rights.

Issue: Non-PIE revenue account holders of Australasian shares

Submission
(595 – AXA, 492, 880 – First NZ Capital)

Revenue account property holders that are not PIEs will be taxed at 85% on their non-Australasian shares but will be taxed at 100% (on a realisation basis) on their Australasian shares. The different treatment of Australasian and other shares appears to be an unintended consequence of the reforms. Accordingly revenue account property holders that are not PIEs should only be taxed on 85% of the gain on their Australasian shares (with all other equity investments, including New Zealand shares, also treated as international shares).

Comment

The issue of the discount under the market value and smoothed market value methods has been superseded by the proposed fair dividend rate method. Non-PIE revenue account holders of interests in Australian-resident listed companies would be taxed on realised share gains (which is their current treatment), under the proposed Australian exemption. Officials consider that it is appropriate for this current tax treatment to apply in respect of shares in Australian-resident listed companies held by non-PIE revenue account investors.

Recommendation

That the submission be declined.

Issue: Exchange traded funds

Submission

(640W – State Street Global Advisors)

Investments in Australian exchange traded funds (that invest in Australian companies), which are listed entities but operate under a trust rather than corporate structure, should be exempt from the new FIF rules.

Comment

We consider that it would be very difficult to construct an exemption that specifically targeted exchange traded funds to the extent that they invested in Australian-listed companies, especially given that stapled securities are a feature of the Australian stock market. Officials have recommended, in the next section, that investments in certain Australian unit trusts (including listed unit trusts that are exchange traded) that meet certain turnover requirements and other criteria should be allowed to access the Australian FIF exemption. This should address some of the concerns raised.

Recommendation

That the submission be declined.

AUSTRALIAN UNIT TRUSTS

Clause 51

Issue: AUTs should be included in Australian exemption

Submissions
(12a – NZ Funds, 578 – NZICA, 608 – ING, 589 – KPMG, 579 – Macquarie, 553 – Brook Asset Management, 560 – Institute of Financial Advisers, 575 – Direct Broking, 925W – ASFONZ, 936 – ABN AMRO, 1221 – Ernst & Young, 1347W – Northplan Financial Services / Swain Investment Services/ Colin Strang Financial Planning, 468W – Platinum Asset Management, 496W – Fundsource, 603 – Goldman Sachs JBWere, 674W – Waterfront Industry Superannuation Fund, 1131 – David Patterson (MinterEllisonRuddWatt), 471W – David Sissons, 467W – M.D. Macfarlane, Plan B Financial Services, 640W – State Street Global Advisors, 631 – R P Deeble, 1136 – Stuart + Carlyon)

If the offshore proposals proceed, the bill should be modified to include investments in certain Australian unit trusts within the scope of the proposed exemption in the FIF rules for Australian resident listed companies. The exemption should apply only to investments in the following two classes of Australian unit trusts (so called "recognised Australian unit trusts"):

(1) An Australian-resident unit trust:

- whose New Zealand-resident investors are only a portfolio investment entity; a qualifying unit trust; a GIF; a life insurer; or a superannuation fund; and
- that invests 90% or more of its assets in Australian-resident companies; or turns over a minimum of either 25% of its assets (by value) each year or 33% of its assets on a rolling three-year average basis.

(2) An Australian resident unit trust:

- that uses the RWT proxy rules for meeting the tax obligations of its New Zealand investors; and
- turns over a minimum of either 25% of its assets (by value) each year or 33% of its assets on a rolling three-year average basis.

Investors who have interests in Australian unit trusts and elect into the RWT proxy regimes offered by such vehicles prior to 1 April 2007 should have this income excluded from the FIF rules (and will not have to file a return). The RWT proxy rates for an Australian unit trust should be based on PIE portfolio investor rates.

Investments in all Australian unit trusts (both listed and unlisted) should be included within the proposed exemption from the new offshore tax rules. Alternatively the legislation should treat investments in listed Australian unit trusts the same as listed companies whilst imposing a minimum deemed income (5% pa) based on the Australian unit trust's opening value.

Investments in Australian unit trusts that themselves invest exclusively or primarily in Australian-resident companies should be exempt. Three suggested constraints for investors to receive the exemption are:

- 85% or more of the holdings of the trust are Australian-resident companies listed on the Australian stock exchange that are subject to Australian tax law.
- The trust is listed on the Australian stock exchange.
- Holdings of the unit trust are publicly available on a frequent basis.

Comment

Australian unit trusts were not included in the proposed exemption from the FIF rules for Australian investments because they could be used as roll-up vehicles to invest outside Australia in companies that pay little or no dividends (and therefore avoid the new offshore tax rules). New Zealand investors could invest in these vehicles and derive income in the form of capital gain, without a tax liability arising on this income in either Australia or New Zealand.

A number of the submissions have made useful suggestions to address the concerns about the ability to use Australian unit trusts to roll-up gains and avoid the application of the new FIF rules. Officials consider that investments in Australian unit trusts that meet minimum turnover requirements and where the investor elects to use the RWT proxy mechanism for their investment in an entity should qualify for the Australian FIF exemption. This is meant to accommodate current arrangements, where investors in certain Australian unit trusts can have their tax liabilities satisfied by way of the RWT proxy, thereby reducing compliance obligations.

Officials consider that the Australian unit trust should be required to turn over a minimum of 25% of its profit-making assets each year. This would result in Australian capital gains tax being payable on realised gains on these assets which should reduce the incentive to invest in Australian unit trusts because they roll-up offshore share gains to avoid tax. The minimum turnover requirement should not take into account investments in loss because otherwise there could be an incentive to dispose only of such investments to meet the minimum turnover requirement.

