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*A special report from the*
Policy Advice Division of Inland Revenue

# Foreign Investment PIEs

This special report provides early information on the new Foreign Investment Portfolio Investment Entity (PIE) rules, which were part of the recently enacted Taxation (Tax Administration and Remedial Matters) Act 2011 (the Act). It precedes coverage of the new legislation that will appear in a *Tax Information Bulletin* to be published later in the year.

In summary, the Act introduces two new categories of PIE: "foreign investment zero-rate PIEs" and "foreign investment variable-rate PIEs". For the sake of brevity, these will be referred to as "zero-rate PIEs" and "variable-rate PIEs" in the rest of this document. PIEs and entities becoming a PIE will be able to become a zero-rate PIE from 29 August 2011 (the date the Act received Royal Assent) and a variable-rate PIE from 1 April 2012.

The rules for foreign investment PIEs aim to align the tax treatment of non-resident investors in PIEs with the tax treatment of direct investors. Resident investors in a foreign investment PIE will continue to be taxed as if they were in an ordinary PIE.

This report is intended to provide timely assistance to entities (whether currently a PIE or not) that are considering electing to be a foreign investment PIE. Further guidance on the new foreign investment PIE rules will be available over the coming months on Inland Revenue's website and in a *Tax Information Bulletin.*

## Background

When the portfolio investment entity (PIE) rules were originally developed in 2007, the focus was ensuring that the rules operated properly for resident investors in KiwiSaver funds. The rules were designed so the tax treatment of a resident investor in a PIE roughly matched that of direct investment into the PIE's underlying assets. This required reasonably complex rules in a number of areas. Given the complexity of the new rules and the systems changes for managed funds it was not practical at that time to also provide non-resident investors in a PIE a tax treatment similar to that of direct investors.

Non-resident investors are currently taxed at a flat 28 percent on their PIE income, regardless of the income's source and type. In many instances this rate is much higher than that which would apply had the investor invested directly into the PIE's underlying assets. For example, a non-resident investing in a foreign company would not be subject to New Zealand tax. This is because of the general principle underlying the tax system that non-residents should only be subject to tax on their New Zealand-sourced

income. Despite this, such an investment through an ordinary PIE would be taxed at 28 percent.

The PIE rules have had time to bed-down and the relevant legislation is now relatively settled. At the same time, various reports (most recently, the report of the International Funds Services Development Group) noted there is the potential for New Zealand to become a "financial hub" – providing back-office services to international managed funds. To take advantage of such an opportunity, the over-taxation of non-resident investors in PIEs would need to be resolved. This is the objective of the new foreign investment PIE rules.

## Key features

- The Act introduces two new categories of PIE: "foreign investment zero-rate PIE" (referred to as "zero-rate PIEs") and "foreign investment variable-rate PIE" (referred to as "variable-rate PIEs"). The rules for these PIEs aim to align the tax treatment of non-resident investors in the PIE with the tax treatment of direct non-resident investors. Resident investors in a foreign investment PIE will continue to be taxed as if they were in an ordinary PIE.

- The new rules are optional. PIEs do not need to elect to become one of the new types of PIE and can continue to apply the existing rules, where PIEs are taxed at 28 percent on the income attributable to non-residents.

- Zero-rate PIEs are generally only able to invest offshore. De minimis levels of New Zealand-sourced income are allowed, however. This allows such a PIE to finance its day-to-day operations with a New Zealand bank account, for example.

- Zero-rate PIEs are taxed at zero percent on all PIE income attributable to certain non-residents.

- Variable-rate PIEs can invest into both New Zealand and offshore assets.

- Variable-rate PIEs face a variety of different tax rates on income attributable to non-residents, depending on the type and source of the income.

## Application dates

The rules for zero-rate PIEs will apply from the date of Royal Assent of the Act 29 August 2011. The rules for variable-rate PIEs will apply from 1 April 2012.

