Taxation of foreign superannuation

An officials' issues paper

July 2012

Prepared by the Policy Advice Division of Inland Revenue and the New Zealand Treasury

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Taxation of foreign superannuation – an officials' issues paper.
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Introduction

1.1 This paper proposes changing the rules for taxing foreign retirement savings held by New Zealand residents.

1.2 People who migrate to New Zealand or return to New Zealand after working overseas will often have retirement savings in their previous country of residence.

1.3 The Government is concerned that the current rules for taxing foreign retirement savings can result in inconsistent outcomes, and can be highly complex for people to apply.

1.4 This paper proposes replacing the existing rules for taxing foreign superannuation with a single set of rules which would be fair and simple from a compliance perspective.

1.5 In brief, interests in foreign superannuation schemes would no longer be taxable on an accrual basis under the foreign investment fund (FIF) rules. Instead, the proposed new rules would provide that all pension payments would remain taxable in full on receipt. Lump sum withdrawals or transfers would be partially taxed on receipt. The tax would approximate the amount of tax on investment gains that would ordinarily have accrued during the period that an individual is resident in New Zealand, had the individual transferred the original amount to New Zealand.

1.6 The temporary exemption for transitional residents will continue to apply to receipts from foreign superannuation schemes. Other rules that exempt Australian superannuation in certain circumstances (such as the New Zealand-Australia double tax agreement, and the arrangement on trans-Tasman portability of retirement savings) will also remain unchanged.

1.7 The changes would be included in a tax bill scheduled for introduction later this year or towards the middle of next year.

Summary of suggested changes

- Tax on all "foreign superannuation interests" would be governed by the new rules. They would be specifically excluded from the FIF rules.
- "Foreign superannuation interests" would be based on the current definition of "foreign superannuation scheme" in the Income Tax Act 2007.

- All foreign superannuation would be taxable on receipt, as follows:

  1. Pensions would be taxed at an individual's marginal tax rate when the payments are received.

  2. Lump sums would be partially taxed using an "inclusion rate". The excluded amount would not be taxable. The amount that is taxable would depend on the length of time between when an individual arrives in New Zealand and when they withdraw or transfer the superannuation. At the time of the withdrawal or transfer from a foreign superannuation scheme, they would apply the relevant inclusion rate based on the date they became a New Zealand-resident as follows:

Years since migration	*Inclusion rate*
0-2	0%
3-4	15%
5-8	30%
9-12	45%
13-16	60%
17-20	75%
21-24	90%
25+	100%

  An individual's marginal tax rate would be applied to the amount that results after applying the inclusion rate. For example, an individual with a marginal tax rate of 33% who makes a withdrawal of $50,000 when they have been a New Zealand-resident for eight years would have a tax liability of $4,950 (being $50,000 x 30% inclusion rate x 33% tax rate). In this case, this represents an effective tax rate of approximately 10%.

- The temporary exemption for the foreign income of transitional residents will continue to apply, as will certain rules that exempt Australian superannuation.

- The proposed new rules would apply from the 2011–12 income year. However, people who returned FIF income from their foreign superannuation for the 2010–11 income year by 31 March 2012 would continue to have that interest taxed under FIF rules. They would not be taxed on any subsequent distributions under the new rules.

- A retrospective measure would allow people who withdrew foreign superannuation as a lump sum between 1 January 2000 and 31 March 2011 and who did not comply with their tax obligations at the time to elect to use an inclusion rate of 15% for their withdrawal or transfer. To qualify, an individual must disclose the existence of the transfer to Inland Revenue before 1 April 2014. Alternatively, they can choose to return income under the rules which existed at the time.

- Some people who have transferred their foreign superannuation to a New Zealand superannuation scheme may have a tax liability on that amount. If the New Zealand scheme is "locked-in" and so does not allow access to the funds until retirement age, the individual may have difficulty paying their tax. Officials invite comment on whether there should be a mechanism that allows tax to be paid from the transferred amount held in the New Zealand superannuation scheme and, if so, how this should operate.

How to make a submission

1.8 Officials invite submissions on the matters raised in this issues paper concerning the taxation of foreign superannuation. Submissions on this paper should be made by 3 September and be addressed to:

Taxation of foreign superannuation
C/- Deputy Commissioner
Policy Advice Division
Inland Revenue Department
P O Box 2198
Wellington 6140

1.9 Or email: policy.webmaster@ird.govt.nz with "Taxation of foreign superannuation" in the subject line.

1.10 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for officials from Inland Revenue and the Treasury to contact those making submissions and to discuss their submission, if required.

1.11 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider there is any part of it that should properly be withheld under the Act should clearly indicate this.

CHAPTER 2

Background

2.1 This chapter describes New Zealand's current rules for taxing foreign superannuation. It also outlines the reasons why a review of these rules is appropriate.

New Zealand residents' interests in foreign superannuation

2.2 Immigrants to New Zealand and returning New Zealanders often hold investments in foreign superannuation schemes which were acquired while they lived and worked outside New Zealand. The range of retirement savings is extensive and varies from country to country. However, in very general terms, retirement savings can include interests in:

- Defined contribution schemes. These are generally where an individual and/or their employer contribute to a superannuation scheme. The amount eventually distributed to the individual represents those contributions plus investment earnings.
- Defined benefit schemes. Under these schemes, the amount that is eventually distributed to the individual is pre-determined. An individual may or may not contribute directly to the scheme. If the individual does contribute to the scheme, the amount received does not generally depend on the amount of their contributions.

2.3 In some cases – such as if the foreign government has made contributions to the individual's investment, or given a tax deduction for contributions that the individual has made to their investment – the individual may not be permitted to access their savings until retirement age. These are called "locked-in" schemes.

2.4 Distributions of retirement savings from a superannuation scheme or another intermediary can take various forms. Generally, these will be as either a periodic pension, a lump sum, or a combination of both. In some cases, a lump sum payment is (or must be) transferred to another superannuation scheme or used to purchase an annuity.

2.5 An individual may also have an entitlement to receive a pension from a foreign Government or a similar statutory body.