The exemption should only be available to those investors in the Australian unit trust who elect to use the RWT proxy mechanism. This is because the RWT proxy mechanism gives some assurance that New Zealand tax liabilities will be satisfied. Investors that do not elect to use the RWT proxy rules would be subject to the fair dividend rate method. It is also expected that the RWT proxy, who will generally be a New Zealand-based agent, will be able to advise investors on whether an Australian unit trust meets the turnover requirements.

Recommendation

That submissions to include certain Australian unit trusts in the proposed Australian FIF exemption be accepted, subject to officials' comments.

Issue: Listed Australian unit trusts should not be included in Australian exemption

Submission
(593 – BT funds)

Listed Australian unit trusts should not be included in the proposed tax-free capital gains tax treatment for PIEs as otherwise a compliance-intensive anti-avoidance regime will be required to stop Australian unit trusts being used to frustrate the proposed new international tax regime.

Unlisted Australian unit trusts should receive the benefit of the capital gains tax exemption as this is necessary to allow New Zealand funds to access international share exposures without creating tax inefficiencies.

Comment

Australian unit trusts that meet the criteria outlined in the response to submissions on the previous issue, should qualify for the Australian FIF exemption from the proposed offshore tax rules, regardless of whether or not they are listed. Whether an Australian unit trust is listed or not does not seem to be a relevant factor in determining whether it should be exempt from the FIF rules. This is because the proposed criteria to qualify for the Australian FIF exemption should ensure these vehicles distribute a reasonable level of income each year (which would be taxable in both Australia and New Zealand) and the use of the RWT proxy should mean that the New Zealand tax liabilities will be satisfied.

Recommendation

That the submission that listed Australian unit trusts be excluded from the Australian exemption be declined, subject to officials' comments.

Issue: Exemption for Australian unit trusts that invest in Australian-listed equities

Submission
(575 – Dimensional)

Australian unit trusts that primarily invest in Australian-listed equities should effectively receive the benefit of the Australian FIF exemption. Qualifying Australian unit trusts should be treated as being in the New Zealand system for the purposes of allocating their income and calculating the tax liability of New Zealand investors, with the obligation for payment of tax falling on the New Zealand investor. To provide tax neutrality it would be necessary to divide the capital gains of Australian unit trusts into exempt (i.e. Australian listed companies) and non-exempt capital gain.

An approach for Australian unit trusts with New Zealand investors is to make a monthly determination of the proportion of taxable and non-taxable securities in the Australian unit trust. By averaging the monthly values over a year a good estimate of the average underlying exposure of the Australian unit trust to taxable and non-taxable securities should be obtained.

Comment

Officials consider that an appropriate approach to deal with investments in Australian unit trusts has been developed in response to the earlier submissions on this issue. The preferred approach would exempt from the FIF rules investments in Australian unit trusts that meet certain turnover requirements and which incorporate the RWT proxy mechanism.

The approach proposed in this submission would be complicated to incorporate in legislation and difficult to apply in practice.

Recommendation

That the submission be declined.

FIVE-YEAR EXEMPTION (GPG)

Supplementary Order Paper No.44

Issue: Exempting revenue account investors from tax on realised share gains for duration of holiday

Submission

(573 – Guinness Peat Group, 597 – PricewaterhouseCoopers, 608 – ING, 593 – BT Funds, 582 – NPF)

PIEs should not be taxed on realised gains on shares subject to the five-year holiday, that are disposed of during that holiday. This treatment would provide consistency in taxation between direct and indirect investment. It would also be consistent with the rationale for the five-year holiday, which is to allow time for the government to review the CFC rules and then give entities covered by the holiday time to consider shifting their headquarters to New Zealand. Finally, this treatment would remove unnecessary compliance costs for PIEs who would otherwise have to separately account for shares covered by the holiday on a realised basis which is difficult to incorporate with the look-through treatment under the PIE rules which require attribution on a quarterly basis.

Comment

We consider that the policy rationale for the five-year exemption has not changed under the proposed fair dividend rate method and therefore recommend that the exemption be retained. We also consider that revenue account investors in GPG should be given the option of applying the fair dividend rate method, rather than the current tax rules (which would tax their realised share gains).

We do not however consider that investments by PIEs in GPG should be treated as an investment in a New Zealand or Australian company for the simple reason that GPG is not a New Zealand company. It is therefore not subject to New Zealand's tax rules. The comprehensive nature of New Zealand's company tax system, which encourages dividend distribution, was a key reason for providing PIEs with an exclusion from tax on their share trading income from investments in New Zealand companies. GPG, in contrast, does not pay out a large percentage of their earnings by way of dividends and taxing PIEs only on this income would improve the competitive position of an investment in GPG compared to all other offshore portfolio share investments (which would be taxed on a 5% fair dividend rate). This would not be desirable.

Officials consider that institutional investors in GPG should have the option of paying tax on their GPG investments using the fair dividend rate method. This should address the compliance point that paying tax on realised shares gains would be difficult to incorporate with the effective look-through treatment under the PIE tax rules.

Recommendation

That the submission that PIEs holding investments in GPG only be taxed on the dividend income from those investments be declined. Investors on revenue account should have the option of applying the fair dividend rate method to these shares.

Issue: Exclusion for foreign entities with substantial NZ presence

Submissions

(578 – NZICA, 564 – Austral Pacific Energy, 568 – Corporate Taxpayers Group)

Investments in foreign companies with a substantial presence in New Zealand (for example, where 50-90% by value of the entity's assets are in New Zealand) should be excluded from the proposed FIF rules.

The GPG exemption should be expanded to apply to other companies whose principal business is based in New Zealand. This should be achieved by changing the following requirements:

- The requirement for there to be 20,000 shareholders should be reduced to 20 shareholders (to be in line with the definition for electing into the PIE rules where 20 non-associated investors set the requirement for widely held status).
- The appropriate threshold for a significant proportion of New Zealand shareholders should be 20%, not 50%.

