The Proposed Changes to the Treatment of Offshore Investments

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Thank you for the opportunity to speak to you today. The last time I presented to the Estate and Tax Planning Council, I shared an after 5 client function with a young man by the name of Craig Stobo.

He enlightened us that evening with an intelligent and insightful presentation on a topic that he was passionate about - perceived inequities within the current system for the taxation of equities.

Of course, he was obviously speaking with the right people at that time as he was shortly thereafter commissioned to research and write the Stobo report. This was issued two or three years ago. Although it was sent back for further consideration, much of what is currently proposed has the hallmarks of the Stobo proposals.

Of course this is not the first time that attempts have been made to reform what is commonly known as the FIF regime. I have been in New Zealand for 18 years and throughout that period the FIF regime has been subject of much debate, much review and much desire of reform and probably quite a lot of non-compliance!

Probably the best two examples of the desire for reform were the MacLeod review and Stobo report which were comprehensive discussions documents. In contrast the 15 pages of self-justifying spin leaves me as a tax professional quite under whelmed with the lack of detail and certainly with more questions than answers.

No doubt the devil will be in the detail and we await the Tax Bill which is due to be released this month as an opportunity for further submissions on the proposals.

So what am I rambling on about? No doubt you will have read much of the proposals in the press and the various comments. My job today is to highlight for you the proposals to lead you through one of two examples so that you can begin to consider how this affects the many trusts and clients that you advise.

Qualifying Collective Investment Vehicles

Let’s deal with the easy part, namely the proposed changes to managed funds. There will be two proposed concessions:

1. Lower income savers investing in vehicles that adopt the new rules as qualifying collective investment vehicles will be taxed at their marginal personal tax rate.

Currently lower income savers are taxed at 33% on their savings in a managed fund even though their personal marginal tax rate may be 19.5%.

2. Capital gains on New Zealand and Australian shares held in a vehicle that adopts the new rules will no longer be taxed.

Obviously the Government has sold the benefit of both of these reforms.

The lower marginal rate harks back to the proposals which were commonly referred to as the TOLIS proposals. The current proposal indicates that the saver (note the change in terminology from a taxpayer) will elect for their savings to be taxed at an appropriate rate based on whether their previous year income is $48,000 or less, other savers will be taxed at 33%.

The qualifying vehicle will pay tax on the investment income, on behalf of the saver, at the savers tax rate.

Investors will not generally need to report this investment income in their tax returns, meaning that individuals are not currently required to file a tax return, will not have a file a return under the new rules.

They do however propose that if a qualifying vehicle makes an investment loss, it will generally be available to savers without a tax return having to be filed. Similarly costs incurred in deriving income from these qualifying investment vehicles are to be deductible. Just how the IRD will implement these proposals, without requiring tax returns to be filed, remains to be seen but that is certainly the intention of the proposed changes.

The proposal to exempt capital gains on the disposal of New Zealand or Australian listed shares are designed to eliminate some of the boundary issues that Craig Stobo was so passionate about. These included dealing with the difficulties of determining who might be a trader in share versus those who have acquired shares with the intention of long term hold. It also helped to remove the anomaly between the passive investment funds and those of the actively managed funds which are taxed as trading entities.

I suppose we should be pleased to receive this concession; however I cannot for the life of me understand the restriction to New Zealand and Australian shares. To deliberately exclude the two largest capital markets in the UK and the US, and other important investment areas, is quite inappropriate. It will surely drive investor behaviour into New Zealand and Australian shares at the cost of investing in other diversified investments.

The qualifying collective investment vehicle is a vehicle which:

§ Has as its principle activity the provision of investment and savings services;

§ It will have at least 20 investors, with no individual investor holding more of a 10% ownership interest in the vehicle;

§ The vehicle must not own more than 10% of any underlying entity;

- § It will not issue separate classes of units to stream different categories of income from the same asset to different unit holders; and

- § It must be a New Zealand tax resident or otherwise liable on its worldwide income in New Zealand.

Naturally there are exceptions to the investment-in test being the minimum of 20 investors, and the investment-out test being the total of investments greater than 20% with the usual anti-avoidance provisions.

A qualifying collective investment vehicle will be taxed on dividends from New Zealand and Australian shares, but will not be taxed on realised gains derived from trading in those shares.

For other offshore shares held outside Australia, the taxable income would generally be 85% of accrued changes in share value plus dividends on an unrealised basis. This is known as the 85% comparative value method.

The intention is for it to be compulsory for KiwiSaver default funds to enter the qualifying collective investment vehicle.

Also defined benefit superannuation schemes will have the opportunity to elect into the new rules in order to receive the benefits. These vehicles would however be required to pay tax at a flat rate of 33% rather than at the investor's tax rates.

On entry into the new tax rules, a qualifying vehicle will need to undertake a notional wind-up being a deemed disposal and reacquisition of the vehicles assets on entry. Any income on assets held on revenue account would therefore be brought to tax in that income year but spread over a three year period. Any losses on transition would be available to offset investment income derived in the future years.

Overseas Share Investments – Individual Direct Investors

Now for the hard part - the second element of the reforms aimed at individual direct investors is much less palatable and is likely to have a much broader application than eluded to in the press releases and information distributed to date.

No question it is a capital gains tax. For those individuals who will end up paying income tax on 85% of a capital gain derived in the future, this will be regarded as a capital gains tax.

The new tax rules apply to people who hold less than a 10% interest in a foreign company. The grey list has gone with exception of people who invest directly in Australian resident companies listed on the Australian Stock Exchange and who do not actively trade their shares. It is not clear whether this will extend to those who invest through a trust rather than directly. My gut feel is that it will be restricted to individual direct investments.

