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To the Tax Working Group

Submission - Future of Tax: Interim Report, Extension of Taxation of Capital Income to Shares in Companies

This submission is from the Financial Services Council of New Zealand Incorporated (**FSC**) to the Tax Working Group ("TWG") on the Future of Tax: Interim Report ("The Report").

The FSC represents New Zealand's financial services industry having 35 members at 31 October 2018. Companies represented in the FSC include the major insurers in life, disability, income, and trauma insurance, and some fund managers and KiwiSaver providers plus law firms, audit firms, and other providers to the financial services sector.

Our submission has been developed through consultation with FSC members, and represents the views of our members and our industry. We acknowledge the time and input of our members in contributing to this submission.

The FSC's guiding vision is to be the voice of New Zealand's financial services industry and we strongly support initiatives that are designed to deliver:

1. Strong and sustainable consumer outcomes;
2. Sustainability of the financial services sector; and
3. Increasing professionalism and trust of the industry.

Executive summary

We welcome the opportunity to submit our views on the Future of Tax: Interim Report.

Given the focus of the FSC on growing and protecting the wealth of New Zealanders, our submission is centred around the extension of the taxation of capital income as it relates to investments of KiwiSaver and other retirement schemes, Multi-Rate Portfolio Investment Entities (MRPIEs) and Life Insurance policyholders.

We also submit on other matters including:

- the recommendation on removing Employer Superannuation Contribution Tax (ESCT) for employees earning up to $48,000 per annum, and,
- a five percentage point reduction for each of the lower PIE rates for KiwiSaver also applying to non-KiwiSaver Retirement Schemes and MRPIEs.

The FSC believes that the tax system should encourage investment and saving for retirement.

The FSC therefore supports any recommendations of the Tax Working Group that both encourages greater savings and provides a “level playing field” between direct investment and investment via managed funds and retirement schemes.

The FSC submits that:

1. Shares should be excluded from being a targeted asset category.

2. If key point 1 is not accepted, the current Australasian share exemption for MRPIEs should be retained.

3. The recommendation on removing ESCT for employees earning up to $48,000 pa should also apply to non-Kiwisaver Retirement Schemes; and a five percentage point reduction for each of the lower PIE rates for KiwiSaver should also apply to both non-KiwiSaver Retirement Schemes and MRPIEs.

I can be contacted on [1] to discuss any element of our submission.

Yours sincerely

[1]

Richard Klipin

Chief Executive Officer, Financial Services Council

Extension of Taxation of Capital Income to Shares in Companies

1. Exclusion of Shares from Targeted Asset Category

The Future of Tax Interim Report includes an option to extend the taxation of capital income to shares as part of the targeted approach. The Report states shares are included as they are regarded as "relatively easy to tax".

The FSC submits that shares in companies should be excluded. It is FSC's view that interests in land have created the asset class tax bias and therefore, interests in land should be the primary target of any extension of taxation of capital income, not shares.

Taking into account that any taxation of gains arising from disposal of the family home are specifically excluded from the types of asset classes that may be considered by the Tax Working Group (TWG), the bias towards interests in land will still be present. Therefore, excluding shares from the taxation of capital income may partially offset this bias. Anti-avoidance rules around land rich companies could ensure that companies are not used to bypass a tax on property gains.

The value of company shares is significantly determined by underlying cashflows that are generally taxable when derived by companies. In addition, Australasian companies generally have high yields which mean taxable dividends. Given these factors, it is not necessary to include shares in the targeted asset categories and accordingly they should be excluded.

The FSC is also concerned that extending the regime to encompass Australasian shares may have a negative impact on New Zealand's capital markets. For example, where the Fair Dividend Regime (FDR) is maintained, for some NZ companies, it may be desirable for them to relocate offshore if that would mean a better tax outcome for their New Zealand investors.

2. Taxing Australasian Share Gains of KiwiSaver, Other Retirement Schemes and MRPIEs

As above, the FSC submits that shares be excluded from the targeted asset category if the TWG recommends an extension of the taxation of capital income. If this is not accepted and share gains and losses will be subject to tax, the primary issue for the FSC is how equity is maintained amongst investors in KiwiSaver, other Retirement Schemes and MRPIEs, and direct investment, in a way that is practically achievable and seeks to minimise risk and compliance.

The Report outlined a number of options to do this. We comment on several of these below in order of preference:

2.1. Status quo with current exemption for Australasian shares

This is our preferred option. We recognise the concern of the TWG around what this would mean for direct investment versus investing via managed funds, and that this may mean the Australasian share exemption is limited to long-term retirement savings. A practical consideration in doing this will be how to make it work given wholesale interfunding structures through which a majority of KiwiSaver and other Retirement Schemes, along with other MRPIEs, currently invest.

2.2. A full accrual basis (including foreign shares), with possibly a discount for Australasian shares:

- Overall, this would be practically workable and should enable funds to maintain equity between investors.