2.6 The scope of this review is limited to New Zealand tax-residents who hold interests in defined contribution or defined benefit foreign superannuation schemes. Pensions and lump sums received from a foreign Government would not be covered by the new rules unless the payments arose as a result of services provided by the individual to that government. Furthermore, while New Zealand-residents may also have other overseas investments that they intend to use as retirement savings (for example, shares, bank deposits and real estate), this reform will not change the taxation of those investments.

Current taxation of foreign superannuation

2.7 Most countries will tax interests in domestic superannuation schemes at one or more of the following levels:

- the contribution to the pension scheme;
- investment earnings of the pension scheme; and/or
- the pension benefit or payment to the recipient.

2.8 For instance, when a New Zealand-resident has contributed to a New Zealand superannuation scheme (that is, there is no international dimension), New Zealand taxes the retirement savings on a "TTE" basis. This refers to *taxing* the contributions to the superannuation scheme, *taxing* the investment earnings of the scheme and *exempting* the pension benefit or distribution.

2.9 The TTE approach is consistent with the way that other New Zealand-based savings are taxed. For example, an individual who deposits income derived from their employment in a financial institution will have had their employment income taxed, and will be taxed on any interest income that they earn. When they withdraw an amount from their bank account, the withdrawal is not taxed.

2.10 By comparison, a New Zealand-resident with foreign retirement savings has always been taxed under different rules, which may not follow the TTE approach.

2.11 Before 1993, New Zealand taxed pensions or lump sum payments when they were received. In 1993, the foreign investment fund (FIF) rules were introduced for all foreign investments, apart from investments in controlled foreign subsidiaries. The primary purpose of these rules was generally to tax interests in foreign investments, including foreign superannuation schemes, on an accrual basis rather than on receipt. This approach to taxation is generally desirable because it ensures that investments in foreign assets are not favourably taxed relative to investments in New Zealand assets.

2.12 As a starting point, the FIF rules applied to interests in foreign superannuation schemes.

Tax treatment of foreign superannuation schemes under the FIF rules

2.13 Under the current FIF rules, interests in foreign superannuation schemes are generally taxed using either the fair dividend rate (FDR) method, the cost method, or the comparative value (CV) method.

2.14 The FDR and cost methods tax a deemed 5% return, based either on the market value or the cost of the investment.[1] The CV method taxes the increase or decrease in the value of the investment by taking the difference in value at the start and end of the year.

[1] The FDR method generally applies when a market value for the interest is available. The cost method may be used when a market value for the interest is not available.

2.15 When an interest in a foreign scheme is a FIF, any actual returns (that is, a pension or lump sum) are exempt from tax.

Carve-outs from the FIF rules that apply to foreign superannuation

2.16 Some interests in foreign superannuation schemes can be "carved out" of the FIF rules, meaning they are instead subject to the general taxation rules. The following exemptions from the FIF rules were enacted in response to various concerns. These concerns are, in particular:

- Foreign superannuation schemes are often locked-in. This means that the funds generally cannot be withdrawn or otherwise assigned until a specified retirement age. Imposing accrual FIF taxation may create cashflow hardships as the individual's tax liability would have to be met out of other income.
- Investments in foreign superannuation schemes are usually not tax motivated. Instead, they arise because a New Zealand-resident previously lived and worked offshore and established an interest in a foreign superannuation scheme during that period.
- Accrual FIF taxation is out of step with how most other countries tax superannuation, which normally occurs on distribution. This creates problems in coordinating the timing of tax payments and foreign tax credits with the treatment in other jurisdictions.

2.17 *Locked-in schemes:* The main carve-out from the FIF rules that applies specifically to foreign superannuation is for locked-in schemes. This carve-out addresses the major concern that the FIF rules would create cashflow problems for people with such interests.

2.18 *New migrants' four year relief:* When the carve-out for locked-in schemes did not apply, a carve-out was previously available to new residents to give them time to adjust to the FIF rules. This meant that a new migrant was not required to comply with the FIF rules for the first four years in which they were resident. The interest became subject to the FIF rules after the end of the four-year period. This carve-out was replaced in 2006 by an exemption for transitional residents.

2.19 *Australian superannuation schemes:* Interests in some Australian superannuation schemes have also been carved out from the FIF rules. In Australia, it is generally compulsory to make contributions to a superannuation scheme. This carve-out was introduced to address concerns that the FIF rules were difficult to comply with.

2.20 *$50,000 minimum threshold:* The FIF rules do not apply if an individual's total FIF interests (that is, their interests in the foreign superannuation scheme and any other foreign interests covered by the FIF rules) are less than $50,000. This carve-out was introduced to reduce compliance costs for people with minimal foreign investments.

2.21 *Transitional residents' exemption:* The transitional resident rules were introduced in 2006. An individual will generally be a transitional resident if they are a new migrant or have been away from New Zealand for more than 10 years, and do not claim Working for Families tax credits. Transitional residents do not need to account for foreign interests under the FIF rules during approximately the first four years in which they are resident in New Zealand. Further, they do not need to pay tax on most foreign income that they earn in that period. This provides a window in which they are able to transfer their foreign retirement savings to New Zealand tax-free.

Taxation of foreign superannuation interests if the FIF rules do not apply

2.22 When an interest in a foreign superannuation scheme is carved out from the FIF rules, it is subject to general tax rules – that is, tax on receipt.

2.23 In the case of pension payments, this is a straightforward matter of returning the amount of the pension received and being liable to taxation at an individual's marginal tax rate.

2.24 In the case of lump sum payments, the tax treatment is more complex and the tax consequences may not be consistent across different people. In some cases, the entire amount of the lump sum payment would be taxable, some cases would involve partial taxation and in other cases the entire amount would be exempt.

2.25 While a transfer to a New Zealand superannuation scheme may not intuitively be considered a receipt of funds, it should be noted that potential taxation also applies when the individual has transferred the lump sum directly to another superannuation scheme. For tax purposes, a transfer is deemed to be a disposal of the individual's interest in the original superannuation scheme and a purchase of rights in the new superannuation scheme. A transfer to another scheme is therefore a taxable event akin to a withdrawal that is subsequently reinvested.

