

Taxation of non-controlled offshore investment in equity

An officials' issues paper on suggested legislative amendments

December 2003

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and by the New Zealand Treasury*

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CONTENTS

Chapter 1	INTRODUCTION	1
	Summary of the options and evaluation	3
	Submissions	4
Chapter 2	THE OFFSHORE INVESTMENT ENVIRONMENT	5
	Investment type	5
	Investor type	6
	Investment destination	7
Chapter 3	ECONOMIC FRAMEWORK	8
	The treatment of foreign taxes	8
	Source versus residence taxation	9
	Constraints in the international context	9
	Taxing actual income versus expected income	10
	The options within the framework	11
Chapter 4	THE CURRENT RULES FOR NON-CONTROLLED OFFSHORE INVESTMENT AND PROBLEMS	12
	The current tax rules for non-controlled investment in grey list countries	12
	Problems with the grey list	13
	The current tax rules for investment in non-grey list countries	15
	Problems with the current rules	16
Chapter 5	OPTIONS FOR REFORM AND COMMON FEATURES	18
	Assets covered	18
	Definition of “non-controlled interest”	19
	Countries covered	19
Chapter 6	A STANDARD RETURN RULE	20
	Objectives of the proposal	20
	Alternative income calculation method	21
	Explanation of the business test	22
	Setting the rate	24
	Treatment of debt	26
	Valuation of assets	28
	Part-year adjustments	33
	New part-years for acquisitions and realisations of qualifying assets	34
	Opening value calculated as the average of values over a 12-month period	45
	Monthly or daily asset holding period	47
	Conversion of income into New Zealand dollars	48
	Treatment of credits for non-resident withholding tax (NRWT)	49
	Trans-Tasman recognition of imputation credits	51

	Treatment of companies under a standard return rule	53
	Entry and exit from a standard return rule	55
	Evaluation	58
Chapter 7	OFFSHORE PORTFOLIO INVESTMENT RULES	61
	The domestic versus the offshore rules	62
	Suggested approach	63
	Investors with limited access to information	64
	Investors with access to detailed information	70
	Further issues	73
	Evaluation	75
Appendix 1	Taxation of domestic savings vehicles	78
Appendix 2	Main approaches considered for attributing debt	88
Appendix 3	Example – calculation of standard return income for easy-to-value assets	90
Appendix 4	Example – calculation of standard return where there is a bonus issue of “units” for nil consideration	94

Chapter 1

INTRODUCTION

- 1.1 In July 2000 the Government established an independent review of the structure of New Zealand's tax system, Tax Review 2001. The Review indicated that New Zealand's rules relating to the taxation of offshore portfolio investment by New Zealanders were a priority area for reform. The problem identified by the Review was the inconsistent treatment of different types of offshore portfolio (or non-controlled) investments.
- 1.2 The Review suggested that the risk-free return method (RFRM) could be applied to replace the current rules that tax non-controlled offshore investment in listed shares and retail unit trusts. The recommendation was that the RFRM would apply to all offshore investments in these assets – no matter the country of investment.
- 1.3 Under this method of taxation, taxable income would be based on an imputed rate of return to an asset. The return would be calculated by applying an assumed risk-free rate of return to the value of the asset at the start of the year. The investor's personal tax rate would then be applied to taxable income to calculate the RFRM tax liability.
- 1.4 Since the Review released its final report, tax policy officials from the Policy Advice Division of Inland Revenue and from the Treasury have been considering the issue of the tax treatment of non-controlled offshore investment in equity. This paper examines the issue, and suggests options for change. It seeks views on the suggested changes before officials make recommendations to the government on the matter.
- 1.5 At present, the foreign investment fund (FIF) rules provide a system to tax non-controlled offshore investments. The FIF rules were developed in the late 1980s and early 1990s. The rules were the product of some difficult trade-offs, and as a result, there have always been weaknesses in the rules. Moreover, the New Zealand economy and investment environment have changed considerably over the last ten or so years. In particular, New Zealanders regard offshore equity investments as much more of a normal part of their investment portfolio. Corporate residence has become more mobile as have people. New Zealand is increasingly a migration destination for people from outside Western Europe and North America, and new migrants often bring with them substantial offshore investments. These developments have highlighted the inherent weaknesses of the existing tax rules.
- 1.6 One weakness of the current rules is the distinction they make between the so-called "grey list" countries – countries whose tax systems are similar to New Zealand's, as specified in Schedule 3 of the Income Tax Act 1994 – and those that are not on the grey list. As a result, equity investments in non-grey list countries can be subject to comprehensive income tax treatment (under an accrued capital gains tax), whereas similar investments in grey list

countries are taxed only on dividends and, in certain cases, revenue account gains (on realisation).

- 1.7 Not only does this distinction distort how and where New Zealanders invest, it has also created base maintenance problems. This has occurred most notably in the area of Australian unit trusts that are owned by New Zealand investors and invest in New Zealand debt instruments, such as New Zealand government stock. The returns to the funds are tax-free in Australia (because of the Australian tax treatment of trusts) and virtually tax-free in New Zealand (where only a 2% approved issuer levy is deducted from interest payments made to the unit trust). Comparatively, a New Zealander investing directly in New Zealand government stock would be subject to full taxation on the interest income derived.
- 1.8 At the same time that the current rules can create low levels of New Zealand tax on some investments and base maintenance problems, they have also been seen as imposing an unfair level of tax on those investments subject to the full force of the FIF rules. This may encourage New Zealanders to migrate and discourage people from migrating to New Zealand.
- 1.9 The base maintenance issue raised by New Zealanders investing in Australian unit trusts that in turn invest in New Zealand debt instruments could possibly be countered by a targeted measure. As the Australian unit trust problem is caused by the ability of New Zealanders to invest in funds virtually not subject to tax in Australia or New Zealand, a measure could be developed to bring such investments into, for example, the FIF rules. It would not, however, be easy to do this. A measure that made subject to the FIF rules unit trusts that were not taxed on beneficial income overseas would significantly change the New Zealand tax treatment of investment vehicles in Australia, the United Kingdom and elsewhere. Moreover, it would leave unchanged the underlying problems of the FIF rules. Therefore more far-reaching options are being canvassed in this paper.
- 1.10 Two options are presented in this paper. The first approach is referred to as the “standard return rule”, and the second approach is referred to as the “offshore portfolio investment rules”.
- 1.11 The standard return approach would apply a version of the Tax Review’s RFRM proposal to non-controlled offshore equity investment in a non-business context. As with the RFRM proposal, taxable income would be calculated by applying a statutory deemed rate of return to the opening value of a qualifying asset. The current tax rules for non-controlled offshore investment would apply for investment in a business context. The aim of the standard return approach is to ensure that non-controlled offshore investments held outside a business context are taxed at a level that equates to a reasonable dividend yield.
- 1.12 The offshore portfolio investment rules would provide a series of income calculation methods for non-controlled offshore investment in equity. The main method would calculate taxable income as a portion of the change in

share value and distributions derived. This option would provide rules that would apply to all non-controlled offshore investments in equity, irrespective of the country of investment or the legal form of investment. The aim of the approach is, first, to minimise the influence of tax on investment decisions by providing as much consistency as possible and, second, to provide rules that are not unduly costly to comply with by providing income calculation mechanisms that are simple to use.

1.13 These options should be evaluated by the extent to which they are effective at countering the identified base maintenance issue and the extent to which they narrow the differences between domestic and various types of offshore investment (including differences between different offshore investments).

1.14 In a related development, representatives of the New Zealand savings industry have suggested that consideration should also be given to extending a RFRM approach to unit trusts and similar investment vehicles resident in New Zealand. The government has agreed that officials should include a broad option developed by the industry in this issues paper, shown in Appendix 1.

Summary of the options and evaluation

<i>A standard return rule</i>	<i>Offshore portfolio investment rules</i>
<p>The option</p> <p>Investments would be taxed on an imputed 4% standard return rate (distributions such as dividends would not be taxed when derived)</p> <p>It would broadly apply to non-business investments in foreign companies, unit trusts, foreign superannuation schemes and life insurance (qualifying assets)</p> <p>The standard return rate would apply to the opening market value of qualifying assets (if available, otherwise approximated market values)</p> <p>Acquisitions and realisations of qualifying assets during an income year would be accounted for in the income tax calculation as part-year adjustments. (The standard return rate would be reduced to reflect part-year holding periods.)</p>	<p>The option</p> <p>These rules would apply to holdings of non-controlled offshore equity investments which cost more than NZD\$15,000.</p> <p>Broadly, investors with non-controlled interests of 10% or greater in foreign companies would be taxed on:</p> <ul style="list-style-type: none"> – a <i>branch equivalent</i> basis (taxable income calculated as if the company were a NZ branch); or – a <i>foreign accounts</i> basis (taxable income based on the share of the company’s after-foreign tax income prepared under the accounting rules of the foreign jurisdiction); or – a <i>revised comparative</i> value basis (70% of the sum of the yearly changes in value of the interest plus dividends would be taxable); or – an <i>imputed rate of return</i> (only available for smaller taxpayers or those unable to use the other methods – taxable income calculated using a rate of return based on the five-year government stock rate – dividends would not be taxable when derived) <p>Investors with non-controlled interests of less than 10% in a foreign company or interests in assets other than companies would be restricted to using either a <i>revised comparative value basis</i> or an <i>imputed rate of return</i></p>

Issues addressed

It addresses the low-effective tax rate that can arise in respect of certain grey list investments as it assumes taxable income based on a reasonable dividend of 4% each year, irrespective of whether a dividend is actually paid out

It addresses the Australian unit trust issue as New Zealand investors' share of the income derived by the unit trust would be taxable at a deemed 4% rate

It addresses liquidity issues that can arise under the FIF rules as steep increases in the value of investments during a year would not be brought to tax

Issues addressed

It addresses the low effective tax rate that can arise in respect of certain grey list investments as near-full economic income to these investments would be taxable.

If offers consistent treatment of different types of offshore investment – the same tax treatment for grey list/non-grey list; revenue account/capital account; and passive/active investments

It addresses the Australian unit trust issue as New Zealand investors' interests in these unit trusts would be taxable on a change-in-value basis each year as well as dividends derived

Submissions

1.15 We invite submissions on the options discussed in this issues paper. Specific issues on which comment is sought are highlighted at the end of each chapter, although this is not intended to limit the scope of submissions. In particular, we invite submissions on the overall approaches taken.

1.16 All submissions should be addressed to:

Offshore investment
C/- General Manager
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON

1.17 Submissions on the options presented should be made by 15 February 2004. They should contain a brief summary of their main points and recommendations. All submissions received by the due date will be duly acknowledged.

1.18 Please note that submissions may be the subject of a request under the Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you feel there is any part of your submission which you consider could be properly withheld under that Act (for example, for reasons of privacy), please indicate this clearly in your submission.