So what are we talking about?

- § The most likely means of calculating income will be the 5% cap method. Essentially this means that investors will measure the change in value of their offshore portfolio over the year. If the value has increased, 85% of this increase is the maximum amount that would be taxable. This brings the amount that is taxed for individual investors into line with that of managed funds.
- § Secondly, investors then calculate what portion of the 85% increase in value should be taxed in that year. If the dividends or repatriated income exceed at least 5% in the year, then they will be taxed on their dividends. If the dividends are less than 5% in cash, then they will pay tax on the unrealised gains up to 5% of the gain in value, after reducing it to 85%.

This is best illustrated by an example. If a share portfolio has increased from $100,000 to $110,000 during the year, the increase in value is $10,000 of which 85% means that $8,500 is the maximum amount that would be taxable. The portion of the $8,500 increase in value is taxable in year 1 would be $5,000 being the greater of $5,000 being 5% returned on the $100,000 investment and any cash received equals to $5,000. If the dividends exceeded $5,000, my understanding is that the dividend would be taxed in full in that year and the gains would be carried forward to the future?

So what are the key elements?

- § Firstly the 5% cap method is calculated by applying to an investor's pool of offshore assets. This is designed to be compliance costs at a minimum and will allow for an offset between underperforming investments which incur losses and those that increase gains. The intention is the negative returns of the overall portfolio runs at a loss, that loss will be deductible against other taxable income.
- § The pooling is also intended to provide a measure of rollover relief such that investors can sell one offshore asset and purchase another without being taxed in that year on any carried forward gains. This assumes that the sale is reinvested in offshore assets. If the sale proceeds are not reinvested but are say direct to New Zealand shares, the brought forward gains would be taxed.

I said that the above method was likely to be regarded as the most likely method. However there are to be other methods available including:

- § An 85% comparative value method which means that you will pay on 85% of the change in share value as your go on an unrealised basis.
- § A modified branch equivalent method where the investor pays tax on the company as if it were a New Zealand branch.
- § A standard rate of return method where the offshore investment will be taxed each year on 5% of its cost, with a cost based increased each year by deemed income of 5%. When the asset is sold, there will be a wash-up to ensure that 85% of excess gains and losses will be taxed or allowed as a deduction.

Just what the boundary issues will be in relation to these methodologies remains to be seen. It may well be that assets held by family trusts will not be eligible for the 5% cap

method and will somehow be forced into the 85% comparative value method or the branch equivalent method.

That would be consistent with our current deemed rate of return approach with the FIF's. Of course, we have not had to worry about that to date because of the grey list.

The $50,000 Exemption

Many of you will be aware that currently we have a $50,000 exemption from the FIF regime. It applies to all FIF investments when aggregated together by an individual investor. Again investments in grey list countries have not been required to be included in this calculation.

Unfortunately the $50,000 exemption is to be limited to those countries of which we have a double tax agreement. Obviously that includes the grey list countries but it is a much lower threshold given that previous investment in grey list countries were not required to be included in the calculation.

Australian shares are not included in the calculation but all other shares will be.

There is a further modification whereby individual investors who have the option of applying a threshold based on market value rather than cost, can be applied. This is a market value as at 1 April 2007, having regard to all interest acquired before 1 January 2000. It allows those investments owned at 1 January 2000 is calculated as at the market value on 1 April 2007. This amount is then divided in two and added to the cost of investments purchased post 1 January 2000 to determine whether the $50K minimum threshold has been breached.

In conclusion you can see the Tui billboard already. New Zealand does not have a capital gains tax – yeah right!

The proposed changes will have a significant impact on investor behaviour. It would not surprise me if it drove more and more people into residential rental properties out of a concept of simplicity. Watch this space for rental properties which are bought and sold on a regular basis. The IRD have announced that negatively geared rental properties could indicate that those assets were brought with the intention of resale. Any property bought with the intention of re-sale are of course taxed so watch this space. There will be many threshold issue which will arise once the full details are announced. My own pick is that:

- Investors will be encouraged to save through managed funds based in New Zealand who are qualifying collective investment vehicles. The building of wealth which is limited to New Zealand and Australia will be disappointing but they will make that judgment call in the hope of deriving a tax free capital gain.

- It is likely that investments in offshore assets will need to be held by individuals rather than through family trusts.

- There will be many products that have come on the market over recent years which will be taxable to individuals. The OM-IOP series promoted by Westpac is one. Deliberately established as a foreign investment fund based in the Cook

Islands, people were encouraged to acquire those shares by staying below the $50K threshold and using them as a savings scheme to promote tertiary education.

- On the positive side, provided you can qualify within the 5% cap method, at least the capital gains tax is deferred until it is realized. Only 85% of the gain will be realised and this I believe will be reduced by the amount previously returned in the earlier years but adjusted for dividends.

- The pooling method for the offshore assets is however a positive response and careful management of the pool will allow investors to defer the adverse cash-flow implications of the realisations.

The Government (or is it Treasury) (or is it the IRD) have certainly proved to be tenacious in its zeal for reforming the taxation of FIF investments. This leads me to believe that these proposals will become law as at 1 April 2007. We may well only have ourselves to blame as no doubt the industry leaders who are pursued, tax free capital gains from New Zealand based actively managed funds, may well have provoked the removal of the grey list for other FIF investments for the individual direct investor. Clearly the Government like the take back with one hand what they give out with the other.

Thank you once again for the opportunity to present to you this morning. I am happy to take some questions.