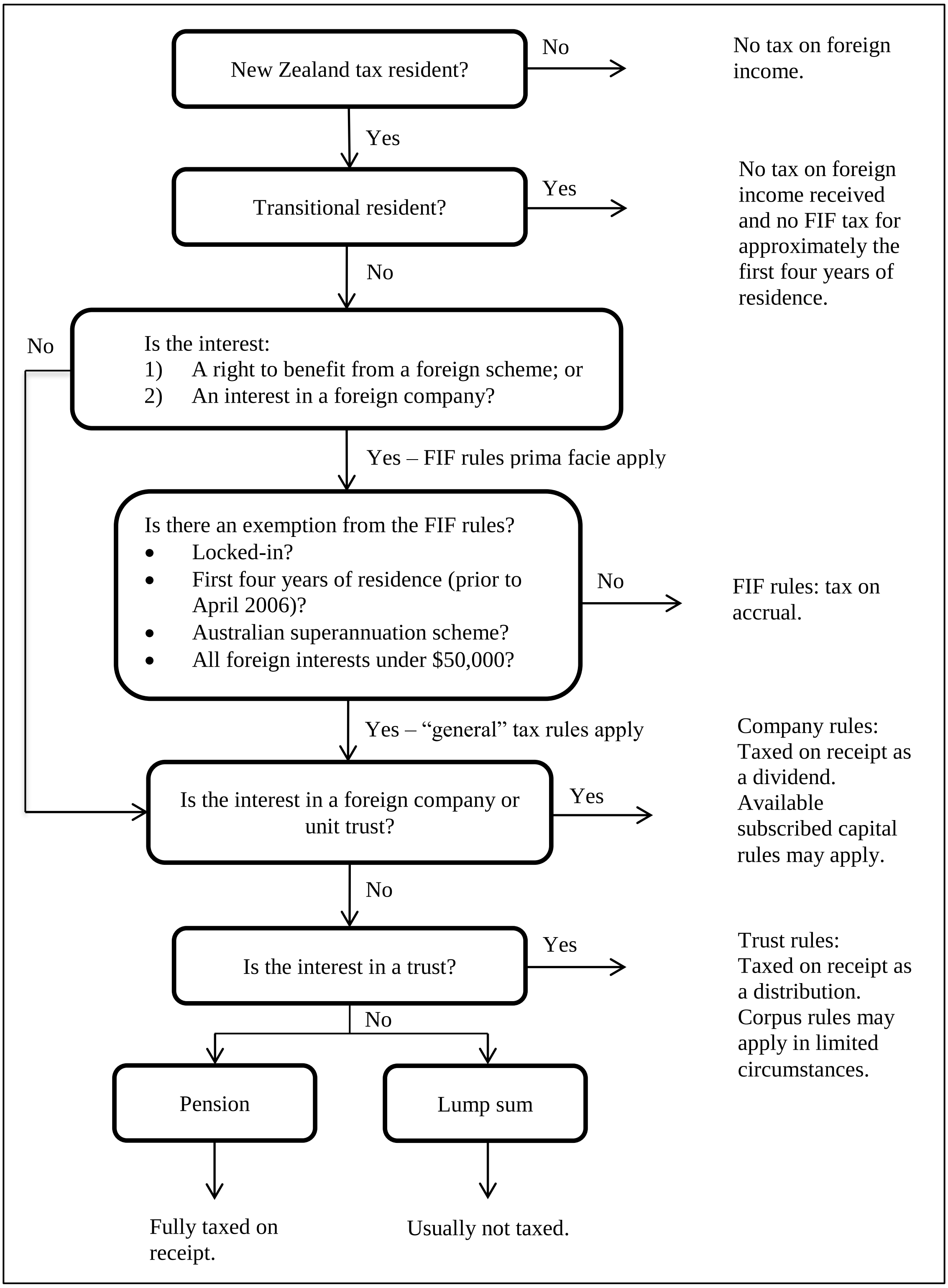
2.26 The disparity in tax treatment arises because the question of whether the pension or lump sum payment constitutes taxable income depends on which of the "general" tax rules apply. This involves an investigation into the underlying legal structure of the vehicle or arrangement in which the savings are held. For example, if the scheme is structured as a company then the amount received will generally be a dividend and therefore taxable at the individual's marginal tax rate. To the extent that rules deeming the dividend to be capital (the "available subscribed capital rules") apply, the amount will not be taxable.

2.27 Moreover, determining the amount to be taxed requires people to not only understand the underlying corporate nature of the scheme, but in some cases to have access to sufficient information about their total capital contributions to the scheme in order to calculate the non-taxable component of the distribution.

Interests in foreign life insurance schemes

2.28 Investments in life insurance schemes often have a savings element. In general, tax on foreign life insurance schemes is returned under the CV method. Officials are not aware of concerns regarding the current taxation of foreign life insurance.

Current taxation of foreign superannuation



Why review the rules for taxing foreign superannuation?

2.29 Officials are concerned that the current rules for taxing foreign superannuation are complex, inconsistent, and lacking in overall cohesion.

2.30 A key problem is that two different sets of rules (either the FIF rules or the "general" tax rules) potentially apply to an individual's foreign superannuation interest. This creates a number of difficulties.

2.31 As noted previously, various exemptions from the FIF rules for foreign superannuation were introduced for a number of policy reasons. People with foreign superannuation must determine whether they are exempt from the FIF rules or not, which can be very difficult.

2.32 Applying the FIF rules to foreign superannuation can be problematic. The FIF rules can be complex for people to understand and comply with. The rules apply regardless of whether an individual has received any distributions from the scheme, potentially creating cashflow problems. It can be technically difficult to apply the FIF rules to certain superannuation schemes (such as defined benefit schemes), for which the valuation of the investment for FIF purposes can be uncertain. In addition, accrual taxation is inconsistent with how most other countries tax superannuation, which normally occurs on distribution. This mismatch can create problems in coordinating the timing of tax payments and foreign tax credits with the treatment in other jurisdictions.