Chapter 2

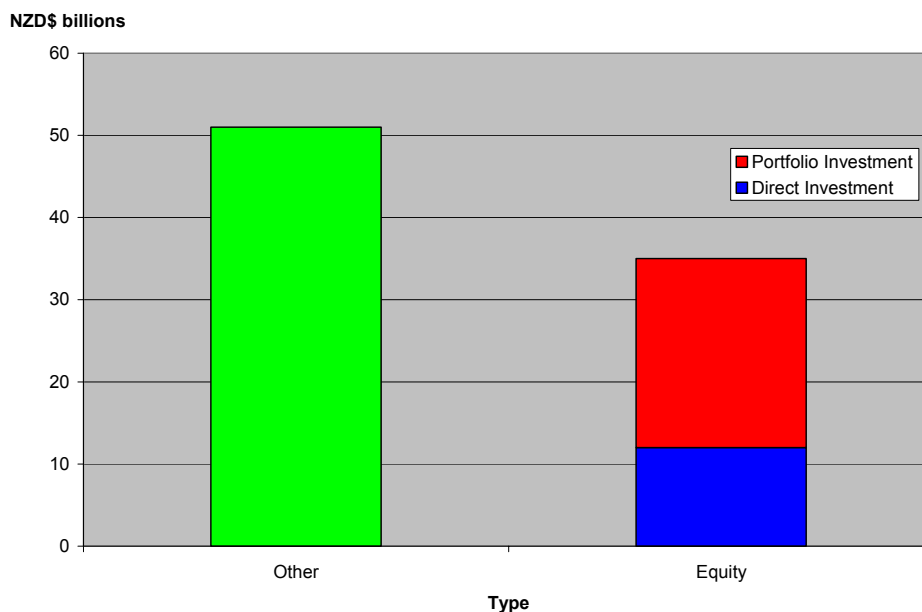
THE OFFSHORE INVESTMENT ENVIRONMENT

- 2.1 The value of New Zealanders' offshore investments as at June 2003 was about NZD\$86 billion. This included equity, debt and other investments.
- 2.2 The equity component comprised around NZD\$35 billion, as shown in figure 1. Equity investments include interests in listed and unlisted offshore companies and overseas institutions such as foreign retail unit trusts, superannuation funds and life insurance policies.

Investment type

- 2.3 An investor's interest is defined as a direct investment, for the purposes of this data, if the investor has an interest of greater than 10% in an entity. Total direct investment in offshore entities made up around NZD\$15 billion, with around NZD\$12 billion of this being equity investment.
- 2.4 An investor's interest is defined as a portfolio investment if that investor has an ownership interest of 10% or less in an entity. Total portfolio investment in offshore entities was around NZD\$34 billion, with around NZD\$23 billion of this being equity.
- 2.5 Around NZD\$37 billion was held as other offshore investments, such as financial derivatives and reserve assets.

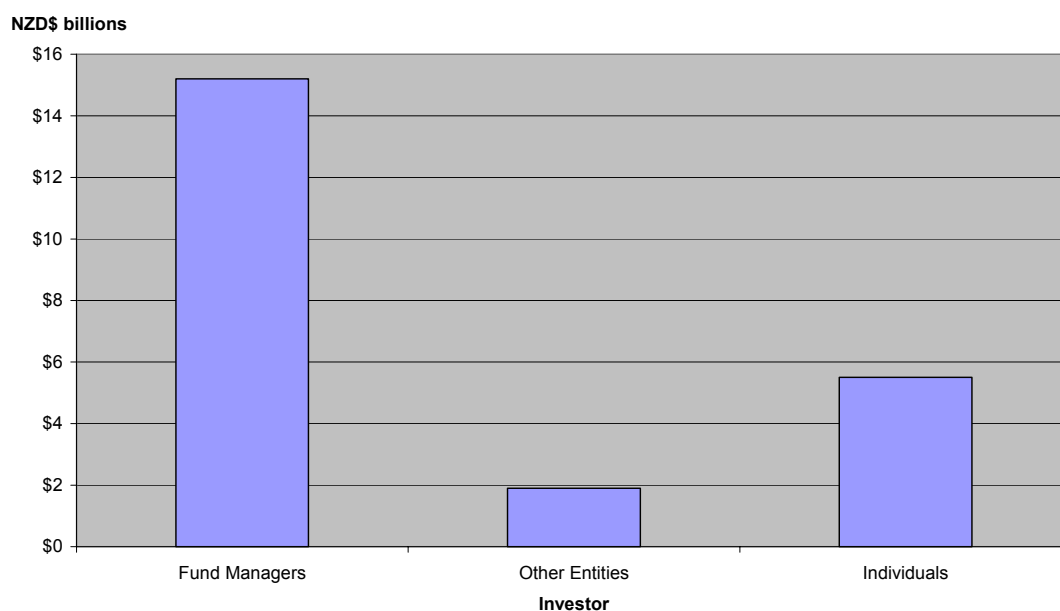
Figure 1: NZ offshore investment by type (as at June 2003)



Investor type

- 2.6 Offshore portfolio investments are held by individuals, fund managers and other entities such as companies.
- 2.7 With regard to equity investment, fund managers and other entities accounted for approximately NZD\$17 billion of portfolio investment, as shown in figure 2.
- 2.8 Around NZD\$15.2 billion of the portfolio equity investment was made by fund managers. This included around NZD\$1.9 billion of investment that was held by small funds that are not included in official statistics.
- 2.9 We estimate that around NZD\$2 billion of investment undertaken through managed funds was made by passive funds – funds that track a recognised stock market index. The remainder of investment was made by funds that are actively managed.
- 2.10 In addition, Statistics New Zealand has estimated that individuals hold around NZD\$5.5 billion of overseas portfolio equity investments directly. Around 60% of this investment (NZD\$3.3 billion) is held in Australia.
- 2.11 Thus the data indicate that fund managers account for almost 66% of the stock of offshore portfolio equity investment.

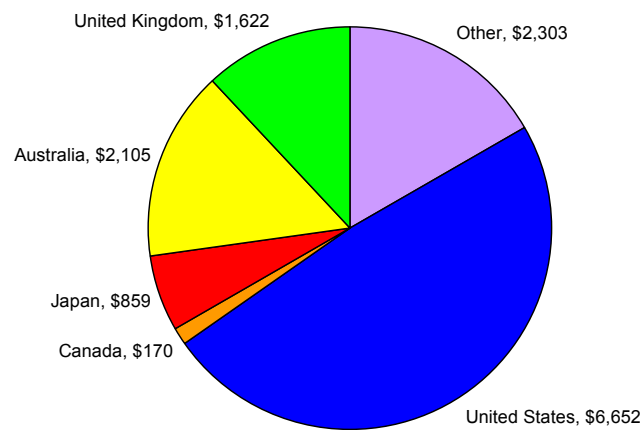
Figure 2: NZ portfolio equity investment by investor (as at June 2003)



Investment destination

2.12 In addition, figure 3 shows a breakdown of portfolio equity investment by large New Zealand fund managers and entities into different countries (excluding the NZD\$1.9 billion invested by small funds):

Figure 3: NZ portfolio equity investment by investment destination as at March 2003
(NZD\$ millions)



Chapter 3

ECONOMIC FRAMEWORK

- 3.1 Tax policy is generally evaluated on the basis of three criteria: efficiency, minimising compliance and administrative costs, and equity.
- 3.2 An efficient tax system would raise the government's required revenue at the least economic cost. In considering efficiency, the impact of policies on the domestic economy as a whole must be considered. In general, the most efficient tax system will be a system that minimises the effect of tax on individuals' decisions. Therefore, in relation to an income tax, efficiency generally implies that all sources of income should be taxed in the same manner. However, this goal needs to be balanced against other concerns such as the compliance costs faced by taxpayers from having all forms of income taxed in the same manner, as well as equity considerations.
- 3.3 Equity considerations are normally expressed in terms of horizontal equity and vertical equity. Horizontal equity implies that individuals with equal incomes should be subject to the same level of tax. Vertical equity involves judgements about the treatment of individuals with different incomes.

The treatment of foreign taxes

- 3.4 In order to attain the maximum benefit for the domestic economy, the international tax rules should create incentives to ensure that when investors make decisions that maximise their private returns, they simultaneously maximise the national return to New Zealand. Given that cross-border flows of income are potentially subject to tax in two countries, it is important to keep the distinction between returns to the individual and returns to the economy as a whole in mind when considering the appropriate treatment of foreign taxes.
- 3.5 From the point of view of attaining the maximum benefit to the domestic economy, payments of foreign tax by New Zealanders are best considered as a cost of doing business in foreign jurisdictions. This is because the return to New Zealanders from investing offshore does not include taxes paid to foreign governments. However, payments of New Zealand tax are part of the return to the domestic economy, as is the after-"all-taxes" return to New Zealand investors. This implies that from an efficiency point of view residents should be given a deduction for taxes paid in foreign jurisdictions.

Source versus residence taxation

- 3.6 International tax rules are usually described as source-based or residence-based. Source-based rules would tax all income earned in a country, without consideration of the residence of the individual or entity earning the income. Residence-based rules would tax the worldwide income of residents of the taxing country and would not tax the income of non-residents. In practice, most tax systems, including New Zealand's, are a combination of source-based and residence-based taxation.
- 3.7 From an efficiency point of view, a small country like New Zealand is generally likely to do best by following residence-based taxation. This indicates that residents should be taxed at the same rate of New Zealand tax on all sources of domestic and foreign income, recognising foreign taxes as a cost of business by allowing them to be deductible. This approach can be described as the residence principle.
- 3.8 The rationale for taxing residents on all sources of income is that if a resident has the choice between two investments that provide the same return to the domestic economy and differ only in that one is onshore and one is offshore, the tax system should not influence the investor's decision as to which investment to take up.
- 3.9 If the after-foreign tax returns to offshore investment were taxed more lightly than the domestic returns to onshore investment, New Zealanders might choose offshore projects in preference to domestic projects that provided the same return to the domestic economy. From an efficiency point of view, investment decisions would not be made to provide the maximum return to the domestic economy. Also, this might make it more difficult for New Zealand firms to gain access to funding.

Constraints in the international context

- 3.10 A number of issues arise when considering the extent to which the residence principle can be applied in the international context.
- 3.11 First, the principle needs to be balanced against the fact that New Zealand residents are mobile. If residents were taxed in a way that was particularly onerous in comparison with the taxation of residents of other countries New Zealand residents might leave New Zealand. This limits the extent to which the New Zealand government can tax residents.
- 3.12 Second, in the domestic context, equity investments are often subject to tax at two levels. Tax is often levied at the entity level, with the entity level tax acting like a withholding tax. Investors are then taxed on income they derive from the entity, with a credit provided in certain circumstances for tax paid at the entity level. A key difference in the international context is that the entity invested into cannot be taxed as part of the New Zealand tax base.

- 3.13 Third, when New Zealand investors own small interests in offshore entities the amount of information available on the income of the entity will generally be so limited that the tax liability must be based on proxies for income.
- 3.14 Fourth, domestic investments are treated differently, depending on whether they are held on revenue or capital account. This results in the total effective tax rate on a domestic investment varying depending on the form of investment. It also means we cannot implement rules that treat all offshore investments in the same manner while being consistent with the treatment of onshore investments.
- 3.15 These constraints imply that the practical approach to the taxation of offshore investment is to design rules that attempt to minimise the influence of tax on the decision of whether to invest domestically or offshore and on the decision of where to locate offshore investment. Such rules would provide income calculation methods that represent a reasonable approximation of how similar investments are taxed domestically, while minimising the compliance costs associated with calculating income.

Taxing actual income versus expected income

- 3.16 Proxies to calculate taxable income could be of two types. First, the proxy could seek to tax the actual income from an investment once that income has been earned – that is, it could tax on an *ex post* basis. This is consistent with how income is taxed in the domestic context. Second, the proxy could seek to tax an investment on the basis of the expected return from the investment – that is, on an *ex ante* basis. As the only information needed to tax an asset on an expected return basis is the initial value of the asset, this method is advantageous in cases of limited information.
- 3.17 Subject to certain assumptions, an investor would be equally happy to be taxed under rules that tax full income on an *ex post* basis and rules that tax an *ex ante* risk-free return. This is because, for the same asset, *ex ante* taxation of risk-free returns places more risk on the investor than does *ex post* taxation of actual returns, since an investor's tax liability would not vary with the actual income derived within the period that the tax liability is assessed. The compensation for assuming this extra risk is that the investor's tax liability would be expected to be lower under *ex ante* taxation of risk-free expected returns.
- 3.18 If investors were unhappy with the new, higher level of risk, they would be able to return to their initial risk position by reallocating their portfolio in favour of lower risk assets, thus lowering both their expected return and risk.