Comment

The reason for exempting interests in certain grey list companies (GPG) for five years from the FIF rules was to give these entities time to consider relocating to New Zealand pending the outcome of the review of New Zealand's controlled foreign company rules. This reason is quite different from the situations being submitted on above, which suggest that an exemption is justified based on the foreign company being invested into having a substantial New Zealand trading or business presence.

The issue of the double taxation of New Zealand shareholders of foreign companies with a substantial New Zealand presence currently exists. This is because the foreign company can pay tax in New Zealand on its profits but cannot flow through imputation credits to its New Zealand shareholders on the resulting dividends. A solution to this problem may seem to be to allow the foreign company to maintain an imputation credit account. The policy reason why only New Zealand resident companies can maintain imputation credit accounts is to ensure that there remains an incentive for a current New Zealand-resident company to remain resident in New Zealand. A New Zealand-resident company is liable to New Zealand tax on its worldwide income whereas a non-resident company is only liable to New Zealand tax on its New Zealand-sourced income. If a non-resident company was allowed to maintain an imputation credit account for the benefit of its New Zealand shareholders this could provide an incentive for a New Zealand-resident company to migrate to escape tax on its foreign-sourced income while still passing on the benefit of New Zealand tax on its New Zealand-sourced income to its New Zealand shareholders.

We therefore recommend that the submissions be declined. Investments in these companies should be subject to the proposed fair dividend rate method.

Recommendation

That the submissions be declined.

Issue: Revenue account investor election

Submission
(597 – PricewaterhouseCoopers, 608 – ING, 593 – BT Funds, 582 – NPF)

Investors who hold shares on revenue account that qualify for the temporary exemption from the proposed FIF rules, for investments in certain grey list entities, should be able to elect that such shares are able to be taxed under the FIF rules.

Comment

As noted earlier, officials agree that revenue account investors that invest in companies that qualify for the five-year exemption should be able to elect to apply the fair dividend rate method. This is likely to be particularly beneficial for PIEs that invest into such companies as attribution of income to investors would be simpler under the proposed fair dividend rate method. In contrast, if the existing tax rules were to apply, investors would be subject to tax on realised gains on these investments. This would require deferred gains and losses to be allocated across tax years and current and future investors, which would be difficult for PIEs to manage.

Recommendation

That the submission be accepted.

FURTHER EXEMPTIONS

Issue: Exemption for work-based superannuation schemes

Submission
(1142 – Carter Holt Harvey Employee Benefits Plan and Retirement Plan)

The proposed offshore investment taxation changes should not apply to work-based superannuation schemes, or as a minimum should be deferred for five years. This is no different to the exemption granted to GPG and the same reasons should apply.

Comment

There is no basis for exempting offshore shares held by corporate superannuation schemes. Investors in these schemes should be treated no differently to other New Zealand investors (including those investing offshore via other savings vehicles, such as unit trusts). To provide an exemption for offshore shares held via a corporate superannuation scheme would give investors in these schemes an unfair advantage. The rationale for the five-year exemption for investments in certain grey list companies – to give these companies time to consider relocating to New Zealand pending the outcome of the review of the controlled foreign company rules – does not apply in the case of offshore shares held by work-based superannuation schemes.

Recommendation

That the submission be declined.

Issue: Exemption for new immigrants

Submission
(591 – Duncan Cotterill, 575 – Direct Broking)

The offshore proposals should not apply to portfolios acquired before immigration to New Zealand, prior to enactment.

All retirement savings held offshore by immigrants to New Zealand should be exempt.

Comment

A permanent exemption for new migrants on shares acquired pre-migration to New Zealand would be unfair vis-à-vis other New Zealanders. Officials note that these migrants will have sufficient time to adjust their holdings, to take into account New Zealand's offshore tax rules, under the recently introduced four-year exemption from tax for new migrants (and returning New Zealanders) on their offshore investments. It should also be noted that most migrants will have experience paying capital gains taxes in other jurisdictions. In contrast, the fair dividend rate method would tax a reasonable dividend yield from their offshore portfolio share investments.

Recommendation

That the submission be declined.

Issue: Temporary exemption for non-resident entities investing in Australasian shares

Submission
(1167W – New Zealand Investment Trust)

A temporary exemption from the new offshore tax rules should be provided for interests in non-resident entities that invest primarily in Australasian equities to allow them time to relocate to New Zealand.

Comment

As noted earlier, we consider that investments in the New Zealand Investment Trust (NZIT) should receive a two-year holiday from the proposed offshore tax rules, if the exemption for investments in GPG is retained. This is because New Zealand investors in NZIT and other grey list entities that have a predominantly Australasian investment policy, would benefit if these entities were to relocate to New Zealand to become PIEs. Another major advantage for the shareholders from these entities migrating to New Zealand is that they would get the benefit of New Zealand imputation credits (which are currently lost).

To qualify for this two-year holiday, the New Zealand Investment Trust, and any other grey list entities would need to have at least 90% of their assets (by value) invested in New Zealand-resident and Australian-resident listed companies. This Australasian investment requirement would have to be maintained throughout the two-year exemption period. Such entities would also need to be listed on the New Zealand Stock Exchange on the date of introduction of this bill and have a substantial New Zealand ownership. A further condition of this temporary exemption should be that the relevant entities notify the Commissioner within 30 days of the date of enactment of this bill that their investors qualify for this exemption.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Publication of list of qualifying companies

Submission
(597 – PricewaterhouseCoopers)

IRD should publish a list of companies that meet the qualifying criteria for the proposed five-year exemption from the proposed FIF rules.