2.33 An individual's overall tax liability can vary significantly based on whether the FIF rules apply or, alternatively, whether the final distribution is taxable under the "general" tax rules. The FIF rules may tax a deemed return on the investment. In contrast, if the final distribution is instead taxable, the entire amount (less capital, when this is allowed) is typically taxable at an individual's marginal tax rate. The extent to which the amount is taxed will generally depend on the underlying legal structure of the scheme.

2.34 The taxation of lump sum receipts from foreign superannuation interests under the "general" tax rules presents particular difficulties. As mentioned, depending on the legal structure of the scheme and the information available, all of the lump sum could be taxable at an individual's marginal rate. On the other hand, an individual may have partial or no taxation on the amount of the distribution.[2] Applying these rules imposes high compliance and administrative costs and does not seem to result in fair outcomes across people in similar circumstances.

2.35 To some extent these concerns, particularly the tax treatment of lump sums, have become more pressing over time. In the past, it was either too difficult, too expensive or indeed prohibited under the scheme rules or other countries' laws to transfer superannuation to New Zealand. Accordingly, at the time the exemptions from the FIF rules were originally introduced, little consideration was paid to the tax treatment of lump sum payments or transfers.

[2] In most cases, partial or no taxation can occur only when the interest is in a scheme which is treated as a company or unit trust for New Zealand tax purposes.

2.36 Contrary to earlier expectations, there have been significant numbers of lump sum transfers made from foreign superannuation schemes since the exemptions from the FIF rules were introduced. Such transfers were most recently facilitated by the United Kingdom rules for interests in superannuation schemes held by non-residents. In many cases, this effectively meant that the FIF rules applied because, by definition, the schemes are not locked-in.

2.37 As a result, people to whom the FIF rules apply are broadly taxed on the return from the scheme for the years in which they are New Zealand-resident. However, these people have an annual obligation to return income under the FIF rules until such time as a transfer is actually made, which can be problematic from a compliance perspective.

CHAPTER 3

Proposed approach for taxing foreign superannuation

3.1 This chapter outlines a proposal for reforming the tax treatment of foreign superannuation.

Guiding principles

3.2 Like most countries, New Zealand generally taxes all New Zealand residents on their worldwide income.[3]

3.3 This approach helps to ensure that decisions to invest in New Zealand or overseas are not driven by tax considerations. (If income from offshore investments was not taxed in New Zealand, it would create a bias in favour of foreign investment.) Under this approach, people who have migrated to New Zealand should have no preference between bringing their assets to New Zealand or leaving them offshore.

3.4 It is important that the rules are as easy to understand as possible. For many people, their foreign superannuation is their most significant financial asset. It is also likely to be their main or only foreign asset. It is important that the rules that they are required to comply with are not overly complex.

Key changes to the taxation of foreign superannuation

3.5 In light of these principles, the key changes to the taxation of foreign superannuation are proposed below.

One set of rules for all New Zealand-residents with foreign superannuation

3.6 As a starting point, people with interests in a foreign superannuation scheme would be taxed under one set of rules. This would avoid the complexity and uncertainty associated with determining whether the FIF rules apply or not. It would also help to ensure that there is equivalent tax treatment for all people with foreign superannuation.

3.7 The interests in foreign superannuation schemes to which these proposals apply would be based on the current definition of "foreign superannuation scheme" in the Income Tax Act 2007. This would include most defined contribution schemes and defined benefit schemes set up to provide retirement benefits.

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[3] It should be noted that New Zealand modifies this approach in certain cases for new migrants – for example, under the transitional resident rules. In those cases, the new migrants are generally not taxed on the transfer of assets they have built up in the country from which they emigrated.

3.8 The definition of a "foreign superannuation scheme" is a superannuation scheme constituted outside New Zealand. In this context, a "superannuation scheme" includes:

- A trust or unit trust established by its trust deed mainly for the purposes of providing retirement benefits to beneficiaries who are natural persons or paying benefits to superannuation schemes.
- A company that is not a unit trust and is established mainly for the purpose of providing retirement benefits to members or relatives of members who are natural persons.
- An arrangement constituted under the legislation of a country, territory, state, or local authority outside New Zealand mainly for the purpose of providing retirement benefits to natural persons.

Taxing foreign superannuation only on receipt

3.9 It is proposed that the FIF rules would no longer apply to any interests in foreign superannuation schemes. Instead, all income (pensions and lump sum payments) would be taxable only on distribution or receipt.

3.10 As previously noted, the FIF rules can be complex to apply. Retaining the FIF rules would mean the existing problems with the FIF rules would remain, particularly when there is:

- a restriction on rights being sold or assigned to another individual or otherwise "locked-in", which presents cashflow difficulties as the funds cannot be accessed to pay the tax liability;
- difficulty in establishing a market value or cost of the superannuation interest, especially for defined benefit schemes; and/or
- a mismatch in the timing of taxation between New Zealand and the foreign country, which means that foreign tax is not able to be credited against the corresponding New Zealand tax liability.

3.11 Taxation on receipt would avoid these concerns, and may be generally more appropriate as foreign superannuation is often unable to be accessed until retirement age.

3.12 All amounts from these foreign superannuation interests would be taxable on receipt under the proposed new rules discussed below.

Taxation of pension payments on receipt

3.13 Under the proposed approach, foreign-sourced pensions would be taxed when they are received at an individual's marginal tax rate. This is the way that foreign-sourced pensions from locked-in schemes are taxed currently. New Zealand-residents holding interests in foreign superannuation schemes would be taxed in a similar manner to residents who receive New Zealand Superannuation or foreign social security pensions. Taxation on receipt is simple for people to comply with.

3.14 Pensions would be taxed in this way regardless of whether the pension is paid directly by a past employer, or through an intermediary such as a trust, company or unit trust.[4]

3.15 The proposal would apply to amounts that would be treated as "pensions" under common law.

Taxation of lump sums on receipt based on an inclusion rate

3.16 It is proposed to tax lump sums in a way that broadly approximates the taxation on investment gains that would ordinarily arise had the original lump sum been invested in New Zealand during the period in which the individual was a New Zealand tax-resident. This approach would apply to lump sum withdrawals or transfers to other superannuation schemes.