- 3.19 It is unlikely that it would be possible to set a risk-free rate of return that resulted in taxpayers being completely indifferent between *ex ante* and *ex post* taxation. However, if *ex ante* taxation were to be used as a proxy for income, the goal would be to levy tax at a rate that provided a reasonable trade-off between the additional risk that the taxpayer bears under this method and the lower expected tax liability that the taxpayer would be subject to.

The options within the framework

- 3.20 In implementing the residence principle, a trade-off will always need to be made between accuracy and compliance costs. This trade-off means that, even if the residence principle is accepted as the correct framework, there is no “correct” way to tax non-controlled offshore investment. Judgments will need to be made as to the appropriateness of different proxies.
- 3.21 This issues paper presents two options. They each take a different approach to the problems in relation to the current rules applying to non-controlled offshore investment.

A standard return rule

- 3.22 The standard return approach maintains broadly the current approach to taxing non-controlled offshore investment. That is, the tax rules applying to investments in a business context would remain the same, and for non-business investments a taxable “standard return” of 4% would be imputed to the investor. If adopted, this approach would represent an incremental step towards the residence principle, since imputing a 4% return should address the areas that currently provide the most significant opportunities to minimise New Zealand tax.

Offshore portfolio investment rules

- 3.23 The rationale of the second option is to apply the residence principle by providing rules that apply to all non-controlled offshore investment. Its purpose is to minimise the influence of tax on the decisions of whether to invest domestically or offshore and where to locate offshore investment. In doing so, it seeks to provide income calculation mechanisms that provide a reasonable approximation of the effective tax rate on similar domestic investments while minimising compliance costs. This option applies the same rules to different forms of offshore investment, irrespective of the country of investment or type of investor.

Chapter 4

THE CURRENT RULES FOR NON-CONTROLLED OFFSHORE INVESTMENT AND PROBLEMS

- 4.1 Two sets of tax rules can apply to non-controlled interests in offshore equity. Which set of rules applies will generally depend on whether or not the investment is in a so-called “grey list” country. The grey list refers to certain investments in seven countries – Australia, the United Kingdom, Canada, Norway, the United States, Germany and Japan. Grey list countries are countries that are considered to have tax systems similar to that of New Zealand.
- 4.2 Around 80% of non-controlled offshore investment in equity occurs in grey list countries.

The current tax rules for non-controlled investment in grey list countries

- 4.3 The main difference between investments in non-controlled offshore entities and onshore entities is that the income earned by offshore entities cannot be taxed within the New Zealand tax base. Ideally, the New Zealand tax rules should address this by approximating the income earned by the foreign entity and attributing it to the New Zealand investor. However, for investments in foreign companies and unit trusts that are resident in a grey list country (“grey list investments”) no approximation of entity level tax is made.
- 4.4 At the level of the investor, grey list investments are subject to the general tax rules that apply for equity investments. That is, the tax treatment will depend on whether the investment is held on capital account or on revenue account.
- 4.5 If a grey list investment is acquired with the purpose of resale, or the sale of the asset could be considered to be part of the ordinary business of the investor, then that investment would be considered to be held on revenue account. The consequence of this is that the investment would be subject to tax on changes in value on realisation as well as on dividends derived.
- 4.6 On the other hand, if the investment is purchased with the dominant purpose of deriving dividend income, it would generally be considered to be held on capital account. In this case the investor would only be subject to tax on dividends derived.

- 4.7 Individuals who hold grey list investments directly, New Zealand funds that passively track foreign indices with grey list resident companies and New Zealand companies that hold grey list investments that do not form part of their business will generally hold their interests on capital account. These investments represent around a third of non-controlled offshore investment in equity.
- 4.8 Institutions that actively manage investors' funds and individuals that trade in offshore equities (most New Zealand retail unit trusts), on the other hand, are likely to hold grey list investments on revenue account. Institutional investors account for the majority of non-controlled offshore revenue account investment.
- 4.9 Although these are the broad principles that apply in this area, the boundary between an investment on capital or revenue account is often very difficult to define.

Problems with the grey list

- 4.10 The different treatment of grey list and non-grey list investments (the treatment of which is discussed later) and the different treatment of capital and revenue account grey list investments gives rise to significant economic costs as it results in tax being a significant factor in investment decisions. This varied treatment also gives rise to compliance costs – for example, as happens when companies migrate from a grey list to a non-grey list country.

Grey list investments held on capital account

- 4.11 The treatment of grey list investments held on capital account provides, from the point of view of maximising returns to New Zealand, a tax incentive to invest offshore as opposed to onshore and to invest in grey list as opposed to non-grey list countries. This incentive has economic costs as money is not directed towards investments which yield the highest pre-tax returns. The treatment also provides a more favourable treatment for individuals that invest offshore directly, rather than through an institution. This is because, generally, the institution will hold the investment on revenue account, whereas a direct investor is likely to hold the investment on capital account.
- 4.12 The bias to invest offshore in the grey list occurs as capital account investment is only subject to New Zealand tax on the dividends derived from the investments. This means that the effective New Zealand tax rate on the total return to the domestic economy (economic income after foreign tax) from these investments can be significantly lower than on an equivalent domestic investment. To illustrate, the dividend yield on the Morgan-Stanley Capital International (MSCI) index for grey list countries, which several passive funds track, is around 1.6%.

- 4.13 This results in a lesser New Zealand tax burden than that applying to domestic investments. This is because, while an equivalent investment in a domestic entity would also only be taxable on dividends in the hands of the investor, the domestic entity would nevertheless be subject to tax in New Zealand on the income from which the distribution is made.

Grey list investments held on revenue account

- 4.14 The taxation of grey list revenue account investments on realisation, rather than on an accrued basis, gives taxpayers the opportunity to lower their effective New Zealand tax rate on the economic income from these investments by deferring realisation.
- 4.15 Under the current rules, however, a significant deferral of tax does not appear to be occurring in practice. This is because it would appear that at least the larger institutional investors realise their grey list investments on a regular basis, such that any New Zealand tax deferral is not large.

Other problems with the grey list

- 4.16 Another significant problem that arises because of the grey list is that taxpayers are able to use offshore companies and unit trusts resident in the grey list to reduce the amount of New Zealand tax that would otherwise be payable on domestic or non-grey list investments.
- 4.17 New Zealand residents can use certain United Kingdom managed unit trusts or Australian unit trusts to access non-grey list investments or avoid tax on investments back into New Zealand. As these vehicles are subject to low or no tax in their home jurisdiction, and investments in the vehicles are subject to very low tax in New Zealand (by virtue of being resident in the grey list), investment through these entities produces a more favourable tax result than investment through a similar New Zealand entity. This creates an incentive to invest in offshore managed funds rather than New Zealand managed funds.
- 4.18 For example, certain Australian unit trusts offer investment products aimed at New Zealand investors that claim virtually to remove any tax being paid on the resulting income. An example of one such structure is when a New Zealand resident purchases units in an Australian unit trust, which then uses those funds to buy New Zealand Government bonds. Interest from the bonds is paid to the Australian unit trust, with only a 2% approved issuer levy deducted. Because Australia, unlike New Zealand, taxes the entity as a trust, rather than as a company, the interest income is not taxed in Australia under Australian tax rules because it is not sourced in Australia and does not relate to an Australian beneficiary. The unit trust then distributes its income by way of non-taxable bonus issues so that the New Zealand investor ends up holding more units in the entity. Given the way New Zealand and Australian tax law interrelates, no New Zealand or Australian tax is payable at this stage. Gains that New Zealand investors derive from the eventual sale of their units may also not be taxable, depending on whether the investment was

held on capital or revenue account. An identical investment through a New Zealand vehicle would be clearly subject to New Zealand tax.

The current tax rules for investment in non-grey list countries

- 4.19 New Zealand investors who hold non-controlled interests in foreign entities resident in countries outside the grey list are generally subject to tax on the income earned from those investments under the foreign investment fund (FIF) rules. Income derived in relation to certain interests in foreign superannuation schemes and life insurance policies (irrespective of country) are also subject to tax under the FIF rules.
- 4.20 New Zealanders with controlling interests in a foreign entity are subject to the controlled foreign company (CFC) rules. However, it is possible for quite large ownership interests in foreign entities to be non-controlled interests and thereby subject to the FIF rules
- 4.21 The FIF rules seek to apply the residence principle by attempting to tax, on an accrued basis, the full economic income of the foreign entity invested into. The rules provide four different income calculation mechanisms. The methods vary in terms of the level of information required for compliance and are discussed below. The methods are listed in descending order of the level of information required:

The branch equivalent method

- 4.22 The branch equivalent method can be used only to calculate income from interests in foreign companies. Under this method, a taxpayer's income or loss is determined as if the foreign company were a branch of a New Zealand company. That is, it requires the company's financial accounts to be adjusted to reflect New Zealand tax legislation. The branch equivalent method is the most accurate income calculation method, but owing to the degree of information required, few taxpayers are able to use the method for non-controlled interests.
- 4.23 Under this method, tax credits are available for foreign non-resident withholding tax deducted from dividends derived and also for the foreign tax paid by a foreign company on its underlying income (if a taxpayer's ownership interest in the company is greater than 10%).

The accounting profits method

- 4.24 Under the accounting profits method, a taxpayer's share of a foreign company's net, after-tax accounting profit (or loss), as calculated in the foreign jurisdiction, is deemed to be the taxpayer's FIF income (or loss) for the relevant income year. Tax credits, under this method, are also allowed only in respect of foreign non-resident withholding tax deducted from dividends derived.

- 4.25 There are a number of restrictions on using this method, including the requirement that the interest be an interest in a foreign company listed on a recognised exchange and the after-tax profits be calculated under the generally accepted accounting principles operating in the foreign jurisdiction.

The comparative value method

- 4.26 Broadly, under the comparative value method, the net change in the market value of a FIF interest during the income year and any distributions derived is deemed to be the FIF income (or loss) for the year. Tax credits for foreign tax paid are allowed in respect of foreign non-resident withholding tax deducted from dividends derived from the FIF interest. A credit for the underlying foreign tax paid by the foreign entity is not allowed. Owing to the lower information requirements of this method, it is used in the vast majority of cases under the FIF rules.

The deemed rate of return method

- 4.27 This method calculates the income from a FIF interest by applying a deemed rate of return to the book value of the interest at the start of the year. The deemed rate of return can be used only if there is insufficient information to use any of the other calculation methods or by individuals with small holdings. The deemed rate of return method is typically used to calculate income from interests in foreign superannuation schemes and life insurance policies. The deemed rate of return is currently 9.90%.

Exemptions

- 4.28 In addition to the exemption for companies and unit trusts resident in grey list countries, there is a *de minimis* rule which exempts from the FIF rules taxpayers whose total cost of acquiring FIF interests is NZD\$50,000 or less. There are also a number of exemptions for certain foreign investment schemes, such as employment-related superannuation schemes and foreign superannuation schemes or life insurance policies held before a taxpayer becomes a New Zealand resident.

Problems with the current rules

- 4.29 One of the main criteria for establishing whether the FIF rules are an appropriate method for calculating income from offshore investment depends on how well the rules approximate the effective tax rate on a similar domestic investment.
- 4.30 The comparative value method, for example, would on average approximate the economic income of the entity invested into. However, in certain cases it may not be an accurate proxy of what the taxable income of a particular entity would be under New Zealand tax law. Equally, the deemed rate of return taxes on the basis of an imputed rate of return, so taxable income will often depart from actual income.

