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Proposed technical amendments to portfolio investment entity rules

Use of formation losses

A portfolio investment entity's (PIE's) formation losses should be spread over three years. A PIE will have available to use on each day of the first three years **total formation loss X 1/1095**. To the extent that there is insufficient net income on a day to offset the amount of available formation loss for the day, the difference is added to the amount of formation loss for the next day – and so on. Once the 1095 day period has ended there is no daily restriction on the amount of formation losses that can be used each day. Formation losses cannot be rebated or flowed through under any circumstances.

A PIE's formation losses that represent 5% or less of the PIE's net asset value (on entry into the PIE rules) are not subject to this restriction.

There should be no restriction on flowing through or rebating current period losses.

PIEs should have the choice to apply formation losses at the entity level or at the investor class level.

Formation losses – effect on credits

Formation losses should not be used to offset net income to the extent that the PIE has income covered by New Zealand tax credits. This restriction would continue to apply after the 1095 day period referred to above has ended. The relevant credits are imputation, DWP and RWT. To calculate how much income is covered by New Zealand tax credits – and therefore cannot be offset by formation losses – the credits are grossed up to an income amount by dividing the credits by 0.33.

Foreign tax credits

Foreign tax credits (FTCs) are attributed daily to the investors in each portfolio investor class as they arise. Each investor's FTC share is equal to their share of the class's foreign income (i.e. equal to their portfolio investor interest in the class).

For non-zero rated investors in the PIE, the PIE offsets the investor's separate entitlement of accumulated FTCs against the investor's tax liability at the end of the year (or when the investor exits). An investor's entitlement to the FTCs that are not used at the end of the year are forfeited.

FTCs received by non-PIE zero rated investors are accumulated in the same way as above and allocated at the end of the year or when the investor exits. The investor will take the credits into account in their own tax return. The FTCs can only be used to offset tax payable on portfolio investor allocated income from that PIE.

Where a retail PIE invests into a wholesale PIE, any FTCs received by the wholesale PIE are allocated by the wholesale PIE (without reference to that PIE's income) to the retail PIE each day - and so on down any further tiers of PIEs until allocated to non-PIE investors where the treatments described above apply.

Quarterly PIEs should be allowed to carry forward excess FTCs across subsequent quarters in the same income year.

Treatment of investor expenses

The portfolio entity tax liability and rebate mechanism should be adapted to enable fees charged direct to investor accounts or cash accounts (that sit outside the PIE) to be deducted at the PIE level to reflect the individual investor position.

Investor return adjustments

Amendments are required to ensure that the adjustment made to an investor's interest to accurately reflect their share of the tax on PIE income or loss also reflects the commercial operations of PIEs. These amendments would ensure that the adjustments can be done on an investment class basis, may be carried out on the same day as tax calculations are made, do not unnecessarily give rise to further taxation as a result of unit cancellations, and should be made within 2 months of the end of the tax year for PIEs who calculate tax daily.

Distributions from PIEs

An amendment is required to clarify that only portfolio listed companies must attach full imputation credits (where available) to distributions. The current drafting could be interpreted to include other portfolio investment entities which were not intended to be caught by the provision.

A clarifying amendment is needed to ensure that distributions from portfolio listed companies to natural person investors are excluded income.

An amendment is required to ensure that distributions from portfolio tax rate entities to non-residents are not subject to further tax through deduction of non-resident withholding tax as non-resident investors are already subject to tax at 33% at the PIE level.

An amendment is required to ensure that non-resident investors in portfolio listed companies are still subject to non-resident withholding tax on dividends which carry full dividend withholding payment credits. This income should therefore not be treated as excluded income.

Eligibility criteria

An amendment is required to ensure that entities that derive (as opposed to allocate) certain types of income will be eligible to be PIEs. The types of income should be expanded to include income from other PIEs and distributions from superannuation funds. This would ensure that PIEs investing into other PIEs and superannuation funds will satisfy the income type eligibility requirement.

Unlisted companies should be allowed to be treated temporarily as portfolio listed companies if they meet certain criteria. The main criteria are that they are widely held and that they have commenced the process of listing on the New Zealand Stock Exchange and that listing is completed within two years of this treatment commencing.