## Detailed analysis

**Introductory provisions**
*Sections HM 2, HM 6 and YA 1*

Section HM 2 has been amended to include the two types of foreign investment PIE in the list of PIE types. Additionally, section HM 6 has been amended to set out the intended effects for investors in foreign investment PIEs - namely:

- that for a "notified foreign investor" in a foreign investment PIE, the PIE has a tax liability that resembles that of the investor if they were to make the investment directly; and,

- a notified foreign investor should have no tax liability on their PIE income unless they have been treated as a notified foreign investor when they do not in fact meet the relevant requirements.

A "notified foreign investor" is essentially a non-resident who has elected for the new rules to apply to them and has supplied the required information to the PIE. This concept is described more fully below.

Definitions have been inserted in section YA 1 for "foreign investment PIE", "foreign investment variable-rate PIE", "foreign investment zero-rate PIE" and "notified foreign investor".

**Notified foreign investors**
*Sections CX 56, HM 55D and YA 1*

The new tax treatment of investors in a foreign investment PIE applies to those who elect to become a "notified foreign investor". The relevant criteria for this election are set out in section HM 55D.

The general rule is that a notified foreign investor must be a non-resident. Specifically, a person cannot be:

(i) resident in New Zealand;

(ii) a controlled foreign company;

(iii) a non-portfolio foreign investment fund; or,

(iv) a non-resident trustee of a trust other than a foreign trust.

To target what is a non-portfolio foreign investment fund (FIF), the legislated restriction is that the item "income interest" in section EX 50(4) cannot be 10% or more for an investor. In effect, this means that if a FIF has a New Zealand-resident investor entitled to 10% or more of its income, either directly or indirectly, that FIF cannot elect to be a notified foreign investor.

Non-resident trustees of trusts other than foreign trusts cannot be a notified foreign investor. Such trustees are not taxed in the same way as other non-residents, so it is not appropriate for them to be treated as notified foreign investors. Similarly, resident trustees of foreign trusts are not able to be notified foreign investors as such trustees are taxed as New Zealand residents on any New Zealand-sourced trustee income.

In addition to a person not being one of the types described above, in order to be treated as a notified foreign investor, a person must also provide the PIE with the information set out in section 28D(1) of the Tax Administration Act 1994. Examples of required information are the person's name, address, country, and their tax file number in their home country (if applicable).

If an investor in a foreign investment PIE meets these requirements, the investor can notify the foreign investment PIE that they wish to be treated as a notified foreign investor. If the person meets the relevant criteria, they then become a notified foreign investor. Special rules apply when a person transitions to or from being a notified foreign investor as set out in section HM 55E. See "Change in status of investors" on pg 14 for more detail.

### *PIE relying on notification*

Investors must self-assess that they are a person who can be a notified foreign investor. Accordingly, a foreign investment PIE can rely on an investor's notification that they should be treated as a notified foreign investor.

The investor must provide the PIE with the information set out in section 28D(1) of the Tax Administration Act. If the investor does not, the PIE is unable to treat the investor as a notified foreign investor.

### *Ineligible investor treated as a notified foreign investor*

If an investor has been treated as a notified foreign investor when they do not in fact meet the relevant requirements, the investor will generally be treated in the same way as a resident investor who notifies a PIE of a tax rate that is too low. That is, section CX 56 will not apply to the PIE income attributed to them, so the income will not be excluded. If this is the case the investor should include the attributed PIE income in their tax return and is able to claim a tax credit for any tax paid by the PIE on their behalf.

An exception to this general rule is if one of the transitional rules in section HM 55E apply. These are described in more detail on pg 14.

### *Commissioner can override notification*

Although a PIE is able to rely on an investor's notification that they are eligible to be a notified foreign investor, section HM 55D(6) provides that the Commissioner of Inland Revenue is able to advise the PIE to disregard the investor's notification and treat them as an ordinary non-resident investing in a PIE, taxed at 28%. This notification must be on reasonable grounds.

**Calculation of income and tax liability for notified foreign investors**
*Sections DB 54B, HM 35C, HM 47, HM 55F, HM 64, HM 65 and schedule 6*

Foreign investment PIEs have special rules for calculating PIE income attributed to notified foreign investors and the associated tax liability.