- 4.31 The comparative value and deemed rate of return methods have also been criticised for causing liquidity problems and being harsh in certain circumstances. These criticisms are levelled at the comparative value method when, for example, the underlying value of an investment increases steeply over a year and the investor is required to pay tax on the increase in value on an accrued basis.
- 4.32 The main criticism of the accounting profits and branch equivalent methods is that they can be compliance-cost intensive. Consequently it would appear that few taxpayers use these methods under the FIF rules.

Chapter 5

OPTIONS FOR REFORM AND COMMON FEATURES

- 5.1 We have identified a number of problems with the current tax rules for non-controlled offshore investment in equity. We have also identified two approaches which we consider would address these issues. The first is referred to as the “standard return rule”, and the second is referred to as the “offshore portfolio investment rules”.
- 5.2 The two approaches have several features in common: in the areas of the assets covered, the definition of “non-controlled interest”, and the countries covered.

Assets covered

- 5.3 The offshore portfolio investment rules would apply to offshore investment by New Zealand residents in assets that are currently covered by the FIF rules. The FIF rules apply to non-controlled interests in foreign companies and unit trusts and interests in foreign superannuation schemes and foreign life insurance. A standard return rule would also broadly apply to assets currently covered by the FIF rules.
- 5.4 The following exemptions from the FIF rules would also be exemptions under either approach:
- interests in employment-related foreign superannuation schemes;
 - interests in foreign life insurance policies or foreign superannuation schemes acquired by natural persons before they become resident in New Zealand for the first time; and
 - certain foreign private pensions and annuities derived from an interest in a qualifying foreign private annuity.

Exceptions to assets covered

- 5.5 The standard return approach would not apply to certain shares in foreign companies that are not listed on a recognised exchange and for which a market value cannot be ascertained in an “approved” market (discussed in detail in chapter 6). In addition, the rules would not apply to shares in foreign companies, where the share is a fixed rate share, and the dividend payable is above the standard return rate.

- 5.6 A fixed rate share is defined in section OB 1 of the Income Tax Act 1994 as, broadly, any share issued by a company where the only dividend payable in respect of that share is payable at a rate which is a specific fixed percentage of the amount subscribed in respect of the issue of the share or an amount that is determined by a fixed relationship to economic, industrial, commodity or financial indexes, or to banking rates or general commercial rates of interest.
- 5.7 If a fixed rate share in a foreign company yields a dividend that is less than the standard return rate, it is reasonable to assume that the shares are expected to generate other returns. The standard return approach should tax more appropriately the returns to those interests. For fixed rate shares that yield dividends above the standard return rate, the current taxation rules would apply.

Definition of “non-controlled interest”

- 5.8 Under both approaches, the boundary between controlled and non-controlled investment would remain the same for investments in foreign companies and unit trusts. That is, the distinction would continue to be governed by the provisions that separate the FIF rules from the CFC rules.¹
- 5.9 An interest in a foreign company or unit trust is removed from the FIF rules if it is an investment in a CFC and the ownership interest that the investor has in the CFC is 10% or greater. An interest will be an investment in a CFC if the foreign company has, during the relevant accounting period:
- a total of five or fewer New Zealand residents whose individual or aggregate interests in the company are greater than 50%; or
 - a single New Zealand resident holding an interest greater than 40% in the company and no other resident, or persons associated with the single New Zealand resident, have a comparable or greater interest; or
 - a total of five or fewer New Zealand residents have the power to exert control over shareholder decision-making in relation to the company.

Countries covered

- 5.10 Both approaches would apply to investments in entities resident in all foreign jurisdictions. In other words, the grey list would be repealed for non-business, non-controlled offshore investments under the standard return rule and for all non-controlled offshore investments under the offshore portfolio investment rules.

¹ See sections CG 4(1) and CG 15(2) of the Income Tax Act 1994.

Chapter 6

A STANDARD RETURN RULE

- 6.1 A standard return rule is a method to determine taxable income for certain non-controlled offshore investments in equity. The rule would operate by applying a statutory rate of return to a qualifying asset's value at the beginning of an income year to determine the taxable income for that asset. Any returns from the asset, such as dividends or capital gains, would not be subject to tax.
- 6.2 The rule would apply to assets that were held outside a business context. It would, therefore, apply mainly to individuals holding qualifying assets.

Objectives of the proposal

- 6.3 As discussed in Chapter 4, the main problem that we have identified with the current rules is the low effective New Zealand tax rate that can apply in respect of grey list investments held on capital account. We did not identify any significant problems with the current tax rules as they applied in a business context.
- 6.4 For this reason, a standard return rule would target non-business investment, while leaving unchanged the rules applying to investment in a business context.
- 6.5 The approach also attempts to align the treatment of non-business taxpayers' investments within and outside the grey list by applying a standard return rule to most non-business investment currently covered by the FIF rules.
- 6.6 The standard return approach attempts to address these problems as far as possible within the existing taxation framework that applies to capital account investment domestically. This explains the standard return rate being set at a real risk-free rate of 4% which, broadly, reflects a reasonable dividend yield on an equivalent domestic investment held on capital account.

Alternative income calculation method

- 6.7 We consider that a standard return rule would be the main income calculation method that would be used for investment in qualifying assets. However, if an investor's interest is in a foreign company, and they have access to sufficient information, they would have the option of applying the branch equivalent income calculation method currently provided under the FIF rules. This option would continue to be available as the branch equivalent method is the most accurate mechanism to calculate income from a foreign company.
- 6.8 All the tax rules that apply as a result of using the branch equivalent method (such as conduit tax relief and underlying foreign tax credits) would continue to operate. As is the case under the current FIF rules, there would be strict rules preventing investors from changing between income calculation methods.

Explanation of the business test

Under this option, non-controlled offshore investment held in a:

- non-business context would be subject to a standard return rule; and
- business context would be subject to current tax rules.

- 6.9 Under a standard return rule a “business” test would distinguish between non-controlled offshore equity investments that are to be subject to a standard return and those that are to be subject to the current rules.
- 6.10 Under this test, if income from an investment was considered to be derived from a business (in accordance with section CD 3 of the Income Tax Act 1994) the investment would be subject to the current rules. However, if income from an investment was not considered to be derived from a business, the investment would be subject to the standard return rule.
- 6.11 An alternative to the business test would be a boundary based on whether the investment was held on capital or revenue account. Under this test an investment that was held on capital account would be subject to the standard return rule, while an investment held on revenue account would be subject to the current rules. Broadly, an investment would be considered to be on revenue account if it was purchased with the dominant purpose of resale, if the proceeds were part of the investor’s business income or if the proceeds were derived from a profit making scheme.
- 6.12 The main problem with a capital-revenue test is that certain investors with grey list investments might have incentives to argue that their investments were held on revenue account. Such taxpayers could prefer current revenue account rules over the standard return rule because, for investments held over a long period of time, tax would be payable only on derivation of dividends and realisation of the investment, rather than on an accrued basis. It might be relatively easy for taxpayers to argue successfully that an investment was held on revenue account because one of the tests, “acquisition for the purpose of sale”, is subjective and therefore difficult for Inland Revenue to challenge.
- 6.13 These arguments would be more difficult to make under a business test because the investor would be required to demonstrate that the proceeds from the sale of an investment were part of the investor’s business profits. Section OB 1 of the Income Tax Act 1994 defines “business” to include:

...any profession, trade, manufacture, or undertaking carried on for pecuniary profit.

- 6.14 The approach of the New Zealand Court of Appeal to determining whether a business exists for the purposes of this definition has been the development of a two-fold test² that requires an examination of the nature of the activities carried on and the intention of the taxpayer in engaging in those activities. When determining whether activities were undertaken for pecuniary profit, objective evidence such as the volume of transactions and the commitment of time, money and effort are relevant.
- 6.15 Therefore significant weight is put on objective evidence in both legs of the two-stage business test. This should ensure that a business or non-business boundary in the context of the standard return rule is relatively robust.

² The leading case on the definition of “business” is *Grieve v CIR* (1984) 6 NZTC 61,682.

Setting the rate

Under this option, the standard return rate would be set at 4%.

- 6.16 The Tax Review, when considering the risk-free rate of return method (RFRM), recommended the adoption of a risk-free rate of return based on New Zealand government stock interest rates, adjusted for inflation. The rationale for this was to approximate the rate of return from a risk-free investment. The Tax Review considered that New Zealand government stock was an appropriate approximation of risk-free lending. Consequently, it considered a nominal rate of 6% (the relevant government stock interest rate at the time) less an inflation component of 2%, resulting in a real risk-free rate of return of 4%.
- 6.17 The standard return approach is consistent with the assumptions underlying a risk-free rate of return: that investors should not be taxed, on an *ex ante* basis, on the returns to their investments that are compensation for risk. Our tax system is not inflation-adjusted and thus a nominal (6%) rather than a real (4%) rate seems *prima facie* more justifiable. The objective of the standard return approach, however, is to align more closely the tax treatment of investors who hold non-business (capital account) investments.
- 6.18 In the domestic context, the capital-revenue boundary results in returns to risk being taxed relatively comprehensively if an investment is held on revenue account, but this is not the case if the investment is held on capital account. As noted earlier, the reason for this is that a domestic investment held on capital account is taxable, in the hands of the investor, only on dividends derived. Given that the average dividend yield on New Zealand equities is around 4%, much of the compensation for risk is in the form of capital gains. A real risk-free rate of 4%, therefore, seems an appropriate approximation of how domestic capital account investments are taxed in the hands of the investor. If the approach was extended to include non-controlled offshore investments held in a business context, the standard return rate for those investments would need to reflect that gains on realisation are taxable in respect of equivalent domestic investments. This would suggest that a more appropriate standard return rate for business investments, in the offshore context, is 6%.
- 6.19 A standard return rate of 4% also has the advantage of not being out of line with the average dividend yield in countries where the vast majority of New Zealand individual investors' non-controlled offshore investment is located. For example, average dividend yields for Australian listed companies are between 3 and 4%, while in the United Kingdom, average yields range from 3 to 3.5%. Dividend yields in the United States are typically lower, at around 1.8%, but this can be attributed to a number of factors, including the United States taxing company income and dividends without providing a credit for company tax paid.

6.20 A 4% standard return rate should, therefore, ensure that investors generally have enough dividend income to meet their tax liability under a standard return rule. Assuming an investor's marginal tax rate is 39%, an investment would need to yield a 1.56% dividend for the investor to be able to meet the associated tax liability, under a standard return approach, out of dividends derived ($4\% \times 39\% = 1.56\%$).

Treatment of debt

Under this option:

- as a general rule, the current interest deductibility rules would continue to apply to interest costs on funds used to purchase qualifying assets; and
- an anti-avoidance rule would need to be considered to deny interest deductions on borrowed funds if the funds are used to finance investments in a foreign entity investing in New Zealand debt.