Comment

Inland Revenue will publish in its *Tax Information Bulletin* a list of companies that have provided notification that their shareholders qualify for the temporary exemptions (i.e. the five-year and two-year exemptions referred to previously) from the FIF rules. An amendment is needed to give Inland Revenue the authority to publish these company names notwithstanding the secrecy provisions.

Recommendation

That the submission be accepted by making an amendment to the secrecy provisions to allow Inland Revenue to publish the names of companies that it has received notification from that their shareholders qualify for the temporary exemptions from the FIF rules.

Issue: Exemption for inherited shares

Submission
(965, 1226 – Deloitte)

There should be some relief for shares which have been inherited, as beneficiaries have not actively chosen to invest. For example, holders could be given a timeframe within which to exit the investment.

Comment

Officials consider there is no policy justification for exempting inherited shares from the FIF rules. Income from inherited offshore shares should be treated in the same way as income from offshore shares acquired through other means.

Recommendation

That the submission be declined.

Issue: Extension of holiday for new migrants

Submission
(734 – Todd Corporation)

A new immigrant in Australia would be taxable on their employment income and investment income having an Australian source. Foreign income would not be subject to Australian tax. The person can remain temporarily resident so long as they do not acquire Australian citizenship. In response to this New Zealand has introduced a four-year holiday. The Committee should note the need to align the taxing provisions of New Zealand and Australia.

Comment

The temporary exemption from the offshore tax rules for new migrants (and certain returning New Zealanders) was enacted by a previous Act of Parliament. This submission is therefore outside the scope of this bill.

Recommendation

That the submission be declined.

Issue: Exemption for returning New Zealanders

Submission
(615 – Business NZ)

The exemption from the FIF rules for returning New Zealanders should decrease the minimum amount of time they should have been out of the country from 10 years to a minimum of five years.

Comment

As noted in response to the previous submission, the temporary exemption from the offshore tax rules for new migrants and certain returning New Zealanders was enacted by a previous Act of Parliament. This submission is therefore outside the scope of this bill.

Recommendation

That the submission be declined.

Issue: Exemption for retired individuals

Submission

(734 – Todd Corporation, 1333P – G C Gould)

The international tax proposals should not apply to retired individuals who hold offshore shares on capital account and who are aged over 65 as at 1 April 2007.

Comment

Officials consider there is no policy justification for an age-based exemption from the offshore tax rules.

Recommendation

That the submission be declined.

DE MINIMIS THRESHOLD

Clauses 7 and 20

Issue: Level of threshold

Submissions

(578 – NZICA, 589 – KPMG, 588 – TCA, 585 – NZ Exchange-listed UK Investment Trust Companies, 560 – Institute of Financial Advisers, 568 – Corporate Taxpayers Group, 575 – Direct Broking, 577 – ASB Group, 881, 1138 – Perpetual Trust Limited, 580 – Stratex Networks, 936 – ABN AMRO, 965, 1226 – Deloitte, 1339W – Blackmore Virtue & Owens, 1347W – Northplan Financial Services / Swain Investment Services/ Colin Strang Financial Planning, 492, 880 – First NZ Capital, 510 – Liontamer, 657W – Sothertons, 503W – Anonymous, 471W – David Sissons, 467W – M.D. Macfarlane, 415W – Andrew Reid, 882W – Lee Stevens, 631 – R P Deeble)

Submissions commented that the proposed NZD$50,000 de minimis was too low and should be raised. Alternatives given ranged from $80,000 to $1 million (with the average between $100,000 and $250,000). The de minimis was considered too low on the basis that the removal of the grey list exemption for portfolio investments will effectively reduce the benefit of the current threshold. NZD$50,000 was also not considered representative of the level of savings required for financing retirement.

However, some submissions (from managed funds) commented that if the de minimis remained only for individuals investing offshore directly and was not extended to cover investments through a PIE, it should be set lower than NZ$50,000.

Comment

Officials earlier recommended keeping the de minimis threshold for individuals, if the fair dividend rate method recommendation is accepted. We do not recommend increasing the threshold above the NZD$50,000 level that is currently proposed. Increasing the de minimis significantly would undermine the core objective of these reforms which is to remove the current distortion between investing directly in offshore shares and investing through New Zealand managed funds (investors investing offshore via PIEs would not get the benefit of this threshold). A modest de minimis level for individual direct investors, such as that contained currently in the bill, can be justified on compliance cost grounds.

Recommendation

That the submissions be declined.

Issue: Family trusts

Submission

(578 – NZICA, 589 – KPMG, 588 – TCA, 560 – Institute of Financial Advisers, 568 – Corporate Taxpayers Group, 575 – Direct Broking, 881, 1138 – Perpetual Trust Limited, 1221 – Ernst & Young, 965, 1226 – Deloitte, 1347W – Northplan Financial Services / Swain Investment Services/ Colin Strang Financial Planning, 510 – Liontamer, 682W – Private Trust Company, 503W – Anonymous, 467W – M.D. Macfarlane, 631 – R P Deeble)

The de minimis exemption should be extended to trusts that invest on behalf of beneficiaries that are individuals (for example, family trusts). If this is not done then investments through trusts will be disadvantaged compared to direct investments, creating a distortion. Specific anti-avoidance rules should be designed to counter the risk of multiple trust structures being used to avoid the offshore tax rules.

Comment

The NZ$50,000 de minimis threshold currently does not apply to offshore portfolio share investments held via family trusts to prevent this threshold being exploited by the creation of multiple trusts for the benefit of the same individual. For example, if ten family trusts could be established for the benefit of the same individual, the de minimis would effectively be increased to $500,000. The use of specific anti-avoidance rules to prevent this mischief, as suggested in submissions, would not be feasible as family trusts are discretionary. This could result in persons being made beneficiaries of the trust in future, with no way for Inland Revenue to determine who the real beneficiaries of the trust are.