A clarifying amendment is required to ensure that all failures to meet eligibility requirements are considered for an entity to become a PIE.

An amendment to the shareholding investment eligibility criteria is needed so they are based on a market value measurement instead of voting interests. This change is intended, in particular, to prevent unit trusts being used to circumvent the percentage threshold and achieve effective control of underlying investments.

An amendment is needed to require a portfolio investor proxy to provide information to a PIE each quarter if the portfolio investor proxy considers that the investors in the portfolio investor proxy would cause the PIE to breach the PIE eligibility criteria.

PIE and investor tax calculations

A monthly allocation period should be allowed for quarterly PIEs.

The tax calculation options should be expanded to accommodate investors with multiple portfolios within PIEs to allow tax to be effectively calculated at a portfolio or PIE level when they leave a fund.

A PIE calculating tax daily should have the option to deduct and pay tax for part years when an investor only partially leaves the fund.

PIEs should have the option of treating investor switches (across portfolios within a PIE or across PIEs) as a taxable event with the result that a PIE would calculate and pay tax for the investor at the time of the switch (if this option were taken).

An amendment is required to ensure that double taxation does not occur when a corporate investor inadvertently omits to elect a 0% rate. Also, in this situation, a credit should be provided for tax paid at the PIE level.

An amendment is required to provide investors with a refund of excess credits where the credits represent residual investor interest amounts paid to Inland Revenue from a PIE.

An amendment is needed to ensure that the rate for certain individuals leaving a PIE must be their most recently provided "prescribed investor rate".

Superannuation funds

Under current legislation, income relating to unvested contributions to superannuation funds electing to be PIEs will generally be taxed at investor tax rates where the vesting period for the contributions is three years or less. An amendment is required to lengthen the vesting period to five years to align with certain vesting requirements for KiwiSaver funds.

New Zealand Superannuation Fund

An amendment is required to allow the New Zealand Superannuation Fund to be treated as a PIE to ensure that the benefit of the Australasian share exemption is available to the fund.

Companies Act 1993

An amendment is required to correct a cross-referencing error in the Companies Act 1993 which should refer to the investor return adjustment provision in the PIE rules.

A minor clarification is required to remove the reference to payment of differential dividends being "required".

Definitions

The definition of a "portfolio tax rate entity" should be amended to exclude "portfolio defined benefit fund", not "defined benefit fund" as currently drafted.

To accommodate temporary breaches of the threshold test for a portfolio land company an amendment is required to provide that the threshold must only be met for 300 days in the year.

To deal with a situation where a quarterly PIE deducts tax when an investor leaves the fund, the definition of "portfolio investor exit period" should be amended to include a period where the PIE has not withheld the tax from the investor for the period.

An amendment to the definition of "prescribed investor rate" is required to resolve a conflict within the definition. This will clarify the different rates which are available to trustees. In addition, this definition should include portfolio investor allocated loss in determining which tax rate an individual investor should use.

Investor certificates

An amendment is required to ensure certificates for investors leaving quarterly PIEs are issued at the end of the month following the month they leave the fund. Under current legislation, certificates are only required annually in June.

Tax returns for portfolio investment entities

Annual income tax returns are not required for PIEs that are portfolio tax rate entities under the new rules. However an amendment is required to limit non-filing to portfolio tax rate entities that do not pay provisional tax. PIEs that pay provisional tax will continue to file tax returns.

Minimising investor tax returns

An amendment is required to ensure that investors receiving small amounts of income (which is not excluded income) from quarterly PIEs will not fall back into the tax return filing net where these amounts, combined with other sources of income which have not been correctly taxed at source, is \$200 or less.

Other clarifying amendments

Some sections, or part thereof, need to be repealed as they are redundant or need to be deleted or replaced to give effect to policy intent. These sections relate to some information requirements, broadening access to the PIE rules for foreign investment vehicles, the Commissioner of Inland Revenue making determinations, investments held by entities acting on behalf of PIEs, exclusion of life insurers from certain PIE eligibility requirements, and the exclusion from non-resident withholding income of dividends from portfolio listed companies.

Other cross-referencing

An amendment is required to correct the cross referencing error in the provisions relating to credits received by a portfolio tax rate entity or portfolio investor proxy.