2. Overseas share investments by individual direct investors

Under the new rules, different types of investment income will be taxed consistently, whether direct investment by individuals or through managed funds. For direct investors in overseas shares, the changes also mean that investments into certain countries will no longer be disadvantaged.

The new tax rules will apply to people who hold less than a 10% interest in a foreign company. These rules remove the full accrued capital gains tax currently levied by the foreign investment fund tax rules.

For these individuals, the special tax exemption from the foreign investment fund rules for investments in “grey list” countries will be abolished. The “grey list” consists of Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States. At present, most individual investors who invest directly in companies resident in “grey list” countries pay tax only on dividends.

Investment in Australian-resident listed companies

People who invest directly in Australian-resident companies listed on the Australian Stock Exchange who do not actively trade their shares will continue to be taxed only on their dividends.

NZD$50,000–$100,000 minimum threshold

Individuals holding shares outside Australian-resident listed companies will, in most cases, be able to hold a portfolio that the new rules will not apply to. If the original cost of the shares purchased totals less than NZD$50,000, the new tax rules will not apply. These investors will continue to pay tax on dividends. A couple could hold offshore shares outside Australia costing NZD$100,000 or less before the new rules would apply.

The threshold would apply to investments in offshore listed companies that are resident in countries with which New Zealand has a double tax agreement.

Individual investors would also have the option of applying a NZD$100,000 minimum threshold (based on market value on 1 April 2007) for interests acquired before 1 January 2000. This should help investors who cannot remember the cost of investments that they have held for a number of years. The amount calculated under this threshold would be halved and added to the cost of investments purchased on or after 1 January 2000 to determine whether the NZD$50,000 minimum threshold has been breached.

Taxing substantial share portfolios outside Australasia

For individuals whose direct offshore share investments are outside Australia and cost over $50,000 a simple two-step calculation will be required. This calculation is designed to provide a certain and reasonable level of tax on offshore investments each year and is capped at 5%.

For investors to calculate their tax under the 5% cap, the two steps required are:

Step 1: Investors measure the change in the 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.

Step 2: Investors calculate what portion of 85% of the increase in value should be taxed in that year. If they have dividends or repatriated income of at least 5% then that is their total taxable income.

If an investor receives less than 5% in cash, but has positive share gains, then up to 5% of those gains are taxable after reducing those gains to 85%. If 85% of the increase in value is more than the 5% deemed return (or cash), the remainder is carried forward to the next year.

The tax paid on a 5% deemed return will be less than 2% of the investment's value.

The following simple example illustrates how the 5% cap method works:

Mary is an offshore investor and her tax rate is 39%. At the beginning of year 1 Mary's investment is worth NZD$100,000. At the end of year 1 the investment is worth NZD$110,000. She does not receive any dividends from the investment. How does she calculate her tax for year 1 under the 5% cap method?

Step 1 *What is 85% of the change in value in the year? $8,500 ($110,000 - $100,000 = $10,000; $10,000 x 85%)*

Step 2 *What portion of the $8,500 increase in value is taxable in year 1? $5,000*
Greater of $5,000 (5% return on $100,000 investment) and $0 (cash received) = ***$5,000***

Only $5,000 of the $8,500 is taxable in year 1. The tax payable is $1,950. This is 19.5% of her total return. The additional $3,500 is carried forward to year 2.

Offshore portfolio treated as a pool

One of the key features of the 5% cap method is that it applies to an investor's total pool of offshore assets. In other words, investors apply the two-step approach described above to their total portfolio of offshore assets and not on each offshore investment. This is designed to keep compliance costs to a minimum.

Rollover relief with no tax payable on death

The new rules will also allow investors to sell one offshore asset and purchase another without being taxed in that year on any carried forward gains. This means that cash received from selling offshore assets will not trigger a tax liability unless the proceeds are brought back to New Zealand. In addition, there will be no taxation of carried forward gains on the death of an investor.

The overall effect of the 5% cap and rollover relief provisions is that investors will generally pay tax on a maximum 5% return, with gains in excess of this deferred indefinitely.

Underperforming offshore investments

Investors will not have to pay tax on a 5% return unless the offshore portfolio makes an average 5% return. Returns of less than 5% on offshore portfolios will be taxed at 85% of their actual return. A corollary of this is that negative returns will be recognised as a loss for tax purposes in the same way as any gains are recognised as income. This means that the investor will typically be allowed to recognise losses in a year up to 5% of the offshore portfolio's value. These losses could be offset against the investor's other taxable income.

How complex is it?

The 5% cap method is more complex than the current tax rules, which typically tax individuals' "grey list" investments only on dividends. The additional complexity results from investors or their advisors being required to value their portfolio each year and keep a record of any carried forward amounts. However, the ability of investors to treat their offshore assets as a total pool reduces some of this complexity.

The proposal will allow people to use average exchange rates, which is less complex than the current dividend tax rules (which require savers to use the spot exchange rate on the date the dividend was derived).

The 5% cap method will apply only if a person's offshore investments (outside Australia) cost more than a total of $50,000 ($100,000 for a couple), or have a value of over $100,000 for investments purchased before 2000 ($200,000 for a couple). Assuming reasonable diversification, a person's investment portfolio will obviously be fairly substantial before these thresholds were breached.