Recommendation

That the submission be declined.

Issue: Court ordered trust exemption

Submission

(589 – KPMG, 588 – Trustees Corporation Association, 586 – Promina)

The requirement for the settlor to be a relative or legal guardian (or associates) under section CQ 5(6)(a)(i) and section DN 6(5)(a)(i) should be removed.

Comment

The NZ$50,000 de minimis threshold for application of the new offshore tax rules would be available to a small minority of trusts. That is, where the trust arises under the operation of the law and the settlor of the trust is a relative or legal guardian of the beneficiary or a person associated with a relative or legal guardian of the beneficiary and is required by a court order to pay damages to the beneficiary; when the settlor is the ACC; and when the trust is of the estate of a deceased person. As noted earlier, family trusts which are discretionary trusts would not get the benefit of the de minimis exemption.

We consider that the requirement for the settlor to be a parent or legal guardian is consistent with a similar provision in the tax rules for minor beneficiaries. However, officials consider that an amendment should be made to this provision to include the situation where an estate is the settlor and a Court order requires the proceeds of damages or compensation to be held on trust for the beneficiaries of the relevant trust.

Recommendation

That the submission be accepted in part, subject to officials' comments.

Issue: Separate de minimis for nominal value investments

Submission
(597 – PricewaterhouseCoopers)

There should be a separate de minimis available to all taxpayers in respect of specific FIF interests (e.g. memberships in professional organisations), where the interest has a nil or nominal value and where there have been no distributions of income from the FIF.

Comment

Officials do not consider that mere membership in a professional organisation of the type mentioned would normally result in a member having an interest subject to the FIF rules. Officials therefore consider it is unnecessary to have a specific exemption in these circumstances.

Recommendation

That the submission be declined.

Issue: Extending de minimis to indirect interests

Submissions

(592 – Tower, 560 – Institute of Financial Advisers, 577 – ASB Group, 1142 – Carter Holt Harvey Employee Benefits Plan and Retirement Plan, 1131 – David Patterson (MinterEllisonRuddWatt))

The NZD$50,000 de minimis exemption should be expanded to include individuals who invest in managed funds. Where the total value of an investor's investments are below the de minimis, irrespective if these are invested directly or through managed funds, they should not be subject to the FIF rules.

The de minimis should be applied to work-based savings schemes, based on the average account balance allocated to overseas shares.

A certification regime could be adopted which would allow investors to certify that their investments outside New Zealand and Australia are less than $50,000 with the result being that they are exempt under the PIE regime.

Comment

The rationale for the de minimis is to provide relief for investors with modest portfolios where the cost of compliance with more complex tax rules would outweigh the additional accuracy of applying such rules – the purpose of the de minimis is not to provide a tax concession as such. This compliance cost reduction rationale does not apply to offshore investments held via managed funds, as it is the fund who would be complying with the offshore tax rules and their scale should mean that they are able to comply with more accurate tax rules.

Recommendation

That the submissions be declined.

Issue Reduction in investments bringing portfolio below de minimis

Submission

(570 – Richard Entwistle)

The submitter asks if the value of a portfolio falls below $50,000 for any reason, whether the exemption would apply. The value of the portfolio may fall due to redemption or a fall in market value.

Comment

The de minimis is based on the cost of offshore shares held rather than their market value. This is so taxpayers can refer to actual cost when determining whether the de minimis applies to them, rather than having to track market values over time. Where an investor holds shares in a year costing more than the de minimis and disposes of a sufficient quantity of them during the same year to bring the cost of shares held under the de minimis, they will still be subject to the new offshore tax rules in that year (as they have held shares costing greater than NZD$50,000 for part of the year). They will, however, receive the benefit of the de minimis in the following year, to the extent they do not purchase any additional shares in that year.

Recommendation

That the submission be noted.

FIF INTERESTS HELD BY CFCS

Submission
(597 – PricewaterhouseCoopers)

An exemption from the new FIF rules should apply for grey list FIF interests held by a grey list CFC. Alternatively, a tax credit mechanism needs to be introduced to ensure that excess New Zealand taxation does not arise.

Comment

Officials consider there is no basis for exempting a grey list FIF interest held through a grey list CFC. Under New Zealand's current controlled foreign company rules, non-grey list FIF interests held via a grey list CFC are required to be attributed directly to the New Zealand shareholders in the CFC. The proposed offshore tax changes would extend this attribution requirement to less than 10% grey list interests held by CFCs, as the grey list exemption is being removed for portfolio investments (other than for investments in Australian-resident listed companies). This is appropriate as a less than 10% grey list interest would be subject to the new offshore tax rules if it were held by a New Zealand-resident directly.

Recommendation

That the submission be declined.

FIF INCOME AND TRUSTS

Issue: Treating unrealised gains as beneficiary income

Submission
(597 – PricewaterhouseCoopers)

The tax rules should clarify that a trustee can treat FIF income from unrealised gains as beneficiary income.

Comment

Whether unrealised gains (such as FIF and accrual income) are beneficiary income is an existing issue. Officials consider that this matter is outside the scope of the bill.

Recommendation

That the submission be declined.

Issue: Calculating FIF income using same methods as a natural person

Clause 58

Submission
(1221 – Ernst & Young)

Qualifying trusts should be able to calculate their FIF income limit under section EX 44C(2) in the same way as natural persons. Although the proposed treatment for qualifying trusts may be concessionary where dividend yields are lower than 5% of opening value, from a policy perspective there seems to be no reason to treat qualifying trusts any differently to natural persons.

Comment

Officials consider this issue would not need to be addressed if the recommendation to replace the smoothed market value method with the fair dividend rate method is accepted.

Recommendation

Officials have recommended that the market value and smoothed market value methods be replaced with the fair dividend rate method. If this recommendation is accepted the issue in this submission will no longer be applicable.