***Calculating income***

The aim of the foreign investment PIE regime is to tax PIE income attributed to non-resident investors in a similar manner to a direct non-resident investor. To reflect this, expenses incurred in relation to notified foreign investors are non-deductible. This is provided by section DB 54B. Further, the calculation formulae in sections HM 35 to 47 are modified so any expenses cannot be subtracted from the income of a notified foreign investor. Carry-forward losses and land losses are similarly set to zero. It should be noted, however, that streaming is not allowed. Expenses and losses must still be attributed to notified foreign investors even though they cannot be utilised by them.

Section HM 35C(2) provides that, for the purpose of the calculations in sections HM 35 to 47, for each investor class, a foreign investment PIE must treat the notified foreign investors of that class *as if* they were in a separate notional investor class. The purpose of this rule is to split each investor class in two – one part containing investors to whom the normal PIE rules apply and one part containing notified foreign investors.

Importantly, it is not intended that a foreign investment PIE be forced to create a notional investor class for its notified foreign investors if there is a better way for the PIE to create the same result.

***Example***

In the current calculation period, ABC, a PIE, has derived $1000 in assessable income and incurred $100 of expenses deriving that income. In addition, ABC has $200 of formation losses that it can use in the period.

ABC has 2 investors, Rachael and Grant, who are each entitled to 50% of its distributions (for simplicity, assume that ABC does not need to meet the investor in requirements of the PIE rules). Rachael is a notified foreign investor and Grant is a resident investor with a 28% prescribed investor rate.

ABC must attribute Rachael's share of its expenses and formation losses; however, it cannot use these to reduce Rachael's net income. Her attributed PIE income is therefore equivalent to her share of the PIE's assessable income - $500.

As Grant is an ordinary resident investor he is able to benefit from ABC's expenses and formation losses. Grant will have attributed PIE income of $350, which is his share of ABC's income less his share of the expenses and formation losses.

The $50 of expenses and $100 of formation losses that ABC was not able to utilise (as they were attributed a notified foreign investor) are exhausted. They cannot be used in a later period.

***Correction of errors***

PIEs, on occasion, erroneously attribute an amount of income to an investor. In some cases it is not possible to directly undo this error, for example due to the passage of time. In such cases a PIE will often attribute an investor, in the current period, an offsetting negative amount of income, which effectively undoes the earlier error.

It is not intended for such an adjustment to be affected by section HM 35C, which modifies section HM 35 so expenses cannot be subtracted from a notified foreign investor's income. Such adjustments are considered to be accounting entries designed to correct earlier errors, so do not form part of the legislated formulae.

***Calculation of tax liability***

Section HM 47 is amended to establish how a notified foreign investor's tax liability should be calculated. Subsection (2B) clarifies that, for a notified foreign investor, the calculation in subsection (3) must be done for each investment type and source. This requirement is only relevant for variable-rate PIEs, for which different tax rates apply for different investment types and sources.

Linking in with this is section HM 55F(2), which requires a variable-rate PIE to identify the source and type (if it is not a foreign-sourced amount) of all amounts attributed to notified foreign investors. The different tax rates for income of differing types and sources are set out in schedule 6, table 1B. The requirement to perform the calculation in subsection (3) for each investment type and source does not apply to a

zero-rate PIE, as all its income attributed to a notified foreign investor is taxed at the same rate (0%).

There is no change in the tax liability calculation for investors other than for notified foreign investors in either type of foreign investment PIE.

Finally, if a notified foreign investor's tax liability is negative, new section HM 55F(6) provides that no tax credit arises.

**Optional flow-through rule**
*Section HM 6B*

PIEs often use a tiered investment structure, where retail PIEs invest through larger wholesale PIEs. New section HM 6B provides an optional flow-through rule to ensure this structure is compatible with foreign investment PIEs.

***Full flow-through***

Sections HM 6B(1) and (2) provide a rule ultimately designed to be used by variable-rate PIEs, however, the rule can be used by any type of PIE.

