Regulatory Impact Statement

Taxation of Non-Resident Investment in Portfolio Investment Entities

Agency Disclosure Statement

This Regulatory Impact Statement ("RIS") has been prepared by Inland Revenue.

This RIS considers the issue of removing a potential barrier to attracting non-resident investment into New Zealand managed funds by ending the current over-taxation of non-residents who invest in portfolio investment entities ("PIEs").

New Zealand generally operates a source and residence basis taxation system, whereby residents are taxed on their worldwide income and non-residents are taxed on their New Zealand-sourced income. However, a non-resident investing through a PIE is currently taxed on both their New Zealand-sourced and foreign-sourced income at the top PIE tax rate of 28 percent. This treatment is inconsistent with how a non-resident investor would be taxed if they invested directly into foreign and New Zealand assets (as opposed to through a New Zealand entity, such as a company).

This proposal is intended to ensure that non-resident investors in PIEs are subject to roughly the same tax treatment on the income they earn as would apply if they invested directly. This includes introducing a zero percent tax rate on foreign-sourced income earned by a non-resident through a PIE, as proposed during the 2009 Jobs Summit. The way that this is addressed is balanced with ensuring that the new rules are reasonably easy for existing and prospective PIEs to comply with, given their current systems.

Other than set out in this Disclosure Statement and the broader RIS, no significant gaps, assumptions, dependencies, constraints, caveats or uncertainties have been identified. It should also be noted that our analysis relies on data provided by the funds management industry on the potential benefits from removing the current tax on foreign-sourced PIE income of non-residents.

In preparing this statement, we have worked closely with the Treasury, which agrees with our analysis.

In addition, extensive consultation on the proposal has been undertaken with the managed funds industry and tax advisors. Their views have been taken into consideration in the design of the proposed amendments to the taxation laws (as outlined in the body of the RIS).

The amendments do not impose additional costs, impair private property rights, reduce market competition, provide disincentives to innovate and invest or override common law principles.

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STATUS QUO AND PROBLEM DEFINITION

1. This RIS considers how the current over-taxation of non-resident investors in portfolio investment entities ("PIEs") may be removed.

2. A non-resident investing through a PIE is currently taxed on their income (whether New Zealand-sourced or foreign-sourced) at the top PIE tax rate of 28 percent. This treatment is inconsistent with how a non-resident investor would be taxed if they invested directly. In particular, a non-resident investing directly would not be subject to New Zealand tax on their foreign-sourced income. This is because the tax system generally follows the principle that non-residents should only be subject to tax in New Zealand on their New Zealand-sourced income.

3. The proposal to remove the tax on foreign-sourced PIE income earned by non-residents investing into a PIE was first raised during the Jobs Summit in January 2009. It was considered that the imposition of tax in this situation potentially acts as a barrier to the development of New Zealand's fund management industry as it may discourage non-residents from investing offshore through PIEs.

4. In addition, the Capital Market Development Taskforce ("CMDTF") recommended pursuing opportunities to develop New Zealand as an exporter of high-value middle and back-office services for fund management companies in its final report to Government in December 2009. One of the areas the CMDTF identified where New Zealand could export financial market services is in the Asia-Pacific region.

5. The Government also established an advisory group, the International Fund Services Development Group ("IFSDG"), to report back on how New Zealand could successfully position and market itself as an international funds domicile. The Government is interested in how this positioning might create opportunities for strengthening New Zealand's funds management industry and capital markets, and raise New Zealand's profile as a successful niche player in financial services.

6. While conceptually it is clear that non-resident PIE investors should not face tax on their foreign-sourced income, the PIE rules are complex and any changes to the current rules would need to be very carefully developed in consultation with the managed funds industry, in order to ensure that they are able to be administered by PIEs.

7. Currently, very few non-residents invest in New Zealand PIEs, so minimal tax is actually paid on foreign-sourced income. This is due to the intensely domestic orientation of the local financial services industry, i.e. very few New Zealand firms manage investments for non-resident investors. In the absence of any change, the current situation where very few non-residents invest in PIEs would continue.

OBJECTIVE

8. The objective is to lift a potential barrier to attracting more foreign investment into New Zealand managed funds by removing the over-taxation of non-resident investors in PIEs.

