Tax Working Group Public Submissions Information Release

Release Document

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taxworkingroup.govt.nz/key-documents

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[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people;

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Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Tax Working Group - Feedback

NOVEMBER 2018

implemented investment solutions

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Feedback on capital gains tax in NZ PIE funds

- Implemented Investment Solutions (IIS) is a licenced as a “managed investment schemes” manager under the FMC Act.
- IIS are experts in PIE fund solutions, which includes the taxation and tax consequences of different investment structures for Kiwi investors.
- Ours is a unique business model in NZ - where we provide fund hosting services to offshore fund managers who want to offer their investment solutions and expertise in PIE compliant regulated funds to Kiwi investors (without setting up NZ business operations and becoming licenced themselves).
- “Fund hosting” business models (like ours) are standard globally in regulated markets. In Australia businesses like ours are called “third party responsible entities”.
- We are a growing business and today manage approximately $3.5 billion and work with seven different investment groups including Legg Mason, Russell Investments, First State and Hunter Investments (who invest with PIMCO).
- IIS also 100% owns InvestNow – which is a fast growing retail platform enabling retail clients to manage their own portfolios online (including PIE managed funds, Australian unit trusts, and more recently multiple banks’ term deposits).
- InvestNow has grown to approximately $250 million of assets and more than 8,000 clients in 20 months. From here InvestNow will look to enter the KiwiSaver market once our bank term deposit offering is fully launched.
- IIS also owns 50% of Hunter Investment Management Limited, which is a boutique fund manager with over $650 million of assets.

Key observations/concerns relating to TWG proposals

- Having different PIR tax rates for KiwiSaver schemes and normal PIEs is problematic from an implementation perspective, illogical from a policy perspective, and favours existing large KiwiSaver providers.

- Capital gains tax on realised gains is difficult/impossible to implement within PIE funds reflecting that tax is at the investor level (as opposed to being done within the PIE fund). We note that this is merit in considering a FDR type of tax for NZ shares, noting that this then becomes a wealth tax.

- IIS welcomes changes to the FIF tax rules for individuals. The current FIF tax rules incentivise individuals to invest in Australian unit trusts for global shares (over NZ PIE funds).

  This reflects the benefits relating to the combination of the ability of individuals to opt out of paying FDR tax in negative return years, coupled with their ability to use their FIF portfolio value at 1 April to calculate their FIF tax (meaning that in positive return years individuals don't pay tax on gains and contributions).

  The influence of this unintended tax incentive (for mum and dad investors to favour FIF funds) is evidenced by Australian investment managers registering and offering 800+ funds to NZ investors under "Mutual Recognition" rules (which in turn evidences that this tax outcome is influencing NZ investors' capital flows).

Concerns relating to having different PIR rates for KiwiSaver

- Having different PIR tax rates for KiwiSaver schemes and normal PIEs is problematic from an implementation perspective, illogical from a policy perspective, and favours existing large KiwiSaver providers.
- In terms of implementation:
  - Modern systems (like registry and the PIP custodial tax platform that supports InvestNow) are client centric.
  - Having different PIR rates for 1 investor based on different types of funds they hold (e.g. KiwiSaver versus normal PIEs) is potentially difficult and expensive to implement.
  - This potentially restricts fintech and smaller groups like InvestNow being able to enter the KiwiSaver market.
- The Tax Working Group's proposed change favours large established KiwiSaver providers.
- Encourages retired people to invest in KiwiSaver over other forms of investments (limited forms of appropriate investment options for retired people).

Feedback on capital gains tax in NZ PIE funds

- If capital gains tax is introduced there needs to be a consistent approach for NZ shares and global shares
  - If NZ shares have capital gains tax, while global shares use the FDR methodology, this will result in capital flowing away from NZ assets.
- Implementing capital gains tax into NZ PIE funds is problematic unless it is on both realised and unrealised capital gains.
  - Only taxing realised gains won't work operationally in PIE funds.
  - Taxing realised an unrealised gains in PIE funds creates a tax distortion between PIE/KiwiSaver funds and investing directly in the underlying shares.
- A capital gains tax under PIE will transfer sharemarket volatility on to the Crown's accounts. Under the PIE regime investors will/should rationally realise losses to get tax back each year so they can invest this back in to the sharemarket.
  - Example: Investor has $100 of NZ shares which falls to $50 (so they have now $50 of market exposure). Realising this loss results in $14 of cash coming to the investor from the IRD (assuming a 28% PIR), resulting in the investor being able to invest $64 in NZ shares (being $50 + $14 from the IRD).
- **Solutions:/Recommendations** Have capital gains tax on all capital assets (abolish FDR method). Tax realised and unrealised gains for all investment types. Alternatively, have RFRM/FDR for all capital assets, or alternatively leave PIEs holding NZ shares as being exempt from capital gains on realised gains (while putting Australian shares under the FDR methodology).