The flow-through rule allows a PIE (PIE A) to be treated as if it has derived another PIE's (PIE B's) income directly. If PIE A applies the flow-through rule, income from PIE B would not be "attributed PIE income" but would retain its character. This includes notional income, such as income under the fair dividend rate (FDR) regime, which is not paid to B but is deemed to be derived by it nonetheless.

The intention is that expenses charged to A by B will also be treated as incurred by A. This should be the case regardless of whether the charge is explicit (i.e. an invoice sent to A) or implicit (i.e. B takes out its charges from what it attributes to A). Nevertheless, these expenses will not be deductible if they are attributed to notified foreign investors or if there is no nexus with assessable income (for example, they were incurred in deriving untaxed amounts).

The flow-through rule is designed to look through multiple levels of PIE. For example, say PIE A invested into PIE B, which in turn invested into PIE C. B could use the flow-through rule for the income it derives from C, and in turn A could use the flow-through rule for the income it derives from B. In effect, A will be treated as if it has derived its share of C's income directly.

Applying the optional flow-through rule requires information about the gross receipts from each investment source and type to flow between PIEs each attribution period. The rule cannot be used unless this information is available. As such, if the information is not available, any attributed PIE income should be treated as such, and accordingly will have a New Zealand source.

***Example***

R is a retail PIE that invests solely into W, a wholesale PIE. R holds 20% of the units in W, so is entitled to 20% of W's income. R is a variable-rate PIE while W is an ordinary PIE.

In the latest calculation period, W has derived the following amounts of New Zealand-sourced income:

$1000 interest income;
$2000 fully imputed dividends;
$5000 from a foreign currency hedge.

W has also derived $10000 in foreign-sourced amounts.

R is able to get this information from W, which is sufficient information to apply the flow-through rule, and chooses to apply the flow-through. Accordingly, R is treated as deriving its share of W's income. Specifically:

$200 New Zealand-sourced interest income;
$400 New Zealand-sourced fully imputed dividends;
$1000 New Zealand-sourced non-interest financial arrangement income; and
$2000 foreign-sourced income.

***Variable-rate PIE treating amounts as foreign-sourced***

Section HM 6B(3) provides a flow-through rule that allows it to treat income derived from a zero-rate PIE (or a PIE eligible to become a zero-rate PIE) as a foreign-sourced amount. This is on the basis that the ultimate investments will generally be offshore.

A similar rule operates for zero-rate PIEs, allowing such PIEs to derive income from a zero-rate PIE (or a PIE eligible to become a zero-rate PIE) although, on its face, the income will be New Zealand sourced. This is described in the section "Allowable amounts".

## Modified residence rules

*Sections HM 8(2) and HM 19B(2)*

Section HM 19B(2) is designed to clarify that a zero-rate PIE will be treated as resident in New Zealand provided it is a unit trust to which the Unit Trust Act applies and has a New Zealand resident trustee. The clarification is necessary because unit trusts are not incorporated, so country of incorporation cannot be used to determine residence. No such clarification is necessary for PIEs that are companies, as place of incorporation is available to determine residence for companies.

The section is not intended to restrict the types of entity eligible to become a zero-rate PIE.

**Investment types and sources**
*Sections HM 11, HM 12, HM 19B(1) and HM 19C*

Sections HM 19B(1) and HM 19C set out the rules for the investment types and sources that zero-rate PIEs and variable-rate PIEs, respectively, are able to derive.

A zero-rate is only able to derive a foreign sourced amount or an allowable amount (a concept defined by section HM 55G).

It is intended that the measurement of whether or not a zero-rate PIE's New Zealand-sourced income falls within the criteria of allowable amounts should only be done quarterly (as per section HM 55H). If a zero-rate PIE inadvertently breaches one of the allowable amount thresholds, the PIE will generally have a quarter to remedy the breach. That said, it is not intended that this rule should be used by a PIE to intentionally derive New Zealand sourced income in between the quarterly tests.