9. As mentioned above, the imposition of tax on non-resident investors on foreign sourced PIE income was identified by the Job Summit and the CMDTF as a barrier to the

development of New Zealand's fund management industry, as it discourages non-residents from investing in New Zealand PIEs.

10. We note that, in the absence of other data, our analysis relies on data from the financial services industry on the benefits that will accrue to New Zealand funds from removing the over-taxation of non-resident investors in PIEs.

11. The financial services industry estimates that removing the tax for non-resident investors on foreign-sourced PIE income would result in $1 million a year in cost savings.

12. Furthermore, the financial services industry considers that removing the over-taxation of non-resident investment through PIEs (in combination with other regulatory measures) could lead to a percentage of global market back-room and administrative services migrating to New Zealand. New Zealand is seen as being a suitable base for these services because of the regulatory framework, political stability, lack of corruption and exchange controls, and the difference in time zones which allows New Zealand to process overnight transactions which are made that day in Europe or the United States.

13. The financial services industry estimates that New Zealand could gain a market share of these activities after 10 years of development. Assuming revenues of 1 percent of assets under management and a 30 percent profit margin, this could create approximately NZ$1 billion of profits and approximately NZ$300 million in taxes.

14. A constraint is that, as an OECD member, New Zealand must ensure that any tax regime does not contravene the principles set out in the OECD report on harmful tax practices. The factors identified by the OECD as indicating harmful tax practices are:

a. A low or zero effective tax rate on the relevant income.

b. Ring-fencing to restrict the tax benefits to non-residents or prevent non-residents from accessing the domestic market. Ring-fencing effectively protects the sponsoring country from the harmful effects of its own incentive regime, so that the regime only has adverse effects on foreign tax bases. As a result, the country offering the regime may bear little or none of the financial burden of its own preferential tax legislation.

c. A lack of transparency in the way the regime is designed and administered. Non-transparency is a broad concept that includes favourable application of laws and regulations, negotiable tax provisions, and a failure to make administrative practices widely available.

d. A lack of effective exchange of information in relation to taxpayers benefiting from the operation of the preferential tax regime.

15. The risks associated with New Zealand's international tax obligations have been considered carefully when developing the proposal for taxing foreign-sourced income derived by a non-resident through a PIE at zero percent. For example, an option which has only non-residents and foreign-sourced income is unlikely to be consistent with New Zealand's international tax obligations – this is because it may be considered to be a harmful tax practice as it precludes residents from investment.

16. A further constraint is ensuring that the new rules are relatively easy for existing and prospective PIEs to implement and comply with, given their different systems.

REGULATORY IMPACT ANALYSIS

17. We have identified two options that could address the problem. These options are designed for two different categories of PIE, so are not mutually exclusive.

a. *Option one (foreign-sourced income only):* This option applies to a PIE with non-resident and resident investors and only foreign-sourced income and allows a zero percent rate of tax to apply to foreign-sourced income earned by non-residents. In addition, we proposed that under this option, the PIE could have a *de minimis* of 5 percent for New Zealand-sourced interest income. This would mean that a PIE could earn up to 5 percent New Zealand-sourced interest income and remain eligible for the zero rate. The rationale for the *de minimis* was to ensure that PIEs could hold sufficient cash reserves in order to meet applications, redemptions and day-to-day expenses, without disqualifying the PIE.

b. *Option two (mix of foreign and domestic income):* This option applies to a PIE with non-resident and resident investors and foreign-sourced and New Zealand-sourced income. The PIE would be required to track each type of income derived and apply different rates.

A further option that was considered, but not followed, was to allow a PIE to have both resident and non-resident investors and a mix of foreign-sourced and New Zealand-sourced income with two rates applying: zero percent for foreign-sourced income and 28 percent for New Zealand-sourced income. In light of consultation, it was decided not to proceed with this option as it did not seem to provide any additional advantages over options one and two.

Option one:

18. This is simpler to legislate for and comply with as, unlike option two, it does not require tracking of different types of income. However, this option does not remove the over-taxation of non-resident investment in New Zealand assets through a PIE, since the PIE cannot hold New Zealand assets.

19. There may be some compliance costs for PIEs that decide to elect into option one (which are not quantifiable as they may vary). However, there may also be cost reductions for existing New Zealand firms which manage foreign funds. In addition, there are methods to reduce compliance costs for PIEs that elect into this option, such as providing a *de minimis* for New Zealand-sourced interest income in order to ensure that PIEs can hold sufficient cash reserves to meet applications, redemptions and day-to-day expenses, without disqualifying them from this option.