Feedback on capital gains tax in NZ PIE funds (continued)

Feedback/thoughts on RFRM/FDR methodology for NZ shares

- Having RFRM/FDR for all capital assets works for PIE funds.
- However, this becomes a wealth tax if considered in the context of private business ownership, or other capital assets like property. As a privately held entrepreneurial company, we are not in favour of a wealth tax of this nature.
- Having RFRM/FDR for PIE funds, and capital gains tax for direct investments will create distortions in saving behaviours.
- Having considered the positives and negatives of each option, if capital gains tax is introduced, we recommend leaving PIEs (which includes KiwiSaver funds) that hold NZ shares exempt from capital gains tax (while putting Australian shares under the FDR methodology).
- This is not a significant change to the existing regime (Currently investors who hold NZ shares directly could be taxed on capital gains. Currently the IRD is simply electing to not enforce the circumstances where an investor should be paying capital gains tax).
- Our proposal (leaving NZ shares within PIE funds exempt from capital gains tax) creates a distortion between PIE funds and other form of investment (e.g. direct investment in shares). However, other possible options we have considered create similar distortions, and this on balance appears the most workable solution.

FIF tax rules for individuals

- FIF tax rules for individuals are flawed and should be bought into line with the FDR rules for PIE funds.
- The FIF rules for individuals creates significant tax incentives as a result of the unique combination of:
  1. The ability for an individual to be able to switch between the FDR and CV calculation methods for all of their FIF e.g. if there are negative returns across sharemarkets; and
  2. The ability for an individual to also elect to pay FDR tax on their FIF portfolio value at 1 April – thus avoiding paying FDR tax on contributions and gains made through the year.
- The following table demonstrates the effect of the unique combination of these factors by comparing an individual's experience if they invested in a FIF (top table) versus a global share PIE (bottom table). This assumes tax rates of 33% and 28% respectively.

The table shows how lightly a global equity investor in a FIF fund is taxed relative to a PIE fund. This assumes that the investor is on the top marginal tax for the FIF investment (33%) and PIR tax rate for the PIE fund (28%). It assumes that in both cases the investor makes a $100,000 deposit on 2 April each year.

In these scenarios the investor pays more than double the amount of tax as a result of being in the PIE fund.

Potential tax benefits of using FIF

FIF	1 April	+ 2 April	Return %	Return $	Tax Paid	Closing Value
Year 1	$0	$100,000	10%	$10,000	$0	$110,000
Year 2	$110,000	$100,000	10%	$21,000	$1,815	$229,185
Year 3	$229,185	$100,000	-5%	-$16,459	$0	$312,726
Year 4	$312,726	$100,000	10%	$41,273	$5,160	$448,838
Totals					$6,975	$448,838

PIE	1 April	+ 2 April	Return %	Return $	Tax Paid	Closing Value
Year 1	$0	$100,000	10%	$10,000	$1,470	$108,530
Year 2	$108,530	$100,000	10%	$20,853	$3,065	$226,318
Year 3	$226,318	$100,000	-5%	-$16,316	$4,454	$305,547
Year 4	$305,547	$100,000	10%	$40,555	$5,962	$440,141
Totals					$14,951	$440,141

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FIF tax rules for individuals (continued)

- As shown on the previous page, individuals receive significant tax incentives to invest in FIF funds as a result of the favourable combination of different components of the FIF tax rules for individuals.
- This in turn distorts investor behaviour explaining why so many Australian fund managers offer Kiwi investors Australian unit trusts under the mutual recognition regime.

> "To date, however, the mutual recognition has been more-or-less one-way traffic: just under 800 of the 1,180 investment offers listed on the Disclose website were issued by Australian providers under the agreement." www.InvestmentNews.co.nz 27 August 2018

- Ironically the FIF diminimis tax rules penalise people who invest into these Australian unit trusts (being people with less than $50,000 invested in FIF funds). Annually Australian unit trusts must distribute all income including realised capital gains. In the medium to longer term this means all returns will be distributed to NZ diminimis investors and taxed. Investors with less than $50,000 in Australian unit trust FIF funds should opt out of diminimis.

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