A variable-rate PIE is able to derive both foreign sourced amounts and New Zealand sourced amounts. However, variable-rate PIEs are not able to invest in New Zealand land (or rights or options in relation to land), nor are they able to derive income from New Zealand land. Non-residents can generally deduct expenses incurred in deriving income from land, so allowing such investment would greatly complicate the foreign investment PIE rules.

Both variable-rate and zero-rate PIEs are able to invest in land not situated in New Zealand. Variable-rate PIEs can also invest in New Zealand companies that own land, although there are limits on the percentage of ownership the PIE can have.

As with zero-rate PIEs, variable-rate PIEs are also generally given a "grace period", designed to allow corrections of any inadvertent breaches of these rules.

**Modified investment-out test**
*Section HM 13*

PIEs are generally only able to hold up to 20% of the voting rights in ordinary companies (or, for unit trusts, 20% of the interests in that trust). This restriction is extended for foreign investment PIEs so that it also applies to land investment companies and entities that qualify for PIE status. In effect, foreign investment PIEs can only exceed the 20% limit on investments in other PIEs (including foreign investment PIEs) and foreign PIE equivalents.

The reason for this broad 20% ownership restriction is to ensure the non-deductibility of expenses attributed to notified foreign investors. Allowing a foreign investment PIE to have controlling interests in subsidiary companies could provide opportunities for that PIE to shift non-deductible expenses to its subsidiary entities, where the expenses may be deductible. The same concern does not arise with controlling interests in subsidiary PIEs due to the operation of the flow-through rule. Thus, the ownership restriction does not apply to such investments.

**Rules for the treatment of investors**
*Section HM 32(3)*

Section HM 32(3) provides that, if a person notifies a PIE that they wish to be treated as a notified foreign investor, that person is treated as having notified the PIE of a tax rate for the purposes of section HM 32(1). The default rate therefore does not apply for the person.

**Foreign investment PIEs and PIE proxies**
*Section HM 33*

The rules for PIE proxies have been modified to cater for foreign investment PIEs. If a PIE proxy chooses to provide the benefits to its non-resident investors of the foreign investment PIE rules, it must:

- act as a proxy for a foreign investment PIE;
- if acting for a variable-rate PIE, obtain that PIE's income details in order to apply the appropriate tax rates to each type and source of income; and,
- collect any information from the investor required by the PIE (such as the investor's country of residence, which is required under section HM 55D(4)).

These new provisions only apply to proxies that choose to act for foreign investment PIEs. There is no change in the treatment of proxies that act only for ordinary PIEs.

**No provisional tax option for foreign investment PIEs**
*Sections HM 41(3) and HM 44*

Foreign investment PIEs are unable to use the provisional tax option for calculating their tax liability. The rationale for this restriction was that, given the nature of PIEs that pay provisional tax, it was considered they would be unable to comply with the new rules.

**Ability to withhold NRWT**
*Sections HM 44 and, CX 56B*

Instead of paying tax on behalf of a notified foreign investor, a foreign investment PIE has the option of withholding non-resident withholding tax (NRWT) on distributions of unimputed dividends paid out to the investor. If the PIE received partially imputed dividends from a New Zealand company, it would be able to use this option to the extent the dividends were unimputed. For example, if it received a $100 dividend with $20 of imputation credits attached, and the PIE distributed the full $100, it could withhold NRWT on $48.57 of the distribution.

As NRWT is a withholding tax, this option can only be applied to amounts actually distributed. Note that, due to the fungibility of money, it is only required that the PIE distribute an amount *equivalent* to what it has in unimputed dividends. This

distribution must be made on or before the date the PIE would otherwise be required to pay PIE tax on the amount.

For example, if the PIE were an “exit PIE” (i.e. pays tax under section HM 42), it would generally have until 30 April after the end of the tax year to make a distribution and withhold NRWT. However, if a notified foreign investor reached an exit period, the PIE would generally need to make the distribution one month after the end of the month in which the exit period fell in order to be able to apply this NRWT option.