3.17 Tax on lump sums would be calculated according to an "inclusion rate". A portion of the lump sum would be included in an individual's taxable income, according to the rates in paragraph 3.25. The excluded amount would not be taxable. The portion of the lump sum that is taxable would depend on the length of time that elapses between the individual's migration to New Zealand and the date at which they withdraw or transfer their savings.

3.18 This approach overcomes the concerns and complexity relating to the taxation of lump sums under the "general" rules mentioned in the previous chapter. It also helps to ensures that tax does not create an incentive to leave superannuation in a foreign scheme as long as possible, rather than bringing it to New Zealand to invest or spend. On the contrary, a two-year grace period is proposed to give new migrants an incentive to transfer their funds as soon as possible post-migration.

Applying the inclusion rate to lump sums

3.19 The inclusion rate approach would tax the individual's lump sum to largely the same extent that they would have paid tax on accrual in New Zealand (taking into account the benefit of deferral). After paying tax on the lump sum, the individual should be in approximately the same position as if they had instead transferred the amount on migration and derived taxable interest income in New Zealand.

3.20 This approach aims to ensure that an individual has no preference between bringing their foreign superannuation to New Zealand on the first day that they migrate to New Zealand and paying tax in the interim, or transferring at a later date. The inclusion approach would therefore focus on taxing an amount that takes into account taxable investment gains while the individual is New Zealand-resident and the time value of money (benefit of deferral). Background information about the methodology used to calculate the inclusion rate is included in the annex to this issues paper.

[4] Currently, there may be some uncertainty about whether pensions paid by an intermediary such as a trust, company or unit trust would be subject to tax as a pension, or as a distribution under the trust rules or dividend under the company rules (as the case may be).

3.21 It should be noted that applying the inclusion rate to lump sum transfers would give a broadly similar tax result to accumulated FIF taxation under the FDR or cost methods.

3.22 The inclusion rate does not explicitly include a deduction for capital. This is because the basic framework for the proposal is to tax an amount that represents the accumulated New Zealand tax that would otherwise have been paid had it been invested in New Zealand.

3.23 These rules would apply regardless of the nature of the underlying legal structure of the superannuation scheme. The trust rules, company rules, and other general provisions in the Income Tax Act 2007 would no longer apply to distributions from foreign superannuation schemes.

3.24 To reduce complexity, officials consider that there is a strong case for providing for "brackets" of inclusion rates (rather than requiring people to apply a formula), and for capping the rates at 100%.

3.25 Under this approach, at the time an individual makes a lump sum withdrawal or transfer from a foreign superannuation scheme, they would apply the relevant inclusion rate based on the date they became a New Zealand-resident as follows:

Years since migration	Inclusion rate
0-2	0%
3-4	15%
5-8	30%
9-12	45%
13-16	60%
17-20	75%
21-24	90%
25+	100%

3.26 The inclusion rate during the first two years after migration should theoretically be 5%, and during years three and four it should be 15%. However, we propose a short grace period of two years so that migrants who are not transitional residents have a period of time in which they can bring their foreign superannuation to New Zealand with no New Zealand tax consequences.

3.27 When an individual makes a withdrawal or transfer partially in the form of a pension and partially in the form of a lump sum, the respective treatment would apply to each portion. That is, the portion taken as a pension would be taxed under the rules for pensions, and the portion taken as a lump sum would be taxed under the inclusion approach.

3.28 When a withdrawal or transfer is from a superannuation scheme in a foreign country that has a double tax agreement with New Zealand, that foreign country is not usually permitted to tax the lump sum. (There are some exceptions to this, such as the 2012 double tax agreement between New Zealand and Canada.) However, when the foreign country can tax the lump sum, New Zealand provides a tax credit for any foreign tax paid on the lump sum when it was distributed. When a New Zealand tax credit is provided, it is limited to the amount of New Zealand tax which is apportioned to the overseas income stream. This policy would remain unchanged under the proposed rules. This means that a tax credit would continue to be available, but only in proportion to the amount of New Zealand tax payable on the lump sum and subject to other relevant limitations.

Transitional resident rules and Australian superannuation schemes

Transitional resident rules

3.29 The transitional resident rules will be retained. These rules provide that new migrants and certain returning residents are temporarily exempt from New Zealand tax on most foreign income, including foreign superannuation.

3.30 Officials consider that retaining the transitional resident rules would be consistent with the proposed approach outlined above. Transitional residents will continue to be exempt from tax on their foreign pension or lump sum distributions from a foreign superannuation scheme, within approximately the first four years since becoming tax resident.

3.31 People who are not transitional residents would face an inclusion rate of 0% on lump sums withdrawn or transferred within the first two years of becoming a New Zealand tax-resident, and 15% (giving an effective tax rate of around 5%) on lump sums withdrawn or transferred in years three and four.

3.32 After the end of the fourth year and the transitional residents' exemption, everyone would face the same inclusion rate (30% in years five to eight, which is an effective tax rate of up to 10%) regardless of whether they were previously a transitional resident.

Withdrawals and transfers from Australian superannuation schemes

3.33 Double tax agreements generally override domestic tax rules. Under the New Zealand-Australia 2010 double tax agreement, lump sums arising in Australia and paid to a New Zealand-resident under a retirement benefit scheme or in consequence of retirement are not taxable in New Zealand.

3.34 In June 2009, New Zealand and Australia signed a bilateral agreement to enable the trans-Tasman portability of retirement savings. Under this arrangement, people with savings in a qualifying Australian superannuation scheme will be able to transfer their savings to a New Zealand superannuation scheme. The new rules also provide that such transfers will be tax-free. In New Zealand, the rules were legislated for in the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010. These rules will come into effect up to two months after

New Zealand and Australia have exchanged notes informing each other that the necessary legislation has been enacted in both countries.

3.35 The rules described in paragraphs 3.33 and 3.34 would not be affected by the proposals in this issues paper.

Contributions made while New Zealand tax-resident

3.36 The proposed rules for taxing foreign superannuation are intended to apply when a New Zealand-resident had contributed to a foreign superannuation scheme prior to becoming a New Zealand-resident. In general, the rules are not intended to apply when the contributions are primarily made while the individual is New Zealand-resident. However, some people may continue contributing to an overseas scheme while in New Zealand because, for example, they are required to under the scheme's rules.