- There should be no ringfencing of losses and it is important that the current regime of allowing managed funds to receive cash refunds continues. If losses are deferred to later periods (eg funds would be required to carry a deferred tax asset which does not work under the Portfolio Investment Entity (PIE) regime), this will lead to equity issues between investors and significantly increase complexity and compliance costs.

- To compensate managed funds for being taxed on an accruals basis, we understand the TWG is considering applying a discount to the accrual gains. The FSC submits that a discount at a flat rate be applied as opposed to each fund determining its own rate based on turnover of shares. The discount would also need to be at such a level to make this basis attractive and to “sell” the concept to investors. We do not believe that simply being able to cash up losses is sufficient to offset the impact of funds being taxable on an accrual basis. There needs to be a discount, particularly given the need for a level playing field between direct investment (if taxable on a realisation basis) and MRPIEs (if taxable on an accrual basis).

- Our members have a range of views on whether to include rest of world shares. Some have a preference, though not unanimous, for accrual on Australasian shares while retaining FDR for foreign shares. One potential benefit would be that it would take away the current FDR hedging issues that currently exist (given only a minority of fund managers are using the current FDR hedging regime due to its complexity and associated compliance). We comment on this separately below also.

  However, extending the regime to the rest of world shares is likely to expose the Government to significant fiscal risks when there a significant market downturns leading to unrealised losses being cashed up.

2.3. A full FDR basis (including Australasian shares):

The FSC believes that it would be a difficult sell for investors if shares held by managed funds were taxed on a full FDR basis, while direct holdings were only taxed on a realised basis. Therefore, we do not support extending the existing FDR regime to also include Australasian shares. However, the FSC submits the existing FDR rate should be regularly reviewed and reset if required. The FSC support the comments in the Report the 5% FDR rate is too high and should be reduced.

3. Application Date for Shares

The FSC has submitted that Australasian shares be excluded from the targeted asset category. If that is not accepted, the FSC submits the implementation date of 1 April 2021 is unrealistic particularly given the uncertainty of current Government and future Government support. If the 1 April 2021 implementation is not deferred, the FSC further submits that there be phased application dates for taxing the targeted asset classes.

Not all of the targeted asset classes need to be taxable from the same date of 1 April 2021. Shares and portfolio shareholdings could be taxable from a later date, say 1 April 2022 at the earliest. This would provide managed fund and KiwiSaver providers sufficient time to make the required changes to their systems and processes to comply with the new rules (including updating any regulatory documents to inform new and existing investors of changes).

4. FDR Hedging rules

The current FDR hedging rules apply to limited scenarios and the tests to meet the rules are complex. Should FDR continue to apply, the FSC submits that the application of FDR hedging rules should be widened to allow more entities to apply FDR to all hedges as long as the entity meets certain thresholds and where possible the rules are simplified.

5. Listed PIEs

KiwiSaver and other Retirement Schemes and MRPIEs invest in listed PIEs. The FSC would be concerned if listed PIEs are taxable on the targeted asset gains within the listed PIE and the disposal of the listed PIE shares also being taxable, giving rise to double taxation.

The FSC submits the current treatment of distributions by listed PIEs should remain.

6. Non-residents

The Report proposes the treatment of capital gains and losses for non-residents will be different from the position for residents. The FSC submits that non-residents investing in a MRPIE should have the same treatment as a resident investor. The different treatment of capital gains and losses would only apply to notified foreign investors in a Foreign Investment PIE. The current tax settings in relation to Foreign Investment PIEs should be maintained.

7. Life Insurance

The Report makes a brief reference to life insurance. It refers to policyholders not being taxed on unimputed distributions of income and we understand that this particular point is largely being made in relation to participating policies.

The FSC submits that life insurance policies should not be within the targeted asset category. In particular, for participating policies, unimputed distributions should not be taxable as they represent a return of policyholder premiums paid.

Participating policies operate on the basis of pooling funds, sharing investment returns and insurance risk. Investment income from pooled funds is currently taxed at 28% on behalf of policyholders, notwithstanding some policyholders may have lower marginal tax rates.

Unimputed distributions of income on participating policies (which are generated when premiums payments are in excess of claims) represent a return of policyholder premiums paid and therefore should not be taxed.

8. Non-KiwiSaver Retirement Schemes and PIE Rate Reductions for all MRPIEs

The FSC submits the recommendation on removing ESCT for employees earning up to $48,000 per annum and a five percentage point reduction for each of the lower PIE rates for KiwiSaver also apply to non-KiwiSaver Retirement Schemes which are equivalent to KiwiSaver Schemes.

This will ensure a consistency and fairness of outcome for members regardless of whether they are saving for their retirement through KiwiSaver or a KiwiSaver equivalent type scheme. In this regard, the FSC is supportive of the submission being made by Workplace Savings.

Further, the FSC submits the lower PIE tax rates for low income earners should also be available to all MRPIEs in the interests of encouraging saving as the FSC originally submitted.