Option two:

20. Option two provides more flexibility (and in fact option one is a sub-option of option two). It could also provide greater benefits, for example, by allowing PIEs to be used as vehicles for non-residents to hold New Zealand debt. However, it is more complex to legislate for and for PIEs to implement and comply with, as it may involve significant systems changes. This is because PIEs will need to track different types of income and apply different rates.

21. The fiscal impact of both options is expected to be minor (less than $10 million per annum). This is because very few non-residents currently invest through PIEs, so very little tax revenue is collected by taxing their foreign-sourced PIE income. The financial services industry estimates that New Zealand could gain a market share of these activities after 10

years of development. Assuming revenues of 1 percent of assets under management and a 30 percent profit margin, this could create approximately NZ$1 billion of profits and approximately NZ$300 million in taxes. In addition, there may be spin-off effects for New Zealand investors who will be able to access the benefits of scale in the new funds. This may lead to a decrease in aggregate fees charged for fund administration and investment services.

22. Neither option has social, environmental or cultural impacts.

23. The two groups that would be affected by the proposed amendments are the fund management industry and non-resident investors earning foreign-sourced PIE income. New Zealand resident investors are not affected by the proposal.

24. A number of modifications to the options were incorporated in light of feedback received during consultation (this is outlined below).

CONSULTATION

25. The introduction of a zero percent tax rate for foreign-sourced income earned by non-resident investors through a PIE was first raised as a proposal during the Job Summit in 2009.

26. An officials' issues paper *Allowing a zero percent tax rate for non-residents investing in a PIE* was released for consultation in April 2010, outlining the two options (listed above in the RIS) for implementing a zero percent tax rate for foreign-sourced income of non-resident investors earned through a PIE. Option 1 would allow resident and non-resident investors to invest in a PIE that derived only foreign-sourced income. Option 2 would allow a PIE to have both resident and non-resident investors and New Zealand and foreign-sourced income but with different tax rates applying to different types of income derived by non-resident investors.

27. Twenty-six submissions were received from tax practitioners and fund managers. Submissions were supportive of the proposed PIE tax changes and generally favoured either option 2 or allowing both options. Furthermore, submitters considered it important that the new rules should be optional for funds to elect into.

28. Further consultation was undertaken in February this year on how best to achieve the objective of removing the current over-taxation of non-resident investment into PIEs and the design of two new categories of PIE (corresponding to the two options or categories outlined in the issues paper).

29. The key feedback received from this further consultation was the need for simplicity and flexibility to cater for the diverse range of systems which PIEs have in place. Concerns were raised about the complexity of the Category 2 PIE (corresponding to Option 2 above), in particular, the need to work out deductions and expenses. Accordingly, a key theme from feedback was the desirability of simplifying the rules that would apply to the Category 2 PIE.

30. Therefore, the proposal has been revised to address the concerns regarding complexity. The key amendment is to add a restriction preventing the two new PIE categories from investing directly into New Zealand land. This would remove the need for PIEs to calculate deductions and expenses with respect to their non-resident investors (where a non-resident invests directly, deductions are only allowed in relation to New Zealand-sourced income

taxed on a net basis, essentially income from land). This then allows a blanket rule prohibiting any deductions for non-residents investing in Category 2 PIEs.

31. Submitters also suggested reducing the number of tax rates for different income types that the Category 2 PIE would need to apply in relation to non-resident investors. The rates we proposed were in line with the rates that would apply if a non-resident invested directly:

(i) 0% on foreign-sourced income;

(ii) 0% on dividends derived from New Zealand companies that are fully-imputed;

(iii) 15% on dividends derived from New Zealand companies that are unimputed where the investor is from a country with which New Zealand has a double tax agreement ("DTA");

(iv) 30% on dividends derived from New Zealand companies that are unimputed where the investor is from a country with which New Zealand does not have a DTA;

(v) 1.44% on New Zealand-sourced interest income (being the deductible approved issuer levy ("AIL") rate).