3.37 The inclusion approach works backwards to presume, on the basis of the assumed interest rate, a particular value of the superannuation interest at the time of migration. Any difference between the transferred amount and the deemed original value are treated as gains. The inclusion approach assumes that contributions made while an individual is a New Zealand-resident are investment gains and effectively taxes them as such. As a result, the amount of the lump sum on which the inclusion rate is applied is too high. An individual's lump sum withdrawal or transfer could be over-taxed.

3.38 In an extreme example, consider an individual who contributes $1,000 to a foreign superannuation scheme while non-resident, and $100,000 while New Zealand-resident. At the time of transfer some years later, he withdraws $150,000 (being $101,000 plus gains). The inclusion rate would apply to the $150,000. The inclusion approach assumes that the increase in value of $149,000 since becoming resident constitutes investment gains and taxes them accordingly. There is no allowance for the $100,000 of New Zealand contributions.

3.39 It is proposed to apply the inclusion rate to the amount of the lump sum after deducting the value of contributions made while New Zealand-resident, as long as those contributions have been subject to New Zealand tax. This would reduce the amount of the lump sum withdrawal on which the inclusion rate is applied by the value of the contributions, thereby reducing the individual's taxable income.

3.40 A deduction would be allowed only to the extent that contributions are required to be made under the scheme's rules. When an individual contributes amounts in excess of those required, those amounts would not be deductible from the lump sum withdrawal or transfer.

3.41 If no allowance is given for contributions made while New Zealand-resident, then the individual in the example in paragraph 3.38 would apply the inclusion rate to the full $150,000. If they withdraw the lump sum in year 10, then from paragraph 3.25 a 45% inclusion rate would apply to the lump sum. If the individual has a marginal tax rate of 33%, their tax liability would be $22,275 (being $150,000 x 45% inclusion rate x 33% tax rate).

3.42 Under the proposed approach, the individual would apply the inclusion rate to $50,000 (being $150,000 less the $100,000 of New Zealand contributions), rather than the full $150,000. Their tax liability would be $7,425 (being $50,000 x 45% inclusion rate x 33% tax rate) instead of $22,275.

Transfers to locked-in New Zealand superannuation schemes

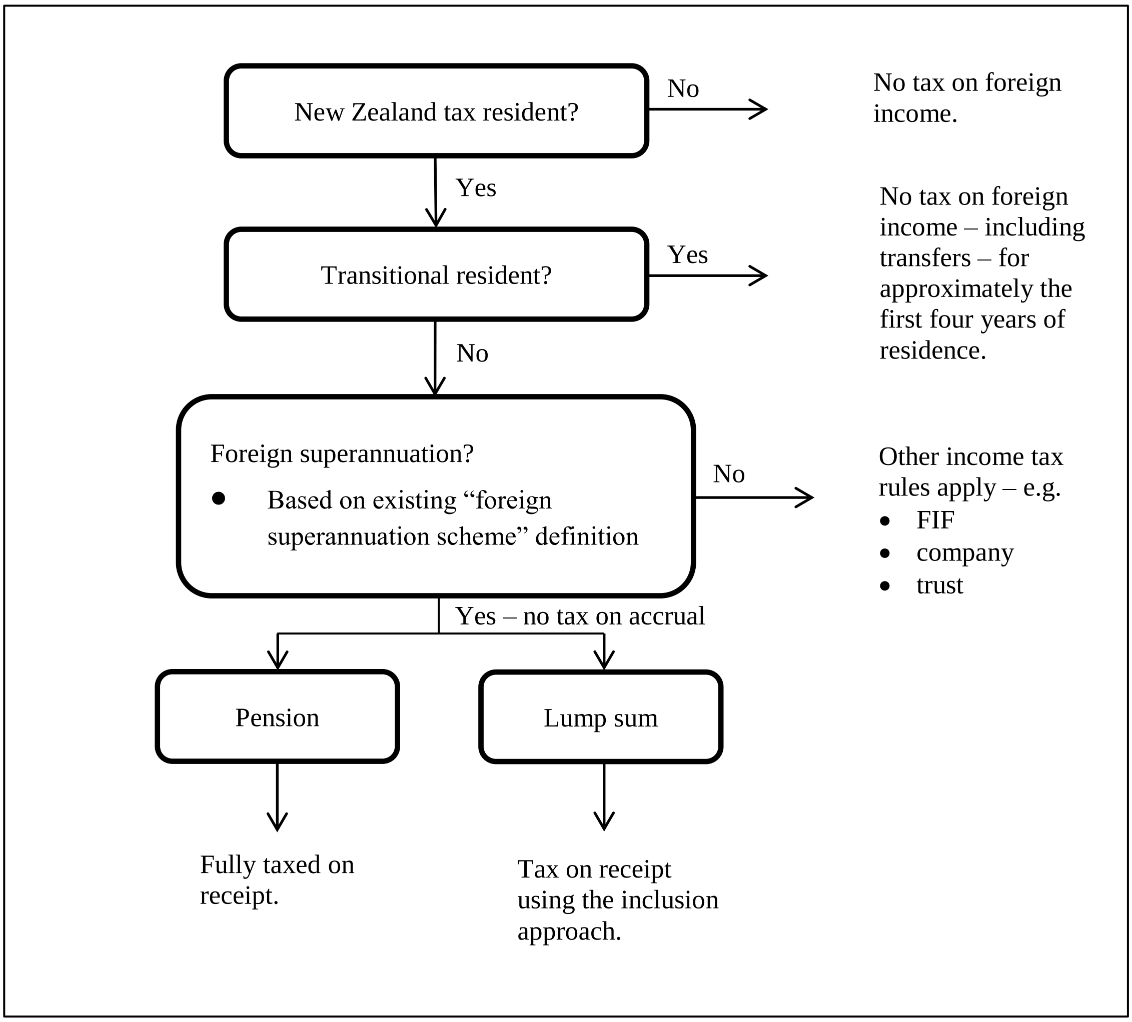
3.43 Some people may wish, or are required, to transfer their foreign superannuation to a New Zealand scheme which has "lock-in" rules (as defined previously).