- 6.21 A standard return rule would impute tax on the full value of a taxpayer's qualifying asset. Expenses incurred in acquiring the asset, such as interest costs on borrowed funds, would be deductible according to normal income tax rules. This would mean that interest on a loan used to purchase a qualifying asset would be fully deductible because the interest would be "payable in deriving the taxpayer's gross income".³
- 6.22 This approach is different from that suggested by the Tax Review in relation to the application of a RFRM. The Tax Review suggested that a RFRM asset's opening value should be limited to the net equity component of the asset, with no deduction for interest costs.
- 6.23 One of the problems of allowing full deductibility of interest costs is the incentive for taxpayers to finance acquisitions of qualifying assets using debt. This is because, under a standard return rule, the imputed rate of return would typically be less than the cost of borrowed funds used to purchase qualifying assets.
- 6.24 Although this incentive would arise under a standard return rule it is worth noting that the same incentive exists at present for assets producing returns that are not fully taxable. For example, a taxpayer that purchases shares on capital account using borrowed funds would receive a full deduction for interest costs, even though the only component of the return that is taxable is any dividends derived.
- 6.25 We considered a number of approaches to determine a taxpayer's net equity in a qualifying asset. Any approach would need to identify which part of a taxpayer's tax-deductible debt portfolio relates to the qualifying asset. Once this was identified, interest deductions in respect of this debt could be disallowed and the value of the debt subtracted from the opening value of the asset.
- 6.26 The options that were considered and the problems associated with each are discussed in Appendix 2. We do not consider that any of these options should be adopted as they would add an unacceptable, additional layer of complexity to the rules.

³ Section DD 1(b)(i) of the Income Tax Act 1994.

- 6.27 A relatively low standard return rate could also create opportunities to borrow in New Zealand and invest in offshore entities that invest directly back into New Zealand debt instruments. Here, the investor would receive a deduction for interest costs incurred, typically, at a rate higher than the standard return rate. An anti-avoidance rule may therefore be needed to deny interest deductions to the extent that borrowed funds are used to finance interests in a foreign entity investing in New Zealand debt.

Submission point

We invite submissions on:

- the need for an anti-avoidance rule to deny interest deductions on borrowed funds if the funds are used to finance investments in a foreign entity investing in New Zealand debt, and what form it might take; and
- approaches that can limit the application of a standard return rule to the net equity component of a qualifying asset that do not give rise to significant compliance costs.

Valuation of assets

Under this option, the opening value for:

- easy to value assets would be their market value;
- hard to value assets for which values can be calculated in an “approved” market would be the value calculated in that market (excluding interests in unlisted foreign companies for which an approved market cannot be verified); and
- hard to value assets (excluding interests in foreign companies) for which it is difficult to approximate market values using an “external” market would be a value based on the asset’s cost price.

Interests in unlisted foreign companies for which an approved market cannot be verified would be subject to tax under the current FIF rules.

6.28 A standard return rule would calculate taxable income on the opening value of a qualifying asset. Therefore, for the rule to operate, it must be possible to establish an opening value for qualifying assets.

Easy to value assets

6.29 In the case of interests in foreign companies and retail unit trusts, market values could generally be used to calculate opening values. Market values are appropriate for interests in foreign companies and unit trusts that are listed on recognised foreign exchanges.⁴ Consequently, the opening value of an interest in a foreign company or retail unit trust that is listed on a recognised exchange would be calculated by multiplying the number of shares or units held by the market value per share or unit at the start of the relevant taxable period.

Hard to value assets

6.30 Hard to value assets fall into two broad categories. The first category comprises assets that are not listed on a recognised exchange. Nevertheless, their market value can be approximated by reference to an “approved” market, an arm’s-length price or the price an investment vehicle is prepared to pay to purchase the asset from the investor.

6.31 The second category comprises assets for which it will not be appropriate or practical to deem a value by reference to an external market. For these assets a market value will need to be approximated by reference to the asset’s cost.

⁴ Section OB 1 of the Income Tax Act 1994 defines “recognised exchange” for the purposes of a number of provisions in the Income Tax Act.

Assets for which values can be calculated in an “approved” market

- 6.32 In the case of interests in foreign companies which are not listed on a recognised exchange, market values may still be ascertainable. For example, in the case of certain interests in foreign companies the Commissioner of Inland Revenue may be satisfied that, even though the asset is not listed on a recognised exchange, the interest can be valued using a market-type mechanism. It is suggested, therefore, that investors should have the option of approaching the Commissioner to determine whether for such assets a market, for tax purposes, exists. If a market is found to exist, the investor will be able to use an opening value calculated in the market to apply the standard return approach.
- 6.33 The broad criteria that could be used by the Commissioner to approve a market include:
- the number of participants in the market or having access to the market;
 - the frequency of trading in the market;
 - the nature of trading in the market – how the price or rate is determined and how the relevant investment assets are traded on the market;
 - the existence, in relation to the market, of an appropriate regulatory body established by law;
 - the potential or demonstrated capacity of a person or group of persons to significantly influence the market; and
 - significant barriers to entry into the market.
- 6.34 Once a market has been approved by Inland Revenue, in respect of a particular asset, it would be added to a list of approved markets. This list would be made widely available for the benefit of all investors.
- 6.35 If no market is found to exist, or an investor chooses not to approach the Commissioner, the current FIF rules would apply to those interests. This requirement is based around the need to ensure that, for example, investors with interests in unlisted companies situated in low (or no) tax jurisdictions that have low dividend distribution policies – in other words, “cash box”-type companies – pay tax at a more appropriate rate than 4% under the standard return approach. Given that in these cases no market value can be verified, it is almost certain that the investor would be required to calculate taxable income under the deemed rate of return method in the FIF rules.

- 6.36 An alternative to this may be allowing use of values calculated under an arm's-length valuation rule. An arm's-length principle is used under New Zealand's transfer pricing tax rules.⁵ The rationale for the arm's-length principle is that it is considered to provide the most accurate measurement of the fair market value, and thereby the true economic value, of a transaction. This is because parties transacting at arm's length would be expected to endeavour to make efficient use of their resources and in doing this, would seek to earn the full return to their economic activities.
- 6.37 The arm's length principle uses the behaviour of an independent firm as the benchmark for what would be expected of a firm seeking to earn the true return from a transaction. In the case of interests in foreign companies, this would be what an independent party is willing to offer by way of consideration to acquire the interest and what the party holding the interest would require to be compensated for parting with the interest. Therefore if a taxpayer is able to satisfy the Commissioner that an arm's-length value can be established in respect of an interest in a foreign company, that value could be used to determine an opening value under a standard return rule.
- 6.38 The key concern with the use of an arm's-length valuation rule is that it often requires reference to be made to the tradability of the asset being valued. Consequently, if a sufficiently wide market for the interest does not exist, arm's-length values may be difficult to determine, at best, and inaccurate, at worst.
- 6.39 For interests in foreign life insurance and superannuation we have considered the use of surrender values and account values, respectively, to approximate market values in respect of these assets.
- 6.40 A surrender value is effectively the price the issuer of a life insurance policy is willing to pay to redeem the policy. One of the concerns arising from the use of surrender values to approximate the market value of a policy is that they can incorporate a penalty for surrendering the policy before maturity, or a bonus for holding the policy to term. This can result in the surrender value underestimating significantly a policy's underlying value. In addition, surrender values may be difficult to obtain as it is unlikely that these values are regularly published or sought by investors.
- 6.41 We are currently considering whether it would be possible to determine a mechanism whereby it would be possible to use surrender values for certain interests in foreign life insurance. One potential mechanism for determining whether surrender values could be used for a particular interest could be based on those policies that were issued by insurers resident in countries where the regulatory framework for life insurance is likely to yield surrender values that represent reasonably accurately a policy's underlying value.

⁵ See "*Transfer Pricing Guidelines*" in Inland Revenue's *Tax Information Bulletin* Vol 12 No 10, October 2000 for a complete description of these rules.

- 6.42 Account values (sometimes referred to as accumulated values) represent the aggregate contributions made to a superannuation scheme and the earnings attributable to those contributions. These values may be available for superannuation schemes where the investor's entitlement is linked directly to contributions made by the investor or on the investor's behalf ("defined contribution schemes").⁶
- 6.43 It may be possible to use account values to approximate the value of an investor's underlying interest in a superannuation scheme – for example, if the account values are published on an investor's statement.

Submission points

We invite submissions on:

- potential mechanisms for using surrender values for certain interests in foreign life insurance policies; and
- whether reliable account values are widely available in respect of defined contribution superannuation schemes.

Market value approximated by reference to "cost"

- 6.44 As noted earlier, for certain interests in foreign superannuation schemes and foreign life insurance, it may be difficult to determine market values by reference to an external market. It is necessary, therefore, to devise a method that can approximate market values for such interests (and any other hard to value assets, excluding interests in foreign companies, which may be non-marketable).
- 6.45 We suggest that the valuation of these assets be based on the relevant asset's cost price in the year of acquisition. In subsequent years taxpayers would be required to increase that cost price by the cost of any acquisitions and by a pre-determined percentage to account for investment growth in the previous year. (The mechanics of this are discussed in more detail later on.)
- 6.46 To be consistent with the treatment of qualifying assets for which a market value is available, the pre-determined percentage by which taxpayers would need to grow the value of this category of assets each year should approximate average investment growth in foreign equity markets. Average investment growth in most years is likely to be greater than the proposed standard return rate of 4%. It is proposed, therefore, that a rate of 10% be used to proxy for investment growth of interests in foreign superannuation schemes and life insurance policies and other hard to value assets in this category.

⁶ These values will not generally be available for superannuation schemes where an investor's entitlement is not linked to the investor's contributions ("defined benefit schemes").

6.47 The 10% rate reflects broadly the long run average Morgan-Stanley Capital International (MSCI) index gross rate of return. The MSCI tracks the performance of a number of the world's largest companies (which foreign superannuation schemes and life insurance policies are likely to invest into to derive capital growth) and represents a gross return (a return inclusive of dividends) on equity.

6.48 The following example illustrates how this would work in a simple case:

In the 2005-06 income year Bob purchases a non-marketable asset for NZD\$45,000. The opening value, when applying the standard return rule in the 2005-06 income year, will be the acquisition cost of NZD\$45,000.

If Bob retains this interest in the following year, the opening value for the 2006-07 year will be NZD\$49,500. That is, the acquisition cost of NZD\$45,000 would be increased by 10% to account for investment growth in 2005-06.

Submission point

We invite submissions on the valuation rule, based on an asset's cost, suggested for interests in foreign superannuation schemes and life insurance policies, and on the potential for use of surrender and account values (if any).

Part-year adjustments

Under this option, qualifying assets held for part of an income year would be subject to a standard return rule.

6.49 For assets held for an entire income year, taxable income under a standard return rule would be calculated by multiplying the opening value of the qualifying asset by a standard return rate of 4%.

6.50 If a person holds an asset for only some of the year, however, the tax liability should reflect the asset's holding period. If it did not, there would be both undertaxation and overtaxation in certain circumstances. The example below illustrates how a standard return rule that did not recognise part-year adjustments would undertax a person who purchases a qualifying asset part-way through the year.

Bill has no qualifying assets at the start of the 2005-06 income year (on 1 April 2005). However, he buys NZD\$40,000 of shares in a foreign company on 31 June 2005. If a standard return rule did not take into account assets purchased part-way through a year, Bill would have a zero tax liability for the 2005-06 income year.

6.51 Similarly, a standard return rule that did not recognise part-year adjustments would overtax if qualifying assets were held at the beginning of the income year and sold during the year. The following example illustrates this:

Jane has a qualifying asset with an opening value of NZD\$5,000 at the start of the 2005-06 income year (on 1 April 2005). However, on 1 July 2005, she sells the entire asset. If a standard return rule did not take into account the fact that Jane sold her investment three months into the year, she would face a tax liability based on holding the asset for 12 months.

6.52 We propose, therefore, to recognise acquisitions and realisations of qualifying assets that occur during an income year. We have identified two methods for recognising part-year adjustments in the standard return calculation.