TRANSITIONAL ISSUES

Clause 71

Issue: Value at which offshore interests enter the new rules

Submission
(597 – PricewaterhouseCoopers, 608 – ING, 592 – Tower, 595 – AXA, 556 – AMP, 568 – Corporate Taxpayers Group, 575 – Direct Broking, 1484 – Alexander Wilson, 734 – Todd Corporation, 674W – Waterfront Industry Superannuation Fund, 692 – Lyon Family Trust)

Both individual and non-individual investors with investments on capital account should use the same basis (i.e. higher of cost or market value) for determining the value at which offshore interests enter the new rules.

All investors should be able to elect higher of cost or market to enter the regime to recognise earlier losses. Currently this is restricted to individuals holding on capital account.

Comment

The issues outlined in submissions would be superseded if the market value and smoothed market value methods are replaced by the fair dividend rate method.

In the context of the fair dividend rate method it is appropriate that all taxpayers enter the new offshore tax rules at the market value of their investments on the start date of the new tax rules (which for most individuals will be 1 April 2007). It would not be in the interests of individual investors to have the higher of cost or market value under the fair dividend rate method as the higher amount would result in more tax being payable.

Recommendation

That all offshore portfolio investments should enter the new offshore tax rules at their market value on the start date of the new tax rules.

Issue: Spreading tax payable on revenue account gains

Submission
(596 – ISI, 604W – Meat Industry Superannuation Scheme)

The notional windup on 1 April 2007 will result in tax being paid early (on 85% of share gains) rather than on realisation (at 100%) sometime in the future. The tax arising on shares in grey list countries (other than Australia) held on revenue account, as a consequence of transitioning into the new FIF rules, should be allowed to be spread over three years.

As drafted, only PIEs will be allowed to smooth the transitional tax obligation created by the offshore tax changes over three years. This transitional provision should be available to all entities.

Comment

Investors who hold grey list equities on revenue account should be required to undertake a deemed disposition at market value on 31 March (on entry into the fair dividend rate method), to crystallise any revenue account gains up to this date. Accordingly, draft section EX 54B(2) should be omitted and draft section EX 54B(3) amended to include revenue account investors.

Given that in many cases this deemed disposition for revenue account investors will accelerate the tax that would otherwise be payable, it is reasonable for this tax to be able to be spread over three years and for it not to affect provisional tax or use-of-money interest.

Recommendation

That the submission be accepted in the context of the new fair dividend rate method, subject to officials' comments.

Issue: Entry into FIF rules for non-standard balance date taxpayers

Submission
(589 – KPMG)

The transitional rules in section EX 54B do not cater for taxpayers with early or late balance dates.

Comment

Officials agree with the submission and note that this issue has been addressed in the Supplementary Order Paper No. 44 introduced on 20 June 2006.

Recommendation

That the submission be accepted.

GENERAL FIF ISSUES

Issue: Migration of persons holding FIF interests

Clause 69

Submission
(585 – NZ Exchange-listed UK Investment Trust Companies)

The crystallisation of a liability for unrealised capital gains on cessation of NZ tax residency should be removed.

Comment

The FIF rules currently provide for a deemed realisation of a person's FIF interests if that person ceases to be a New Zealand resident. Officials consider that this should not be changed.

Recommendation

That the submission be declined.

Issue: Removal of FIF income from provisional tax rules

Submission
(585 – NZ Exchange-listed UK Investment Trust Companies)

FIF income assessed under the bill should be placed outside the provisional tax regime.

Comment

Under the fair dividend rate method, the taxable income in a year would be a maximum of 5% of the opening market value of a person's total portfolio of offshore shares at the start of the year. This certainty should alleviate provisional tax concerns for most investors. Investors would also be able to plan for this tax liability (an average dividend yield of around 2% on their portfolio would be sufficient to meet the resulting tax liability under the fair dividend rate for a 39% taxpayer). Officials also consider there is no policy reason for generally excluding investors subject to the FIF rules from the provisional tax rules.

Recommendation

That the submission be declined. It should be noted that provisional tax concerns for most investors should be largely addressed by the proposed fair dividend rate method.

Issue: Exemption for employment-related foreign pensions

Submission
(585 – NZ Exchange-listed UK Investment Trust Companies)

Overseas employment-related pensions held by New Zealand tax residents should be excluded from the FIF regime.

Comment

Officials note that there are already extensive exemptions for employment-related superannuation interests contained in sections EX 36 and EX 37 of the Income Tax Act 2004. These exemptions will typically exclude from the FIF rules the foreign pensions of persons who migrate to New Zealand. Officials do not consider that further exemptions are justified.

Recommendation

That the submission be declined.

Issue: Extension of rollover relief on reinvestment

Clause 58

Submission
(560 – Institute of Financial Advisers)

The rollover relief available for reinvestment offshore should be extended for six months beyond the end of the tax year.

Comment

Officials consider this issue would not need to be addressed if the recommendation to replace the smoothed market value method with the fair dividend rate method is accepted, as there is no wash-up when shares are sold under the fair dividend rate method (and hence no need for rollover relief in relation to gains on disposal).

Recommendation

Officials have recommended that the market value and smoothed market value methods be replaced with the fair dividend rate method. If this recommendation is accepted the issue in this submission will no longer be applicable.

Issue: Research and development register exemption

Submission
(565 – NZBio)

An additional exception could be developed where investors in companies that are on a research and development company "register" are exempt from the FIF rules. Companies that attribute more than 50% of their expenditure on research and development could elect to be included on the register.

Comment

Officials have recommended, earlier in this report, an exemption from the offshore tax rules for investments in New Zealand start-up companies that move offshore to gain access to finance. We consider that this exemption is sufficient to deal with the concerns raised.