Example – Difference in tax result under current rules and new rules

Jane has a 39% tax rate. At the beginning of the tax year Jane invests in an Australian-resident listed company (Oz Co), a company resident in the United States (US Corp), and a company resident in Singapore (Sing Co). Jane spends $60,000 on each of these investments and does not hold more than 10% of each of the corresponding entities.

At the end of the year, each of the investments is worth $70,000. Jane has also received dividends of $1,000 from each of the companies. No foreign non-resident withholding tax is deducted on the dividends (and hence there are no foreign tax credits).

Current rules

Under the current rules, Australia and the United States are "grey list" countries. This means that interests in companies that are resident in these countries are taxed only on any dividends received if held on capital account (which is how Jane holds these shares). Therefore Jane will pay tax of $390 on each of the dividends received from OZ Co and US Corp ($1,000 x 39%).

Note: Currently, there are eight grey list countries – Australia, Canada, Germany, Japan, Norway, Spain, United Kingdom and United States of America.

Singapore is not one of the grey list countries, so Jane's interest in Sing Co is subject to special tax rules – the foreign investment fund (FIF) rules. There are a number of methods available to calculate taxable income under the FIF rules, with the "comparative value method" being the most commonly used. If Jane elects to use the comparative value method, her taxable income will be $11,000. This is equal to the gain in share value ($70,000 – $60,000) and the dividend derived ($1,000). Jane's tax liability on this investment is $4,290 ($11,000 x 39%).

Under the current rules, Jane's total tax liability on her offshore portfolio share investments is *$5,070 ($390 tax paid on OZ Co investment + $390 tax paid on US Corp investment + $4,290 tax paid on Sing Co investment)*.

New rules

Investors who own 10% or less of an offshore company will not be able to use the grey list.

There will, however, be special rules for investments in certain Australian companies. Under these rules, interests that individuals hold in Australian-resident companies listed on the Australian Stock Exchange will be taxed under the same rules as they are taxed now. Therefore Jane will continue to be taxed only on the dividend that she received from Oz Co ($1,000 x 39% = $390).

Since Jane owns less than 10% of US Corp and Sing Co, she cannot use the "grey list" for those investments. Jane elects to use the "5% cap" method to calculate her tax liability for US Corp and Sing Co. Under this method, Jane must pool her investments.

First, Jane will have to calculate the maximum amount that can be taxed in the year. This is 85% of the change in value of her interests in US Corp and Sing Co, plus the

full amount of dividends received. For Jane, this maximum taxable amount is $19,000 (85% of ($140,000 – $120,000) + $2,000 dividends).

The amount that is actually taxable in that income tax year is the greater of any net receipts from the pool (dividends of $2,000) or 5% of the opening market value of the pool (5% x $120,000 = $6,000). As 5% of the opening market value is higher than net cashflow (but less than the maximum taxable amount of $19,000), Jane pays tax of $2,340 on these investments ($6,000 x 39%). Jane carries forward the difference between the maximum taxable amount and the actual taxable amount ($19,000 – $6,000), on which tax may have to paid in the future.

Under the new rules, Jane's total tax liability on her offshore portfolio share investments is *$2,730 ($390 tax paid on OZ Co investment + $2,340 tax paid on US Corp and Sing Co investment)*.

It is important to note, however, that Jane has a carried forward gain of $13,000, which may be taxed in future years resulting in a potential tax liability in the future of $5,070.

Summary

In the example above, Jane would pay less tax in the year under the new rules than she pays under the current rules. This does not take account of the carried forward gain of $13,000 – which may or may not be taxed, depending on the performance of the portfolio in future and Jane's circumstances. The "5% cap" method allows Jane to spread her tax liability over a number of years, which should help with cashflow.

There will be situations, however, when an investor's tax burden would increase – for example, for investors whose offshore share portfolio is heavily weighted towards investments in companies resident in grey list countries (other than Australia). If these investments have low dividend yields the current tax impost is likely to be significantly less than the impost under the new rules (even with the "5% cap"). The new rules will, however, provide opportunities for these investors to explore investment opportunities outside countries such as the United States and United Kingdom. At present, there is a barrier to do so because of the way the FIF rules treat investments outside the grey list.

Other methods available

While the 5% cap method is likely to be the most common method that individuals will use for calculating tax on substantial non-Australasian share portfolios, they can choose between three additional methods.

85% comparative value method
Under this method, 85% of the change in share value (plus full dividends) will be taxable each year. This method will also apply to an investor's total portfolio of offshore shares that the investor elects to treat under this method.

Branch equivalent method
The "branch equivalent" income calculation method, which currently taxes interests in offshore companies as if the company were a New Zealand branch, will continue to be available for those investors with the relevant information. A simplified branch equivalent calculation method will be available for investors in early stage companies.

Standard rate of return method

Under this method, offshore investments will be taxed each year on 5% of cost, with the cost base increased each year by deemed income of 5%. On realisation of an investment, and repatriation of funds, there will be a wash-up to ensure that 85% of excess gains and losses, respectively, are taxed or allowed as deductions.