New part-years for acquisitions and realisations of qualifying assets

Under this option:

- Each acquisition and realisation of a qualifying asset during an income year would result in a new part-year (with the old part-year ending on the date of the acquisition or realisation).
- Acquisitions and realisations during a year would be valued at the per-unit value of the qualifying asset at the start of the relevant income year.
- The standard return rate would be adjusted to reflect the portion of the income year that is equal to the length of each part-year.
- For qualifying assets when a market value is used as the opening value, the asset would be revalued at the start of each income year.
- For qualifying assets when the opening value is based on cost, the value for subsequent income years would be based on cost adjusted for acquisitions and realisations of the asset, distributions and deemed investment growth.
- For interests in foreign superannuation schemes and life insurance policies, if an investor makes regular and equal contributions, the opening value of these interests would be calculated using a simplified formula.
- Bonus issues of shares or units provided for nil consideration would not give rise to a new part-year. However, a new per-unit value would need to be established for subsequent part-years.
- Bonus issues of shares or units when the investor provides consideration would give rise to a new part-year as the additional shares would increase investor wealth – they would constitute a purchase of a qualifying asset.

6.53 Under this approach, whenever an acquisition or a realisation occurred, a new part-year would begin. The standard return rule would apply to each new part-year. Each new part-year would last until the next transaction. Therefore, under this approach, a new opening value would need to be calculated for each part-year, with the standard return rate adjusted for the length of each part-year. This is our preferred approach for dealing with purchases and sales of qualifying assets during an income year, as it would not require taxpayers to track market values of affected assets during the year – an issue that arises under the alternative method that we considered for dealing with part-year adjustments (discussed later).

6.54 The key issue when determining opening values for new part-years is how best to value acquisitions and realisations of qualifying assets falling in those part-years. The most accurate valuation method for acquisitions and realisations of qualifying assets would be to use the market price of the acquisitions and realisations. Under this approach, the value of an acquisition during a year, whether the acquisition is a new asset or an addition to an existing asset, would be the per-unit cost of the asset at the time of purchase

multiplied by the number of units purchased. Similarly, realisations would be valued at the sale price on the day. This is illustrated as follows:

John purchases 50 shares in a foreign company at a price of NZD\$100 per share at the start of the 2005-06 income year. The value of John's acquisition for the purposes of the standard return rule would be NZD\$5,000. Later in the year John sells 25 of the shares, at a price of NZD\$120 per share. The value of the realisation for the purposes of the standard return rule would be NZD\$3,000.

- 6.55 In the case of realisations, however, instances may arise when a qualifying asset has significantly increased in value during the year and, upon realisation, is worth considerably more than at the start of the year. In such a case, if only part of the asset is realised but the value of the sale exceeds the value of the asset at the start of the year, no tax liability would arise for the new part-year (in which the realisation falls) under a standard return rule. Taxpayers would, therefore, escape tax on the remainder of their qualifying assets for the remainder of the income year. This is illustrated as follows:

In the previous example, assume the price per unit of John's 50 shares in the foreign company, acquired at a cost of NZD\$100 per share, were to double during the year to NZD\$200. If John were to sell half of his holding of the asset, then, at a price per share of NZD\$200, the value of his realisation would be NZD\$5,000, enough to offset his entire acquisition cost. This would be the case even though John still held 25 shares.

- 6.56 Consequently, when valuing a realisation, we suggest that taxpayers have regard to the proportion of the asset that is sold rather than the sale price per unit. Under this rule, the opening value for a new part-year would be the proportion of the asset that remains following the realisation multiplied by the opening value calculated for the most recently ending full income year (in the case of no prior part-year adjustments) or most recently ending part-year. The following simple example illustrates this:

Tracey holds 500 units valued at NZD\$10 each on the first day of the 2005-06 income year. She sells 250 of the units for NZD\$20 each six months into the income year. The aggregate value of the asset for the new part-year is 50% of the value at the beginning of the income year – NZD\$2,500 (NZD\$5,000 x 50%) – not zero (NZD\$5,000 less 20 x NZD\$250).

- 6.57 By valuing realisations as a proportion of the qualifying asset that is sold, this rule would ensure that the ultimate tax liability reflects the appropriate percentage of the asset that is held during a year and the duration of that holding.
- 6.58 Another way of achieving the same result is to value realisations of qualifying assets during the year at the per-unit value of the asset at the start of the relevant income year, if held at the start of that year, or at the cost price per-unit if the asset is first acquired during that year. In the latter case, the first part-year would be deemed to have begun on the date of acquisition.

To be consistent with the valuation of realisations during the year, purchases of qualifying assets during a year would, under this approach, also be valued in the same manner – either at the per-unit value of the asset at the start of the year or at the cost price per unit if the asset is newly acquired. This is the preferred approach as it addresses the problems arising from both valuing realisations at the sale price and valuing sales as a proportion of the value at the start of the year, or a part-year.

Calculating the tax liability under a standard return rule with part-year adjustments for assets for which reliable market values can be ascribed

6.59 The method proposed to calculate an investor's tax liability under a standard return rule can appear complex. Much of the perceived complexity can be removed if a four-step methodology is used for determining the tax liability. These steps for interests in foreign companies and unit trusts that are listed on recognised foreign exchanges and certain hard-to-value assets for which market values are able to be determined in an approved market are discussed here.

Step one: establishing the value of a qualifying asset at the start of the year

6.60 For assets that are held in one income year and rolled over to the next year, the opening value of the asset would be its market value. The opening value would be calculated by multiplying the price of each unit that is quoted in the relevant market on the first day of the income year by the number of units held on that day.

Step two: establishing an opening value for the relevant part-year

6.61 As noted earlier, an acquisition or realisation of a qualifying asset during a year would result in the creation of a new part-year. The opening value for a new part-year would be the opening value calculated for the most recently ending part-year, using this methodology (or if the acquisition or realisation is the first transaction of the year, the value of the asset at the start of the year) plus the acquisition or less the realisation in the new part-year. As discussed, both acquisitions and realisations would be valued at the per-unit price of the asset at the start of the income year, or if the asset being adjusted was first acquired during the income year, the cost price per-unit of that initial acquisition.

Step three: apportioning the standard return rate to reflect the length of each part-year

6.62 To avoid overtaxation it would be necessary to adjust the 4% standard return rate applied to the opening value calculated for the relevant part-year, to reflect the length of that part-year. Therefore the appropriate standard return rate for part-years would be calculated by multiplying the 4% standard return rate by the proportion of the income year that the part-year represents. For example, if the part-year represents six months, the standard return rate would be adjusted as follows:

$$\frac{6 \text{ (months)}}{12 \text{ (months)}} \times 4\% = 2\%$$

Step four: determining the taxable income for the year

- 6.63 Once the opening value and adjusted standard return rate for each part-year has been determined, the taxable income for each part-year would be calculated simply by multiplying the opening value by the rate. To determine the taxable income for the entire year, the taxable incomes for each part-year would be aggregated.
- 6.64 An example of how this method would work is provided in Appendix 3.

Calculating the tax liability under a standard return rule with part-year adjustments for assets for which market values must be approximated (non-marketable assets)

- 6.65 Taxable income for these assets would also be calculated by splitting each income year into different part-years, with a new part-year for each acquisition and realisation. The standard return rate, adjusted for the length of the relevant part-year, would then be applied to the opening value of the asset in each part-year.
- 6.66 The only difference between the method that would be used for these assets and that applying to assets where market values are available would be the need to approximate a market value for the asset at the start of the next year, or any new income year.

Calculating an opening value for the next income year for non-marketable assets

- 6.67 It would be necessary to calculate an opening value for non-marketable assets for a subsequent year with reference to part-year adjustments in the previous year. In this way, provided that distributions and investment growth were also accounted for, it would be possible to provide an approximation of an asset's opening value in the following income year.
- 6.68 Under this method, the opening value for the next income year would be calculated by taking the opening value calculated for the most recently ended part-year and reducing this amount by the value of distributions, such as any dividends derived in the previous year. This figure would then be increased by an amount that would approximate the asset's investment growth in the previous year.
- 6.69 The need to reduce the opening value for the most recently ended part-year by any distributions, such as dividends derived, in the previous year is a reflection that if genuine market values were available, the distribution would generally be accounted for in a lower market value of the asset at the start of the succeeding income year.

- 6.70 The need to increase the opening value for the most recently ended part-year by an investment growth component is to ensure that the tax value of the investment approximates the actual investment growth that would, on average, occur across investments of the type in question. The easiest and most accurate way to do this would be to use the taxable income calculated for past years under the standard return approach to calculate investment growth. This is because aggregate taxable income for a year would represent approximately 4% of the asset's actual opening value in that year (the value taking into account part-year adjustments). Consequently, to calculate investment growth at 10%, it would simply be a matter of dividing taxable income by 4 and multiplying the result by 10.
- 6.71 The following example illustrates the calculation that would need to be undertaken:

In the most recently ended part-year of the 2005-06 income year, Tom had an opening value of NZD\$9,500 for his non-marketable asset. When calculating his opening value for the 2006-07 income year, Tom will need to adjust this value for dividends paid out in 2005-06 and for investment growth. If a dividend of NZD\$380 was paid out in the 2005-06 income year, the opening value for the most recently ending part-year of that year would be reduced to NZD\$9,120 (NZD\$9,500 - NZD\$380). In terms of investment growth, this would simply be the taxable income for the 2005-06 year under the standard return approach – NZD\$380 (assume NZD\$9,500 x 4%) – divided by 4 and multiplied by 10 – NZD\$950.

Consequently, the opening value in the 2006-07 income year would be NZD\$9,120 plus investment growth of NZD\$950 – NZD\$10,070.

Treatment of dividends

- 6.72 Dividends would not be treated as a part-year adjustment in the year they are derived. Although, a dividend is a distribution from a company and will therefore affect the value of a taxpayer's qualifying asset (in much the same way as a purchase or an acquisition), taking dividends into account will result in a number of taxpayers who would otherwise not be required to make part-year adjustments because they do not undertake transactions during a year being required to do so. We consider the compliance costs that would be imposed from accounting for dividends as a part-year adjustment would be disproportionate to the increased accuracy of the standard return income calculation.
- 6.73 The effect of dividends derived would, nevertheless, be accounted for in the valuation of the asset in the following income year, either automatically (in the case of assets for which reliable market values can be ascertained) or in the opening value calculation (in the case of assets for which market values must be approximated).

Treatment of bonus issues for nil consideration

- 6.74 There may be instances, for example, when a foreign company makes an issue of bonus shares to its shareholders for no consideration. Such a bonus issue of shares would result in investors holding more shares with no increase in wealth because the share price would be expected to be diluted to reflect no change to the company's available subscribed capital. Consequently, a bonus issue of shares or units for nil consideration should not trigger a part-year adjustment under a standard return approach as it would not result in a change in the economic value of an investor's underlying investment.
- 6.75 Under the approach proposed for calculating tax under the standard return approach, however, both the price of an asset and the number of units held as at a particular date are important. This is because changes in the number of units during a year (as a result of sales and acquisitions) will need to be valued at the per-unit price of the asset at the start of a year under the proposed method. This standardisation of price per unit for transactions means that the change in the number of units as a result of the bonus issue of shares will affect the value of the asset on which a standard return rule applies.
- 6.76 The problem in relation to bonus issues of shares and units for nil consideration is that while the number of "units" of the qualifying asset will have changed, so too (generally) will the price per "unit", such that there is no overall change in the value of the asset. However, because transactions must be valued at the per-unit price of the asset at the start of the year, if no correction is made any sale or purchase of units after the bonus issue will result in an overvaluation of the sale or purchase price. The example below illustrates this.