If a PIE elects to withhold NRWT on an amount on behalf of a notified foreign investor, that amount is not included in the investor’s assessable income in section HM 35(3) or their income in section HM 36(3). As such, it does not constitute income that the PIE must pay tax on, nor is it included in the investor’s attributed PIE income. Further, section CX 56, which normally deems distributions from a PIE to be excluded, does not apply. In all, this is to clarify that the NRWT is a tax borne by the investor, not the PIE.

Finally, section CX 56B does not apply to the extent a distribution has had NRWT withheld on it. This means the income is not excluded income of the investor. If the amount distributed exceeds the amount that has been subject to NRWT, the balance continues to be excluded.

***Example***

Z has elected to become a variable-rate foreign investment PIE. Z has derived $400 in income, constituting of:

> $200 New Zealand-sourced partially imputed dividends ($200 cash dividend with $40 of imputation credits attached)
> $200 foreign-sourced amounts.

Z has decided it will distribute all of this income to its investors.

Z has two investors: Sarah, who has elected to be a notified foreign investor, and Frank, who is a resident investor with a 28% prescribed investor rate (for simplicity, assume that Z does not need to meet the investor in requirements of the PIE rules). Each investor holds 50% of the units in Z.

Since Sarah is a notified foreign investor, Z has decided withhold NRWT on the payment to her. Sarah's share of Z's dividends is $100 and $20 of imputation credits, which is equivalent to $51.43 in fully imputed dividends and $48.57 in unimputed dividends. Z therefore withholds NRWT on $48.57 of its distribution, which is $7.29 (assuming the applicable NRWT rate is 15%).

The income that Z has withheld NRWT on ceases to be attributed PIE income of Sarah's – her attributed PIE income is now $151.43. Z must pay tax on this amount as usual; however, since it only consists of fully imputed dividends and foreign-sourced amounts, the applicable tax rate is 0%.

Net-of-tax Sarah receives $192.71.

As Frank is a resident investor, Z must pay tax on income attributed to him as per normal. Frank's share of Z's income is $200 (plus $20 of imputation credits) and Z must pay tax on this. Net-of-tax and after accounting for the imputation credits, Frank receives $158.40.

**Use of tax credits by foreign investment PIEs**
*Sections LS 1, HM 51 and HM 53*

The intention of the new rules is that notified foreign investors in foreign investment PIEs are unable to utilise foreign tax credits and imputation credits attributed to them. Other credits can be utilised by notified foreign investors, but we do not expect this to be a common occurrence. PIEs generally hold RWT exemption certificates so it would be unusual for a notified foreign investor to be attributed an RWT credit in relation to interest earned. Nevertheless, if this were to happen, the PIE would be able to utilise this credit on the investor's behalf. In turn, the investor would be taxed at the rate generally charged on interest paid to non-residents. Overall, the treatment should match that afforded to a non-resident investing directly.

It is important to note that a foreign investment PIE cannot stream its tax credits. It must still attribute its credits amongst investors as stipulated by section HM 50, despite the fact that credits attributed to notified foreign investors will generally not be able to be used.

**Modified source rules**

*Section HM 55C*

For foreign investment PIEs, certain source rules are overridden in some situations. Income attributed to a notified foreign investor is not deemed to have a New Zealand source merely because:

- a foreign investment PIE carries on a business in New Zealand; or,
- the income is derived from a contract made or performed in New Zealand, *provided* the income from the contract relates to the PIE's offshore investments.

The restriction that a contract's income must relate to the PIE's offshore investment is designed to cover arrangements such as foreign currency hedges or derivatives to increase or decrease exposure to foreign share markets – even if that contract is entered into with a New Zealand counterparty. The restriction was put in place as otherwise the rule could be too far-reaching. Some contracts may only be given a New Zealand source by the operation of section YD 4(3) (contracts made or performed in New Zealand). Overriding it without qualification would therefore be risky.

Importantly, if there is some other reason for an amount to have a New Zealand source, the income will continue to be treated as having a New Zealand source under section YD 4(18).

