3. New tax rules for New Zealand managed funds

A new set of tax rules will treat investment through intermediaries such as managed funds (collective investment vehicles) in the same way same as direct investment by individuals, thus removing long-standing disadvantages of saving through funds. The new rules will prevent over-taxation of lower income savers, and eliminate the taxation of capital gains on New Zealand and Australian shares held through a fund.

From 1 April 2007, collective investment vehicles that meet certain qualifying criteria will be able to choose to use the new rules. They will be compulsory for KiwiSaver default funds, so will come into effect in tandem with the start-up of KiwiSaver.

Qualification criteria for the new rules

To qualify for the new rules a collective investment vehicle would need:

- to have as its principal activity the provision of investment and savings services (as defined by the proportion of its underlying assets that are used to derive specified investment income);
- to have at least 20 investors, with no individual investor holding more than a 10% ownership interest in the vehicle – the “investment in” test. There will be some exceptions from these requirements – for example, when a qualifying vehicle invests in another qualifying vehicle;
- to own not more than 10% of any underlying entity (or 25% in certain circumstances) – the “investment out” test. There would be exceptions from this requirement for investments in other qualifying vehicles, real property and when the total of investments greater than 10% (or 25%) is not a significant portion (greater than 10%) of the value of the qualifying vehicle’s total portfolio;
- not to issue separate classes of unit that stream different categories of income from the same asset to different unit holders; and
- to meet the New Zealand tax residence rules (or be liable for tax in New Zealand on its worldwide income if not for the fact it is a qualifying vehicle).

Deliberate breaches of the “investment in” and “investment out” criteria (or failure to comply with the requirements outlined below) would result in forfeiture of qualifying status, with no ability for a vehicle to re-enter the rules.

Temporary breaches of the “investment in” and “investment out” criteria would be allowed on start-up or wind-down of a qualifying vehicle or due to inadvertent errors or factors outside the vehicle’s control.

Definition of "income" for a QCIV

Qualifying vehicles would not be taxable on realised gains on domestic shares (investments in New Zealand-resident companies) and Australian shares (investments in Australian-resident companies listed on the Australian Stock Exchange). This non-taxation of realised domestic and Australian share gains would not extend to situations where a qualifying vehicle does not have full equity risk associated with an investment. For offshore shares held outside Australia, taxable income would generally be 85% of accrued changes in share value plus dividends (taxable in full) – the "85% comparative value" method. The definition of taxable income would otherwise remain the same as it is under the Income Tax Act 2004.

Fees incurred by investors investing via a qualifying vehicle would continue to be deductible against taxable income derived via that vehicle.

Requirements of a qualifying vehicle and investors in qualifying vehicles

A qualifying vehicle would be required to pay tax on investment income, on behalf of investors. Lower-income investors could elect a 19.5% tax rate if their total income in the previous year is $48,000 or less. Others would be taxed at 33%.

A qualifying vehicle would have the option to pay tax on investment income (called an "attribution"):

- quarterly (or more frequently), with tax paid at the tax rates of all investors who were present on the attribution date;
- each time an investor exits the vehicle with a general attribution for investors who remain.

Losses made, and tax credits derived, by a qualifying vehicle that are in excess of the investment income of the vehicle would generally be able to be accessed by individual investors.

The tax paid by a qualifying vehicle on behalf of its investors would generally be a final tax. This means that individual investors would not need to return this income in their tax returns. This income would not affect individuals' entitlements to family assistance (under the *Working for Families* package) or their student loan repayment and child support payment obligations.

Defined benefit superannuation schemes

A defined benefit superannuation scheme is a scheme where investors' entitlements are not linked to their contributions.

Defined benefit superannuation schemes can also elect into the new rules and receive the exclusion for realised New Zealand and Australian shares gains. These vehicles would be required to pay tax at a flat 33% tax rate, rather than at investors' tax rates.

Transitional rules

On entry into new tax rules, a qualifying vehicle would need to undertake a “notional windup” (a deemed disposal and reacquisition of the vehicle’s underlying assets) under which any underlying assets held on revenue account would be brought to tax and spread forward over three years. Any losses arising on transition would be available to offset investment income derived via the qualifying vehicle in future years.