Alastair holds 40 shares in a foreign company at the start of the 2005-06 income year at a price of NZD\$5.00 per share. Six months into the year, Alastair receives a bonus issue of 40 shares for which he provides no consideration, increasing the number of shares he holds to 80. The price per share, however, falls to NZD\$2.50, such that the value of his holding remains unchanged at NZD\$200. After the issue, Alastair sells 40 shares. Under the proposed approach, with no adjustment to per-unit price to reflect the bonus issue, the sale of 40 shares would be valued at the price per share at the start of the year – NZD\$5.00. Consequently, the value of the sale would be NZD\$200, which is sufficient to offset his initial opening value. This would occur even though Alastair has only effectively sold half of his holding. The value of the sale should be NZD\$100 (40 x NZD\$2.50) and Alastair should be subject to tax on the 40 remaining shares held, at a price of NZD\$2.50 per share.

- 6.77 The proposed solution is to recognise any transactions after a bonus issue of “units” for nil consideration at a new per-unit value. The new per-unit price would be calculated by keeping the value of the holding after the non-taxable bonus issue constant with that before the issue and dividing by the number of “units” held after the issue. So, in the preceding example, the value of the holding before the non-taxable bonus issue was NZD\$200 (40 x NZD\$5.00). The value of the holding after the non-taxable bonus issue is also NZD\$200 but the number of “units” has doubled (to 80). Consequently, the new per-unit price will be NZD\$2.50 (NZD\$200 / 80 units) for valuing subsequent part-year adjustments.
- 6.78 Appendix 4 provides a more detailed example of how bonus issues of “units” for nil consideration could be dealt with under the suggested method for recognising part-year adjustments.

Treatment of bonus issues that increase investor wealth

- 6.79 A bonus issue could also arise, for example, when a foreign company or foreign unit trust operates a dividend re-investment policy. That is, instead of the dividend being explicitly paid out, it is re-invested in the entity, thereby increasing the investor’s interest in the company or unit trust. Such a bonus issue will therefore result in an increase in the number of “units” held by an investor but, unlike a bonus issue for nil consideration, with an accompanying increase in the investor’s wealth – the company’s available subscribed capital. Consequently, a bonus issue of units which increases an investor’s wealth will trigger a part-year adjustment as this is equivalent to a purchase of additional units during the year, as illustrated in the example below:

At the start of the 2005-06 income year, Megan has 15,000 units in a foreign unit trust (at a price of NZD\$1.50 per unit) which operates a dividend re-investment policy. On 1 October, she derives a dividend of NZD\$800 which is re-invested, resulting in a 500 unit increase in her holding (assume the price per unit has increased to NZD\$1.60 per unit at the time the new units are created). Megan would need to treat the re-investment and subsequent increase in her holding as a new acquisition for the purposes of applying a standard return rule. The re-investment would be valued at NZD\$750 (500 units x value at start of year: NZD\$1.50 per unit) for standard return purposes. Consequently, Megan’s taxable income would be NZD\$450 for the first part-year (NZD\$22,500 x 2%) and NZD\$465 for the second part-year (NZD\$23,250 x 2%).

Calculating taxable income for interests in foreign superannuation and life insurance – a simplified method

- 6.80 Investors with interests in foreign superannuation schemes and foreign life insurance policies are likely to make regular and equal contributions and premium payments, respectively, to these schemes and policies. To apply a standard return rule strictly accurately to these interests, it would be

necessary to treat each contribution and premium payment as giving rise to a new part-year. This would clearly create compliance costs for investors

- 6.81 We therefore consider that the following simplified formula should be used to calculate an opening value based on contributions made and premiums paid in a year:

$$\frac{\text{Contribution or premium payment} \times \text{No of contributions or payments in year}}{2}$$

Note: the simplified formula would be applicable to interests in foreign superannuation schemes and life insurance policies only when the investor makes regular and equal contributions and premium payments.

- 6.82 The following example illustrates how this simplified formula would apply in the first year an investor starts contributing to a superannuation scheme.

Peter starts investing in a foreign superannuation scheme in the 2005-06 income year, making regular contributions of NZD\$200 each month towards the policy. Peter's opening value for the 2005-06 income year would be NZD\$1,200, based on the simplified formula $((\text{NZD}\$200 \times 12)/2)$.

The simplified formula is available to Peter because he has made regular and equal contributions.

- 6.83 When the simplified formula is used a separate method will be necessary to determine the opening value of the investment in the second and subsequent income years.

- 6.84 In the second income year the opening value of the investment would be the aggregate contributions in the preceding year (the first income year), minus distributions in the previous year, plus an amount to account for investment growth in the preceding income year. Investment growth would be the opening value in year one, as calculated under the simplified formula, multiplied by the investment growth percentage. The following example, that builds on the preceding one, illustrates this:

In the 2006-07 income year Peter continues to make regular and equal contributions to the scheme. The opening value of Peter's policy in the 2006-07 income year will be the value of his contributions in that income year, calculated under the simplified formula –NZD\$1,200 – plus the aggregate value of contributions in the 2005-06 income year –NZD\$2,400 – plus the investment growth between years –NZD\$120 (NZD\$1,200 x 10%). Consequently the opening value in the 2006-07 income year would be NZD\$3,720.

(In this example there are zero distributions in the 2005-06 income year.)

6.85 Similarly, in the third income year, the opening value would be aggregate contributions in the first and second income year (minus any distributions in those years) plus investment growth in those years, plus the value of contributions in the third year (calculated under the simplified formula).

6.86 The formula for calculating the opening value on which the standard return rule would apply is:

Opening value in current year

[Value of contributions in current year (calculated under the simplified formula)] + [Value of contributions in previous years, if any] – [Distributions in previous years, if any] + [Investment growth in previous years]

6.87 The formula for calculating investment growth in previous years is:

Year One *(for calculating OV in Year Two)*

Opening value in Year One x investment growth percentage of 10%

where *Opening Value in Year One* = [Value of contributions in year one (calculated under the simplified formula)]

Year Two *(for calculating OV in Year Three)*

Opening value in Year Two x investment growth percentage of 10%

where *Opening Value in Year Two* = [Value of contributions in year two (calculated under the simplified formula) + aggregate value of contributions in year one – any distributions in year one + investment growth in year one]

Year Three *(for calculating OV in Year Four)*

Opening value in Year Three x investment growth percentage of 10%

where *Opening Value in Year Three* = [Value of contributions in year three (calculated under the simplified formula) + aggregate value of contributions in years one and two – any distributions in years one and two + investment growth in years one and two

:
:
:

Year Y (for calculating OV in Year Z)

Opening value in Year Y x investment growth percentage of 10%

where *Opening Value in Year Y* = [*Value of contributions in year Y (calculated under the simplified formula)* + *aggregate value of contributions in years 1...X – any distributions in years 1...X* + *investment growth in years 1...X*]

6.88 The following example illustrates the use of the formula in determining an opening value for Peter's interest in the foreign superannuation scheme in income years three and four:

In the 2007-08 income year, Peter continues to make regular and equal contributions to the foreign superannuation scheme. The opening value of his policy in that income year will be:

- (a) *The value of contributions in the 2007-08 income year under the simplified formula: [NZD\$2,400 / 2]; plus*
- (b) *Contributions made to the scheme in the 2005-06: [NZD\$2,400] and 2006-07 income years: [NZD\$2,400]; plus*
- (c) *Investment growth in the 2005-06: [(NZD\$1,200 x 10%) = NZD\$120] and 2006-07: [(NZD\$1,200 + NZD\$2,400 + NZD\$120) x 10%) = NZD\$372] income years*

$$\text{NZD\$1,200} + \text{NZD\$4,800} + \text{NZD\$492} = \text{NZD\$6,492}$$

In the 2008-09 income year, the opening value of Peter's policy will be:

- (a) *The value of contributions in the 2008-09 income year under the simplified formula: [NZD\$2,400 / 2]; plus*
- (b) *Contributions made to the scheme in income years 2005-06: [NZD\$2,400], 2006-07: [NZD\$2,400] and 2007-08: [NZD\$2,400]; plus*
- (c) *Investment growth in the 2005-06: [NZD\$120], 2006-07: [NZD\$372] and 2007-08: [(NZD\$1,200 + NZD\$2,400 + NZD\$2,400 + NZD\$120 + NZD\$372) x 10%) = NZD\$649] income years*

$$\text{NZD\$1,200} + \text{NZD\$7,200} + \text{NZD\$1,141} = \text{NZD\$9,541}$$

(Assume zero distributions in the 2005-06, 2006-07 and 2007-08 income years.)

6.89 The calculation of opening values using this formula will result in some overtaxation in income years in which distributions have been derived, as these distributions will not be accounted for in the opening value calculation. This is similar to the treatment of dividends derived in respect of interests in foreign companies (for which reliable market values can be ascribed). The value of any distributions would, however, be subtracted from the opening value in the following year. This will result in a lower tax liability in that

subsequent year. The calculation of opening values using this formula will also mean that the calculation of investment growth will result in some overtaxation in income years in which distributions have been derived.

- 6.90 As noted earlier, one way to address this relatively minor overtaxation would be to require a part-year adjustment to be carried out in respect of each contribution to and distribution from a foreign superannuation scheme or foreign life insurance policy when calculating investment growth. This may, however, add a level of complexity that is disproportionate to any improvements to the accurate calculation of income.

Submission point

We invite submissions on whether it would be feasible for part-year adjustments to be carried out in respect of contributions and distributions when calculating investment growth for interests in foreign superannuation schemes and foreign life insurance policies.

Opening value calculated as the average of values over a 12-month period

- 6.91 We have also considered the approach of taxing the average value of an investor's holding of a qualifying asset, over a 12-month period (comprising the yearly income under a standard return rule) as a way of dealing with part-year adjustments. The average value of the asset over the 12-month period would be calculated having regard to the value of the asset at the start of each month in that period.
- 6.92 This method avoids explicitly taking into account acquisitions and realisations of qualifying assets in the standard return calculation. Instead, these part-year adjustments would simply be reflected in the value of the asset holding at the start of a month in the form of a higher or lower value. The following example illustrates how this method would work in practice.

Helen holds 100 shares in a foreign company at a price of NZD\$1 per share. At the start of the 2005-06 income year, the value of her asset is NZD\$100. The value of her shares at the start of each month in the 2005-06 year is shown in the table below:

<i>Mth</i>	<i>Price per share at start of month</i>	<i>Mth</i>	<i>Price per share at start of month</i>
<i>1</i>	<i>NZD\$1.00</i>	<i>7</i>	<i>NZD\$1.23</i>
<i>2</i>	<i>NZD\$1.05</i>	<i>8</i>	<i>NZD\$1.19</i>
<i>3</i>	<i>NZD\$1.12</i>	<i>9</i>	<i>NZD\$1.07</i>
<i>4</i>	<i>NZD\$1.18</i>	<i>10</i>	<i>NZD\$1.01</i>
<i>5</i>	<i>NZD\$1.20</i>	<i>11</i>	<i>NZD\$0.98</i>
<i>6</i>	<i>NZD\$1.25</i>	<i>12</i>	<i>NZD\$0.95</i>

Six months into the 2005-06 year she purchases another ten shares and two months before the end of the income year, sells 60 shares.

Under the 12-month average approach, Helen's opening value for the income year will be the average of the values of her qualifying asset at the start of each month in the year:

<i>Mth</i>	<i>Value of holding at start of month</i>	<i>Mth</i>	<i>Value of holding at start of month</i>
1	NZD\$100 (100 units held x NZD\$1.00)	7	NZD\$135.30
2	NZD\$105	8	NZD\$130.90
3	NZD\$112	9	NZD\$117.70
4	NZD\$118	10	NZD\$111.10
5	NZD\$120	11	NZD\$49 (sale of 60 units: 50 units held x NZD\$0.98)
6	NZD\$137.50 (purchase of 10 units: 110 units held x NZD\$1.25)	12	NZD\$47.50

The 12-month average value would be NZD\$107.