**Zero percent rate for transitional residents**

*Sections CX 56, HM 55D(8) and schedule 6, table 1*

Transitional residents are generally not taxed on their non-New Zealand sourced investment income. Accordingly, transitional residents are able to invest in zero-rate PIEs and be taxed at a 0% tax rate. Similar rules that apply to notified foreign investors are intended to also apply to such transitional residents – for example, fees and expenses should not be deductible to such investors and credits should not be able to be utilised by them. Similar transitional rules to those that apply to notified foreign investors who become or cease to be non-residents in a tax year also apply.

It should be noted that transitional residents cannot be notified foreign investors; they are only able to elect a 0% tax rate in zero-rate PIEs. This is on the basis that, while transitional residents are generally not taxed on their foreign-sourced investment income, they are taxed as a New Zealand resident on any New Zealand-sourced income. Allowing transitional residents to elect to be a notified foreign investor would therefore be inappropriate.

## Change in status of investors in foreign investment PIEs

*Sections CX 56 and HM 55E*

Transitional rules can apply when a person changes to or from being a notified foreign investor. These rules are designed to simplify when an investor transitions to and from being a New Zealand resident. The rules reflect that a person's change of residency can be retrospective by the operation of the "183-day rule" in section YD 1(3) and that not all PIEs will be able to apply an investor's new status immediately.

Section CX 56 applies to an investor if that investor has become or ceased to be a New Zealand-resident in the tax year. For such an investor, any attributed PIE income will be excluded income, even if the investor is treated as a notified foreign investor when they are resident.

Similarly, section HM 55E does not require a foreign investment PIE to change an investor's status as soon as they are notified. At the latest the change needs to be effected by the start of the next tax year, but must be as soon as is practicable by the PIE. If a PIE's systems *are* able to change an investor's status quickly, it cannot defer the change to the start of the next tax year. As described above, if there is a delay in changing an investor's status, there are no consequences for that investor.

## Allowable amounts for foreign investment zero rate PIEs

*Sections HM 19B, HM 55G and HM 55H*

Zero-rate PIEs are generally only supposed to derive foreign-sourced amounts. However, it is acknowledged that such PIEs will, in some situations need to derive some New Zealand-sourced income. Accordingly, zero-rate PIEs are permitted to derive the following "allowable amounts".

### *Income from financial arrangements*

Zero-rate PIEs are able to derive income from financial arrangements with a New Zealand-source in two situations. The first situation is if the arrangements do not pay interest and relate to the PIE's offshore investments. "Offshore investments" in this context is intended to have a similar meaning to that in the modified source rules, discussed above.

The second situation is if the arrangements pay only interest income and have a term of 90 days or less (or no term at all). This exemption only applies if the total value of the PIE's financial arrangements that have a term of 90 days or less (but not including any non-interest arrangements as described above), is less than 5% of the total value of the PIE's investments (*including* the value of any non-interest arrangements).

In both cases, "interest" is intended to have its defined meaning – that is, a payment made for money lent to any person.

The purpose of the first exemption is to allow zero-rate PIEs to enter into derivatives (such as foreign currency hedges) in New Zealand. The purpose of the second exemption is to allow these PIEs to have New Zealand bank accounts to fund day-to-day management costs.

> ***Example***
>
> A variable rate PIE has the following New Zealand-sourced financial arrangements:
>
> - $5000 in a 30-day term deposit, paying interest at 5% p.a.,
> - $10000 in an on-call account, paying interest at 1.43% p.a.,
> - a foreign-exchange hedge (which does not pay any interest), designed to remove the effect of currency fluctuations on its offshore investments, with a market value of $7500.
>
> The total value of all of the PIE's other investments is currently $285,000 and the income from these investments does not have a New Zealand source.
>
> The total value of the PIE's investments is $307,500. The PIE has $15000 in interest-bearing financial arrangements with a term of 90 days or less, or no term at all. As a percent of total investments this is 4.88%.
>
> The PIE therefore meets the requirement of deriving only foreign-sourced amounts and "allowable amounts". The PIE's New Zealand-sourced financial arrangements that pay interest both have a term of 90 days or less and constitute less than 5% of the PIE's investment portfolio. The only other New Zealand-sourced income that the PIE could derive is from a non-interest bearing financial arrangement that relates to the PIE's offshore investments.