Recommendation

That the submission be declined.

Issue: Restriction on what is a FIF interest

Submission
(568 – Corporate Taxpayers Group)

Unlisted portfolio investments should be exempted from the proposals or another practical solution, such as further income calculation methods, should be implemented. For unlisted portfolio investments (and unlisted non-grey list FIFs where the investor holds more than 10% of the entity) the proposed methods are not always applicable or comparable to the true economic result.

Comment

Officials consider the proposed cost-based variant of the fair dividend rate method should cater for portfolio interests in entities for which market values are not available (for example, investments in unlisted offshore companies).

Recommendation

That the submission be declined.

Issue: Family companies

Submission
(568 – Corporate Taxpayers Group)

Investments in family companies have a different genesis to normal international investments. They are not of the nature that competes with investments held in funds. They should be excluded from the ambit of the proposed regime.

Comment

Officials consider that a general exemption from the FIF rules for portfolio investments in family companies could allow investors to circumvent the offshore tax rules by investing through an unlisted offshore company. As noted in response to the previous submission, the proposed cost-based variant of the fair dividend rate method should cater for investments in family companies if such an investment has no market value. More importantly, investments in family companies would not be subject to the new offshore tax rules if they comprise a 10% or greater interest in a grey list company.

Recommendation

That the submission be declined.

Issue: Exemption from wash-up requirements

Clause 58

Submissions
(575 – Direct Broking, 1142 – Carter Holt Harvey Employee Benefits Plan and Retirement Plan, 492, 880 – First NZ Capital, 510 – Liontamer)

The elimination of the accumulated tax liability on capital gains on offshore investments on the death of the investor (as proposed at present) should be extended such that any carry forward gains are extinguished after 10 years of continuous offshore investments and upon the investor reaching the age of 65 years.

The requirement to pay tax on gains above the 5% level by a work-based savings scheme, when capital is repatriated to New Zealand, should be removed.

Comment

Officials consider this issue would not need to be addressed if the recommendation to replace the smoothed market value method with the fair dividend rate is accepted. As there would be no wash-up under the fair dividend rate method, no relief for tax on accumulated gains is necessary.

Recommendation

Officials have recommended that the market value and smoothed market value methods be replaced with the fair dividend rate method. If this recommendation is accepted the issue in this submission will no longer be applicable.

Issue: Redefinition of capital/revenue boundary

Submission
(587 – Russell Investment Group)

A new definition of capital gains should be introduced so that an increase in the value of an investment held for more than 12 months should be defined as a capital gain, and for less than 12 months as income. This approach is used in the United States. Adopting this definition would immediately remove the differences between direct investors and investors in pooled vehicles and remove the tax bias in favour of or against overseas versus New Zealand investments.

Comment

Officials consider that a proposal to tax all gains on shares (New Zealand and offshore) held for more than 12 months would be arbitrary. New Zealand does not have a general capital gains tax. Instead, the tax system deems certain gains to be income (for example, if the gains are derived as part of a taxpayer's business). The United States tax treatment is therefore not comparable as the United States has a comprehensive capital gains tax.

The proposed fair dividend rate should remove the key tax distortions between investing in offshore shares directly and via New Zealand managed funds. The application of the fair dividend rate method should also result in a reasonable level of tax being payable on offshore investments, compared to the status quo. This should achieve a better alignment with the current tax treatment of investments in New Zealand companies.

Recommendation

That the submission be declined.

Issue: Foreign currency conversions

Submission
(1221 – Ernst & Young, 657W – Sothertons)

The legislation should provide explicitly for the New Zealand currency amounts which need to be included as opening values, carried income or carried loss amounts in years following the first year in which a FIF income calculation is performed.

It is not clear if calculations would be made firstly in the foreign currency amount and then converted to NZ$ at the conclusion of the calculation or whether the calculation would use the converted NZ$ balances.

Comment

Officials agree that the foreign currency conversion provisions in the FIF rules need to be made more certain as to how they should be applied from year to year. In particular, having chosen a currency conversion method – actual rates or an annual average rate – for an attributing interest in an FIF the same method should be used in subsequent years for that interest.

In respect of the fair dividend rate method, a person should be required to use the same currency conversion method – that is, either actual (spot) exchange rates or an annual average rate – for all attributing FIF interests for which the fair dividend rate method is used.

Recommendation

That the foreign currency conversion provisions under the FIF rules be clarified in accordance with officials' comments.

Issue: Shares which have no cost

Submission
(1221 – Ernst & Young)

The legislation should be amended to specify the value of shares which have been gifted or inherited. This is particularly important with respect to the de minimis.

Comment

Officials consider that the Income Tax Act 2004 already provides that shares that have been gifted or inherited are treated as being acquired for an amount equal to their market value: subpart FI and section GD 14(3) and (4). This deemed market value rule would also apply for the purposes of the NZ$50,000 de minimis exemption from the offshore tax rules.

Recommendation

That the submission be declined.

Issue: Reduction in number of methods

Submission
(577 – ASB Group)

In light of the opportunity to simplify the current offshore investment tax rules, the options available to portfolio investors to calculate offshore investment income should be reduced to three alternative methods: the cost method, the market value method and the smoothed market value method.

Comment

The branch equivalent and accounting profits method are currently available under the FIF rules and should not be removed from the suite of available FIF calculation methods for portfolio investments (that is, investments of less than 10% in foreign companies). We note that these methods can currently be used in respect of portfolio investments in non-grey list companies and should continue to be available for taxpayers who can use them. These methods attempt to tax the investor on their share of the foreign entity's underlying earnings.

Officials also consider that the comparative value and deemed rate of return methods should be retained in respect of offshore portfolio investments for which the fair dividend rate is not allowed (that is, investments which generate so-called "guaranteed returns").