3.44 The inclusion approach would also apply at the point when retirement savings are transferred to a locked-in superannuation scheme. This means that an individual would have some tax to pay if they do not transfer within the concessionary two-year period or during the exempt period for transitional residents. Applying the inclusion rate to the amount when it is transferred to the superannuation scheme is consistent with the proposed policy outlined above.[5] However, an individual may face cashflow problems if they are unable to access their funds due to the lock-in restrictions.

3.45 Officials invite comment on whether there should be a mechanism that allows tax to be paid out of the transferred amount held in the New Zealand superannuation scheme and, if so, how this should operate.

[5] Investment gains on amounts that have been transferred to a New Zealand superannuation scheme are taxed at the level of the scheme under the portfolio investment entity (PIE) tax rules. Once the entire amount (the transferred amount plus any subsequent investment earnings) is distributed from the scheme, it is exempt.

Proposed rules for taxing foreign superannuation



Examples of the proposed approach for taxing lump sums

Example 1

Deirdre works in the United Kingdom for 20 years for the same employer. She starts on a salary of £40,000 which increases by 3% per year over that period. At the end of each year she contributes 9% of her gross salary to her defined contribution superannuation scheme, which accrues interest at an average interest rate of 4%. At the end of 20 years, her superannuation is worth £138,604.

She quits her job at the end of the 20th year and migrates to New Zealand. After the exchange rate conversion, the investment is worth $284,845. Of this amount, $198,732 constitutes contributions and the remainder ($86,113) is investment gains.

Deirdre decides not to become a transitional resident for the first four years in which she is a resident New Zealand-resident, as she elects to receive Working for Families tax credits.

After four years, Deirdre decides that it would be a good time to withdraw her superannuation savings. At an average interest rate of 4% in the foreign scheme over the four years, the amount has grown to $333,228. This is the value of the lump sum withdrawal to New Zealand.

Although Deirdre has made the withdrawal within four years of arriving in New Zealand she is not eligible for the transitional residents' exemption. The relevant inclusion rate is 15%. For New Zealand tax purposes, $49,984 of the lump sum constitutes taxable income (being 15% of $333,228). Deirdre is currently studying and has no other taxable income. Under the current personal tax rate structure, the tax on her foreign superannuation withdrawal is $8,015. This represents an average tax rate of 2.4% on the $333,228 lump sum.

Example 2

Ken from the USA migrates to New Zealand at age 50 and begins work for a new employer. At the time, he has a 401k account worth US$250,000. At age 60 (10 years later) when he contemplates retirement, he decides to make a lump sum withdrawal rather than receive an annuity. The 401k is valued at $407,224 (at an average interest rate of 5% over 10 years). Ken has not been required to pay any tax on earnings on his superannuation interest during the 10 years that he has been resident in New Zealand.

After the exchange rate conversion, his superannuation is worth NZ$519,525.

The relevant inclusion rate for 10 years is 45%. This means that $233,786 (being 45% of $519,525) would be taxable income in the year of withdrawal. In the year that Ken withdraws his superannuation, he earns more than $70,000 from his employment income, which means that additional income he earns is taxed at the 33% marginal tax rate. His assessable income from his foreign superannuation is therefore taxed at 33%, resulting in a tax liability of $77,149 (being $519,525 x 45% inclusion rate x 33% tax rate). This represents an average tax rate of 14.8% on the $519,525 lump sum.

CHAPTER 4

Implementation and transitional issues

4.1 The proposals in this issues paper are expected to be contained in a tax bill scheduled for introduction later this year or towards the middle of next year.

Start date for new rules

4.2 As noted above, the complexity of the current rules has contributed to many people not complying with the existing law. Moving from the existing rules to the new rules creates transitional issues, both for people who complied with the existing law – either the FIF rules or the tax rules for lump sums – and for those who have not.

4.3 It is proposed that the new rules apply from the 2011–12 income year. In general, people who receive income from their foreign superannuation scheme (a withdrawal, transfer or pension) on or after 1 April 2011 would be taxed under the new rules.

4.4 However, many people have complied with the FIF rules in the past by filing returns disclosing FIF income. It is not appropriate to require these people to pay additional tax on receipt of the income. Consequently, this paper proposes that those who returned FIF income for the 2010–11 income year by 31 March 2012 can continue to use the FIF rules for future periods (that is, they would be grandparented). The 2010–11 income year is appropriate as it is the most recent year for which all FIF returns must have already been filed. These people would not be taxed under the proposed new rules when they receive a pension or lump sum.

4.5 People who transfer or receive income from their foreign superannuation scheme in the 2011–12 or subsequent income years and who do not meet the conditions in paragraph 4.4 would apply the proposed new rules. They would be taxed on receipt of their lump sum or pension rather than on accrual.

Example 3

Jacqui migrated from Canada to New Zealand in 2001 and left her superannuation in the foreign scheme. She is exempt from the FIF rules for the first four years under the new migrants' exemption, but returns FIF income on her foreign superannuation for subsequent income years. In 2015, she decides to withdraw the whole amount as a lump sum. As she returned FIF income in the 2010–11 income year by 31 March 2012, she can continue to use the FIF rules after 1 April 2011. She is not subject to tax on the lump sum withdrawal in 2015 under the new rules.

Application to past lump sum withdrawals or transfers

4.6 In recent years, a number of new tax residents have withdrawn their savings from a foreign superannuation scheme. In many cases, the distribution from the foreign scheme was transferred directly to a locked-in New Zealand superannuation scheme. These distributions are generally subject to tax, and in some instances the New Zealand-resident may have been liable for tax on all or part of the distribution.

4.7 In other cases, however, an individual might have had little or no tax to pay under the existing rules, depending on the underlying legal nature of the foreign superannuation scheme (such as whether it is a unit trust), whether the FIF rules applied, and whether the individual was a transitional resident.

4.8 Some of these people were not aware that they were potentially subject to tax when the foreign scheme distributed their superannuation savings.

4.9 It is important that people comply with their tax obligations under the law that applied at the time. This is to ensure that everyone, including those who paid the appropriate amount of tax, are treated fairly.