***Income from dividends***

Zero-rate PIEs are also able to derive income from New Zealand dividends if the total value of all shares held by the PIE in New Zealand-resident companies is less than 1% of its investments.

The purpose of this exemption is to allow PIEs that track a global share index to be zero-rate PIEs, even though they may have a small exposure to New Zealand equity.

***Income from other foreign investment zero-rate PIEs***

Income from other zero-rate PIEs (or PIEs that could be zero-rate PIEs if they elected to be one) also count as an "allowable amount". This is on the basis that the ultimate investments of the PIE will be offshore. This forms a similar flow-through rule provided to variable-rate PIEs by section HM 6B(3).

**Breaches of the foreign investment PIE rules**
*Section HM 55H*

Section HM 55H provides special breach rules for the additional requirements of foreign investment PIEs. The existing breach rules also apply to foreign investment PIEs where a requirement of being a normal PIE is not met.

As with the original PIE rules, it is intended that whether or not a foreign investment PIE meets the relevant rules is to be tested every quarter. This is because requiring more frequent testing would be excessively costly from a compliance perspective. However, there are certain requirements that, if breached, have immediate consequences.

***Zero-rate PIEs***

Zero-rate PIEs are only allowed to derive foreign-sourced and "allowable" amounts. As described above, certain thresholds apply to some of these allowable amounts – for example, there is a maximum of 1% of total assets in New Zealand shares. If one of these thresholds is exceeded, that breach must be remedied on the last day of the next quarter (when the PIE will again do its quarterly check). If the breach is not remedied, the foreign investment zero-rate PIE will become a foreign investment variable-rate PIE on the first day of the third quarter.

If, on the other hand, a zero-rate PIE derives an amount other than an allowable amount or a foreign sourced amount, the PIE will become a foreign investment variable-rate PIE immediately. The reason for this difference is that it was considered very unlikely that a PIE could inadvertently derive an amount other than a foreign-sourced or allowable amount, but it is feasible that a PIE could inadvertently breach a threshold for an allowable amount from time to time.

***Foreign investment variable rate PIEs***

Variable-rate PIEs are required to meet the requirements of sections HM 55F(3) and HM 19C. Among other things, these provisions require the PIE to identify the source and type of amounts of income derived. If one of these criteria is not met, then, similar to a foreign investment zero-rate PIE, the PIE will have until the last day of the next quarter to remedy the breach. If this is not done, the PIE will become an ordinary multi-rate PIE from the first day of the third quarter.

***Transitional rule***

The rules for foreign investment variable-rate PIEs do not come into force until 1 April 2012. Therefore, section HM 55H(5) provides that if a foreign investment zero-rate PIE breaches one of the rules and loses its status before 1 April 2012, it will become a multi-rate PIE.

**Election to be a foreign investor PIE**
*Sections HM 71B and HM 72*

Section HM 71B provides that an entity can elect to become a foreign investment PIE if it:

- is, or is eligible to be, a multi-rate PIE;
- has, or intends to have, non-resident investors; and
- does not use the provisional tax option of section HM 44 to pay its tax if the entity is a PIE.

The entity's election will have to include which type of foreign investment PIE it wishes to become. Finally, the existing rules providing when an entity's election to become a PIE take effect have been modified to also apply to entities becoming foreign investment PIEs.

**Modified grouping rules**
*Section IC 3*

New subsection IC 3(2D) provides that a foreign investment PIE cannot be part of a group of companies that includes a land investment company. In other words, a foreign investment PIE is only able to group with wholly-owned PIEs.

**Yearly request of information**
*Section 31C of the Tax Administration Act 1994*

Section 31C of the Tax Administration Act 1994 has been modified to provide that a foreign investment PIE must, at least once a year, ask its notified foreign investors to confirm that:

- they are still eligible to be a notified foreign investor; and
- the information the PIE is required to collect under section 28D(1) of the Tax Administration Act 1994 has not changed.

If the PIE receives no response, the PIE may continue to treat the investor as a notified foreign investor.