Recommendation

That the submission be declined.

Issue: Alternative FIF method for unlisted widely held companies

Submission
(965, 1226 – Deloitte, 1192 – Alistair Tod)

Investors who hold investments in widely held unlisted companies are for practical purposes left with only one method to calculate income – this being the cost method. Consideration should be given to allowing individuals to adopt a modified accounting profit method. Under this method, tax payable in New Zealand would be the greater of the share of profit of the company or actual dividend distributions. This could operate similarly to the smoothed market value method but rather than adopting market values, accounting profits would be the basis of the calculation.

Comment

Officials consider that there would be sufficient FIF calculation methods to cater for different taxpayers' circumstances, if the branch equivalent and accounting profits methods were retained, in addition to the proposed fair dividend rate and cost-based methods. We therefore do not consider that a further income calculation option is necessary or desirable.

Recommendation

That the submission be declined.

Issue: Making the international tax regime a code

Submission
(577 – ASB Group)

The new international tax regime should be drafted as a legislative code. Once a particular income stream has been subject to the new international tax regime, no other provisions of the Income Tax Act 2004 should apply to that income.

Comment

Officials consider that this issue will be addressed if the recommendation to replace the market value and smoothed market value methods with the fair dividend rate method is accepted. Under the fair dividend rate method, offshore shares will not be taxed outside the FIF rules. In particular, dividends will not be separately taxable.

Recommendation

That the submission be noted.

TECHNICAL AND DRAFTING ISSUES

Issue: Market value references

Clause 58

Submission
(12a – NZ Funds)

"Market value" should be defined and where it is not clear what market value should be, "fair value" adopted for accounting should be sufficient.

Comment

Officials note that "market value" is a general concept used in the Income Tax Act 2004 and should be sufficient for the purposes of applying the proposed fair dividend rate method. "Market value" has been used in the FIF rules since their inception in 1993. The tax rules do not currently contain a "fair value" concept and officials consider that introducing such a concept would create uncertainty.

Recommendation

That the submission be declined.

Issue: Attributing interest terminology

Submission
(12a – NZ Funds)

The drafting should be clarified by replacing references to "FIF interests" with "attributing interest" terminology.

Comment

Officials agree with this submission.

Recommendation

That the submission be accepted.

Issue: Carried forward FIF income definition

Clause 58

Submission
(12a – NZ Funds, 578 – NZICA, 965, 1226 – Deloitte)

The reference to "FIF income" in section EX 44C(13)(a)(ii) should be amended to "formula FIF income" and the reference to "FIF loss" in section EX 44C(13)(a)(iii) should be amended to "formula FIF loss".

Comment

Officials consider this issue does not need to be addressed if the recommendation to replace the smoothed market value method with the fair dividend rate method is accepted.

Recommendation

Officials have recommended that the market value and smoothed market value methods be replaced with the fair dividend rate method. If this recommendation is accepted the issue in this submission will no longer be applicable.

Issue: Limits on changing FIF calculation methods

Clause 66

Submission
(12a – NZ Funds)

Section EX 50(2)(d), which allows a taxpayer to change their FIF income calculation method from the cost method in certain circumstances, should be clarified.

Comment

Officials consider that the current drafting is sufficiently clear.

Recommendation

That the submission be declined.

Issue: Redundant New Zealand-resident-reference

Clause 51

Submission
(589 – KPMG)

Proposed section EX 33(1)(c)(i) includes a New Zealand-residence requirement. This reference is redundant because the FIF rules apply only to New Zealand residents and therefore should be omitted.

Comment

Officials agree with this submission but note that this provision in EX 33(1)(c) is being replaced as part of amendments proposed to the exemption as currently drafted.

Recommendation

That the submission be noted.

Issue: Drafting of wash-up provision in cost method

Clause 60

Submission
(1239W – Blackmore Virtue & Owens)

The effect of the formula contained in section EX 45B(2)(b) for a person who has to use the cost method for a FIF which is acquired in the income year of disposal is that they are taxed on 85% of the disposal proceeds with no deduction for the cost of the investment.

Also section EX 45B(2)(b) only gives a deduction from the disposal proceeds of cost plus past gains recognised without grossing those gains up by dividing them by 0.85. That is, tax is being charged on the 15% of the unrealised gains which have previously been excluded.

Comment

Officials consider this issue does not need to be addressed if the recommendation to replace the cost method currently in the bill with a cost-based variant of the fair dividend rate method is accepted. If this recommendation is implemented then the submission will be superseded because a consequence of the replacement of methods is that the wash-up in section EX 45B(2)(b) will be removed.

Recommendation

If the recommendation to replace the cost method currently in the bill with a cost-based variant of the fair dividend rate method is accepted, this submission will no longer be applicable because there would be no wash-up under the new proposal.

Issue: Foreign unit trusts

Submission
(597 – PricewaterhouseCoopers, 577 – ASB Group, 468W – Platinum Asset Management)

The current section CD 7 and the section OB 1 definition of "taxable bonus issue" should be repealed in light of the proposed changes in the international tax regime. There is no longer a need for this legislation as the proposed regime will tax 85% of the movement in market value of any bonus units retained by unit holders and 85% of the proceeds from units disposed of where these units are repatriated. If retained, these bonus issues would be taxed at 100% if treated as dividends compared to 85% for bonus issues in a company.

Comment

In light of the recommendation earlier in this report to exclude investments in certain Australian unit trusts from the new offshore tax rules, we consider that it is necessary to retain the recently enacted provisions which treat bonus issues arising from foreign unit trusts as dividends for tax purposes. If these amendments were repealed, the previous base maintenance problem would recur in respect of investments in Australian unit trusts that are exempt from the new FIF rules.

Recommendation

That the submission be declined.