4.10 On the other hand, officials recognise that some of the people who withdrew or transferred their savings would not have done so had they been aware of the tax implications. This has largely arisen as a result of the complexity of the rules.

4.11 To ensure that these people are not unfairly disadvantaged, this paper suggests that it would be appropriate to allow people, in limited situations, to apply either:

- the law that applied at the time that they withdrew or transferred the savings; or
- an inclusion rate of 15%, regardless of the length of time that the individual was resident before the withdrawal or transfer.

4.12 Under the second option, only 15% of the lump sum would be assessable income. The remainder would not be assessable. This would result in an effective tax rate of up to 5% on the lump sum, depending on the individual's marginal tax rate.

4.13 The choice would be available to people who withdrew foreign superannuation as a lump sum between 1 January 2000 and 31 March 2011, and who disclose the existence of the transfer to Inland Revenue before 1 April 2014. The requirements for disclosure will be provided once the policy has been finalised. As noted previously, transfers on or after 1 April 2011 would be subject to the new rules, with the relevant inclusion rates in the table in paragraph 3.25.

4.14 No use-of-money interest or shortfall penalties would apply when an individual chooses to pay tax using the 15% inclusion rate.

4.15 If an individual chooses to calculate their tax liability under the law that applied at the time they withdrew the savings, and they have a tax liability, penalties and use-of-money interest would apply. However, Inland Revenue will have discretion to write off shortfall penalties for people in these circumstances, as long as an individual has not taken an abusive tax position and has not engaged in evasion or a similar act as part of taking a tax position. These people would not qualify for the grandparenting of the FIF rules as in paragraph 4.4 above.

4.16 The proposal aims to ensure that all people are treated fairly, including those who have paid the appropriate amount of tax, and as well as ensuring that new migrants who may not have been aware of the rules at the time they withdrew their superannuation are not unfairly disadvantaged.

Example 4

Robert migrated to New Zealand in 2005 and transferred superannuation worth $90,000 to a New Zealand superannuation scheme in 2007. As he was exempt from the FIF rules under the new migrants' exemption, he should have paid tax on the transfer but was unaware that tax was due.

In 2013, Robert realises that he should have paid tax when he transferred his superannuation. Once the new legislation has been enacted, he tells Inland Revenue of the transfer and chooses to apply the single low inclusion rate to the lump sum amount. He must pay tax on 15% of the $90,000 transfer, which at a marginal rate of 33% results in a tax liability of $4,455. This gives an effective tax rate of just under 5%. Robert would subsequently have no further tax to pay on that transferred amount, although any investment gains in the New Zealand scheme would remain taxable.

Past transfers to locked-in New Zealand superannuation schemes

4.17 As noted in paragraph 3.43, some people may have transferred their foreign superannuation to a New Zealand scheme which has "lock-in" rules".

4.18 If there is a resulting tax liability, the individual may have difficulty paying the tax if they are unable to access their funds due to the lock-in restrictions.

4.19 Officials invite comment on whether there should be a mechanism to allow tax to be paid from the transferred amount held in the New Zealand superannuation scheme and, if so, how this should operate.

ANNEX

Background on methodology used for inclusion rate

Below is background information about the basis on which the inclusion rate approach was calculated.

Policy rationale

An individual with an interest in a foreign superannuation scheme may be able to withdraw an amount from that scheme as a lump sum.

If an individual transfers their superannuation to New Zealand at the time that they first become a New Zealand tax-resident, the amount transferred would be in the New Zealand tax base. In general, this amount can be expected to generate a taxable return (such as interest). If an individual does not transfer their savings immediately on migration but instead transfers their savings at a later date, New Zealand foregoes tax on the interest income that the savings would otherwise have accrued.

Under the inclusion approach, the lump sum would be taxed to an extent that would roughly equal the amount of tax otherwise payable on New Zealand interest income, after taking into account the benefits of deferral of not having paid that tax on accrual. After paying tax on the lump sum, the individual would be in approximately the same position they would have been in if they instead transferred the amount on migration and derived interest income.

The portion of the lump sum to be taxed would primarily depend on the length of time that elapses between the individual's migration to New Zealand and the date on which they transfer their savings. This is relevant because the longer the delay between migration and transfer, the more tax is foregone on interest income that would otherwise have accrued.

Formulae

As explained, the desired policy is to tax the lump sum withdrawal or transfer so that the post-tax amount of the lump sum is equal to the amount that an individual would have had if they instead derived interest income in New Zealand and paid tax on accrual.

The variables in the following formulae are:

- "x" = value of the superannuation interest at the date of migration
- "i" = interest rate, which is set at 5%
- "t" = tax rate, which is set at 33%
- "n" = number of years between migration and the withdrawal or transfer
- "b" = necessary inclusion rate to achieve policy intent

The value of the amount that would otherwise have been taxed on accrual in New Zealand can be written as:

$$x(1 + i(1 - t))^n$$

This is the value of the superannuation on the date of migration after accumulating gains for *n* years at a post-tax interest rate.

The value of the amount transferred in a lump sum to New Zealand and taxed on receipt is:

$$x(1 + i)^n(1 - t)$$

In other words, this amount represents the value of the savings at the time of migration, after being left in the foreign scheme to earn *i* interest for *n* years. It is then taxed on withdrawal at the end of the n^{th} year.

The policy intent is for the value of the first amount to equal the second amount, in order to put the individual in the same position. This gives the following formula:

$$x(1 + i)^n(1 - bt) = x(1 + i(1 - t))^n$$

This can be rewritten to find the inclusion rate, as follows:

$$b = \frac{1 - \frac{\left(1 + i(1 - t)\right)^n}{(1 + i)^n}}{t}$$

The inclusion rates depend on three factors:

- the interest rate (to which the inclusion rate is sensitive);
- the average tax rate (to which the inclusion rate is insensitive); and
- the number of years before the withdrawal or transfer that the individual was a New Zealand-resident (to which the inclusion rate is sensitive).

The inclusion rates do not depend on the amount of income transferred, or on the value of the foreign superannuation interest at the time of migration (the cost base). The cost base is simply assumed on the basis of the applicable interest rate.