32. Submitters proposed that AIL be reduced to zero percent, in line with the changes contained in the Taxation (International Investment and Remedial Matters) Bill 2010 in relation to widely-held bonds. They also suggested removing the 30 percent rate for unimputed dividends where an investor is from a country with which New Zealand does not have a DTA. We have considered these proposals but, on balance, believe that these rates should remain in place. This is to ensure that non-residents investing in the Category 2 PIE are subject to the same tax rates on their income as if they invested directly.

33. Another suggestion from submitters was to bring forward the application date for the Category 1 PIE (corresponding to Option 1 above) to the date of enactment, as this would enable some funds to launch prior to 1 April 2012. We agree that the application date for the Category 1 PIE can be brought forward as suggested.

34. With respect to the proposed 5 percent *de minimis* under the Category 1 PIE for New Zealand-sourced interest income, feedback from consultation was mixed – some submitters supported the 5 percent threshold, while others thought it should be raised to 10 percent, in line with cash requirements contained in some fund mandates. Some submitters also suggested that a *de minimis* of 1 percent for holding New Zealand shares would be helpful under Category 1. We agree with this suggestion, as it would allow funds which track a global index, and hold some New Zealand equities as part of this, to elect into the Category 1 PIE option.

35. A further suggestion from some submitters was that the proposal should be extended to cover listed PIEs (a type of portfolio investment entity that is a listed company). We consider that further analysis is required with respect to extending the current proposal to encompass listed PIEs. Accordingly, the proposal does not propose any changes to the treatment of non-residents investments in listed PIEs.

36. A number of minor technical issues were also raised, which officials are working through. These will be reflected in the legislation.

37. Inland Revenue has worked closely with the Treasury, which agrees with the analysis and recommended option.

CONCLUSIONS AND RECOMMENDATIONS

38. The recommended option is to implement both options one and two outlined in this RIS:

a. a new category of PIE which entities could elect into ("Category 1") that has both resident and non-resident investors and only foreign-sourced income taxed at zero percent, subject to a 5 percent *de minimis* for New Zealand-sourced interest income and a 1 percent *de minimis* for New Zealand-sourced income from equities; and

b. a new category of PIE which entities could elect into ("Category 2") that has both resident and non-resident investors and both foreign-sourced income and New Zealand-sourced income, with the following tax rates applicable:

    (i) 0% on foreign-sourced income;

    (ii) 0% on dividends derived from New Zealand companies that are fully-imputed;

    (iii) 15% on dividends derived from New Zealand companies that are unimputed where the investor is from a country with which New Zealand has a double tax agreement ("DTA");

    (iv) 30% on dividends derived from New Zealand companies that are unimputed where the investor is from a country with which New Zealand does not have a DTA;

    (v) 1.44% on New Zealand-sourced financial arrangement income (being the deductible approved issuer levy ("AIL") rate).

39. This gives both PIEs and non-resident investors flexibility in terms of investment into foreign or New Zealand assets. It also ensures that non-resident investors in PIEs can be subject to the same tax rate on their foreign and New Zealand-sourced income as if they invested directly (this will result in a nil tax rate on foreign-sourced income). This makes investment into PIEs more attractive for non-residents.

IMPLEMENTATION

40. The necessary legislative changes are included in a Supplementary Order Paper to the Taxation (Tax Administration and Remedial Matters) Bill 2010, with application from either the date of Royal assent (for the Category 1 PIE) or 1 April 2012 (for the Category 2 PIE).

41. The new rules will be administered by Inland Revenue through existing channels. Existing PIEs will be able to elect to become one of the new PIEs by contacting Inland Revenue by phone, email or letter.

42. Compliance costs are minimised by making the new rules optional. In addition, the new PIEs will generally be subject to the same requirements that existing PIEs are subject to under taxation law.

43. The new Category 1 and 2 PIEs will generally be required to comply with the existing PIE return and information obligations, which are set out in the tax legislation. However, an additional requirement is that the new PIEs will be required to request certain information

from their non-resident investors, in order to facilitate meeting OECD exchange of information obligations, i.e. the tax file number of the non-resident in their home country, or if this cannot be provided, a declaration stating that they are unable to provide this information.

MONITORING, EVALUATION AND REVIEW

44. Inland Revenue will monitor the outcomes pursuant to the Generic Tax Policy Process ("GTTP") to confirm that they match the policy objective.

45. The GTPP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation, and the identification of remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as necessary following repeal would be added to the Tax Policy Work Programme, and proposals would go through the GTPP.