Consequently, the standard return rate of 4% would apply on NZD\$107.

- 6.93 This method has the significant disadvantage, however, of requiring taxpayers to value their asset at the start of each month in an income year. This may result in significant costs for those taxpayers who do not undertake sales and purchases of the asset during the year and therefore do not regularly track asset values (such as share prices). For this reason we do not support using this approach.

Monthly or daily asset holding period

Under this option, investors would have a choice of determining the length of a part-year by reference to the number of days or months that a qualifying asset is held during the part-year.

- 6.94 Bringing to account part-year changes to qualifying assets raises the issue of how the holding period for these assets should be calculated. The holding period is used to adjust the standard return rate to reflect the length of a part-year. One option is calculating the holding period on the basis of the number of days the asset was held. Another option is calculating the holding period on the basis of the number of months the asset was held.
- 6.95 The two approaches have different advantages and disadvantages. A monthly holding period would, in certain cases, be simpler to use as investors would not be required to track the exact date of acquisitions and realisations. On the other hand, a daily holding period would result in a more accurate calculation of taxable income, thereby reducing potential opportunities for overtaxation. This is because, under a monthly approach, a part of a month during which a qualifying asset is held would be deemed an entire month. This is necessary in order to prevent investors reducing their tax liability by reducing the qualifying assets held at the start of a month.
- 6.96 Although it would be possible to develop rules to increase the accuracy of an approach where the asset holding period is denoted in months, this would add a layer of complexity to the standard return rule.⁷ Equally, while a days approach would be more accurate, it may not be suitable where investors do not transact often and cannot recall the exact date changes to holdings of qualifying assets were made. Consequently, it is considered that a choice of how the asset holding period is defined, whether in months or days, should be available to taxpayers. In this way it is expected that taxpayers will be able to choose the method which best suits their requirements.

⁷ For example, a possible rule would be to deem a qualifying asset, purchased after the middle of a month and sold before the middle of the subsequent month, to be held for only one month (as opposed to two). Such a rule would, however, be arbitrary as there is still scope to argue that the asset is in fact held for less than a month – for example, if purchased in the last week of a month and sold in the first week of the subsequent month. Any further rules to increase accuracy would ultimately result in a something akin to a days approach.

Conversion of income into New Zealand dollars

Under this option, investors would calculate taxable income for qualifying assets in the relevant foreign currency and convert this to New Zealand dollars at the average of the close of trading spot exchange rate for the 15th of each month falling within a taxpayer's income year.

- 6.97 Under the FIF rules, FIF income or losses must be calculated in the currency in which the FIF interest is held. It is converted to New Zealand dollars at the average of the close of trading spot exchange rate for the 15th of each complete month falling within a FIF's accounting period (if the accounting profits method is used) or the investor's income year (if the comparative value or deemed rate of return income calculation methods are used).⁸ Inland Revenue publishes exchange rates which apply on the 15th day of each month (including a cumulative average for the previous 12 months) for a number of countries. Taxpayers can also use an average rate from one of New Zealand's major trading banks if, for example, Inland Revenue does not publish an exchange rate for a particular currency.
- 6.98 We consider that under a standard return rule, taxpayers should continue to calculate income from qualifying assets in the relevant foreign currency and convert this to New Zealand dollars at the average of the close of trading spot exchange rate for the 15th of each month falling within a taxpayer's income year.
- 6.99 The main reason for maintaining an average exchange rate is to reduce the risk of an investor's tax liability being affected by short-term exchange rate fluctuations. In addition, for most affected investors the relevant exchange rate information is already published by Inland Revenue and readily available, making it a relatively low-cost way of complying with the foreign currency conversion requirements.

⁸ Section CG 16(11) of the Income Tax Act 1994.

Treatment of credits for non-resident withholding tax (NRWT)

Under this option, subject to certain restrictions, a credit would be allowed for foreign non-resident withholding tax deducted from any foreign dividends derived, to offset tax payable under a standard return rule.

- 6.100 As discussed earlier, a standard return rule would tax an asset at a rate that approximates a reasonable dividend yield. In other words, the rule would tax an assumed rather than an actual gain, with the result that actual gains such as dividends would not be subject to tax.
- 6.101 Under our double tax agreements, New Zealand is obliged to allow a credit for foreign non-resident withholding tax (NRWT) withheld on dividends derived from companies resident in partner countries. The taxpayer can use the credit to offset New Zealand tax payable on the dividend income. This treatment is confirmed in our domestic law by section LC 1 of the Income Tax Act 1994.
- 6.102 The wording of our double tax agreement articles that provide for the credit⁹ and section LC 1 suggest that the credit is only available if it offsets New Zealand tax payable on the particular form of income derived (in this case the dividend). Therefore, given that the dividend would not be subject to New Zealand tax under a standard return rule, there is an argument that the investor should receive no credit for the foreign NRWT paid.
- 6.103 This result does not appear to be appropriate. The policy underlying the tax credit rules in our double tax agreements and domestic law is to prevent income being subject to two layers of tax, one layer applying in the country of source and the other applying in the country of residence.
- 6.104 Under a standard return rule, the deemed income will usually be different from actual dividends derived. In cases where the actual dividend is greater than the standard return income and the dividend includes credits for foreign NRWT deducted, the issue arises as to what proportion of the credits should be allowed against tax on standard return income.
- 6.105 If an amount less than the actual dividend derived is taxable, the credit allowed should be in proportion to the income that is taxed in New Zealand under the standard return rule – the lesser amount. For example, if foreign NRWT is withheld at, say, 15% on a dividend, the amount of the NRWT that is creditable would be 15% of the income calculated under the standard return approach. An example illustrates this:

⁹ See, for example, Article 24 of the New Zealand / United States of America DTA.

Mary (whose personal tax rate is 33%) has a qualifying asset of value NZD\$100,000 at the start of the 2005-06 income year. Her imputed income for the year under the standard return rule would be NZD\$4,000 (NZD\$100,000 x 4%). In the same year, Mary receives a dividend of NZD\$5,000 with foreign NRWT deducted at 15% – a net dividend of NZD\$4,250 and foreign NRWT of NZD\$750. NZD\$600 (NZD\$4,000 x 15%) of the foreign NRWT would be creditable against tax payable under the standard return – NZD\$1,320 (NZD\$4,000 x 33%). The total New Zealand tax payable by Mary on the qualifying asset would, therefore, be NZD\$720 (NZD\$1,320 less NZD\$600). The excess credits (NZD\$750 less NZD\$600), which relate to non-taxable receipts, could not be offset against other income or carried forward.

Trans-Tasman recognition of imputation credits

Under this option, subject to certain restrictions, imputation credits for New Zealand tax paid that are attached to dividends received from an Australian company could be offset against tax payable under a standard return rule.

- 6.106 Australia and New Zealand have recently reformed their imputation laws to reduce a longstanding problem of the double taxation of certain trans-Tasman investments. From the perspective of a New Zealand shareholder of an Australian company, double taxation can occur if the Australian company derives income from New Zealand. The income is taxed in New Zealand but, before the introduction of the new rules, no portion of the New Zealand tax paid could be credited to the New Zealand shareholders.
- 6.107 The new rules aim to reduce this problem by allowing Australian and New Zealand shareholders of trans-Tasman companies that choose to access the other country's imputation rules to be allocated imputation credits representing New Zealand tax paid and franking credits representing Australian tax paid, in proportion to their ownership interests. However, each country's credits can be claimed only by its residents.
- 6.108 Under a standard return rule, actual dividends derived by New Zealand shareholders of Australian companies would not be subject to tax. Therefore there would be no taxable dividends against which any imputation credits representing New Zealand tax paid could be offset.
- 6.109 Although the actual dividend flow would not be taxed under a standard return rule the dividend will, in substance, already be taxed by attributing a reasonable standard dividend yield of 4%. It would, therefore, be appropriate to allow investors to offset their tax liability under a standard return rule, with imputation credits representing New Zealand tax paid.
- 6.110 Under a standard return rule, the deemed return will usually be different from the actual dividend derived. When the actual dividend is greater than the standard return income and the dividend has imputation credits (representing New Zealand tax paid) attached, the question arises as to what proportion of the imputation credits should be allowed as a credit against tax on standard return income.
- 6.111 A key principle underlying dividend imputation is that dividends can be imputed only up to a maximum of the company tax rate. This means that the ratio of imputation credits to dividends cannot exceed 33:67. (In other words, imputation credits cannot exceed 33/67 of the cash dividend paid.)

6.112 It follows, therefore, that if an amount less than the actual dividend derived is taxable, the maximum imputation ratio should be applied to that lesser amount. Therefore imputation credits attached under the trans-Tasman imputation rules would be creditable to the extent they do not exceed the 33:67 ratio when applied to income calculated under a standard return rule. It should be noted, however, that a situation when the imputation credits exceed the 33:67 ratio, as applied to standard return income, is unlikely to arise often. However, the following example is provided for illustrative purposes:

Paul (whose personal tax rate is 33%) has an investment of NZD\$25,000 in an Australian company. His taxable income under a standard return rule would be NZD\$1,000 (NZD\$25,000 x 4%). Paul receives a net dividend of NZD\$1,250 from the Australian company with NZD\$536 of imputation credits for New Zealand tax paid by the company attached (the amount of the credit is based on the maximum Australian imputation ratio of 30:70 = 30/70 x NZD\$1,250). Under the proposed approach, the maximum imputation ratio of 33/67 would be applied to standard return income of NZD\$1,000 to calculate the maximum imputation credit allowed – approximately NZD\$492 (33/67 x NZD\$1,000). Paul would have no tax liability under the standard return approach once the credits allowed have been offset against tax payable ((NZD\$1,000 + NZD\$492) x 33% less NZD\$492). The credits that relate to receipts that are not taxable (NZD\$536 less NZD\$492) could not be offset against other income or be carried forward.

Treatment of companies under a standard return rule

Application of the dividend withholding payment rules

- 6.113 The main group of investors that would hold investments subject to the standard return rule would be individuals. However, the standard return approach would also apply to New Zealand resident companies that hold non-controlled interests in foreign companies and the interests would, if sold, not comprise part of the company's business income.
- 6.114 Generally foreign dividends derived by New Zealand companies are deemed to be exempt income, under section CB 10 of the Income Tax Act 1994. However, foreign dividends derived from interests in foreign companies which are subject to tax under the comparative value or deemed rate of return method in the FIF rules are deemed not to constitute a dividend by section CG 16(6). The reason for this is to prevent double taxation, as foreign dividends are effectively taxed under these FIF income calculation methods.
- 6.115 The effect of deeming these distributions not to constitute a dividend is that the distributions are not treated as exempt dividends under section CB 10. This is important because foreign dividends derived by New Zealand companies, that are exempt under section CB 10, are subject to the dividend withholding payment (DWP) rules.¹⁰ Under the DWP rules, a withholding payment at the rate of 33% of the dividend must be deducted. If a New Zealand company elects to operate a dividend withholding payment account (DWPA), the DWP paid is credited to this account and can be attached as credits to dividends paid to its shareholders.¹¹ DWP credits are similar in nature to imputation credits. The key difference, however, is that DWP credits in excess of a tax liability are refundable to the shareholder.
- 6.116 It is proposed that dividends derived from qualifying assets subject to the standard return rule would not be subject to DWP. This is the same approach as that adopted in the comparative value and deemed rate of return methods under the FIF rules. That is, the standard rate of return should encompass the portion of the return to a qualifying asset that comprises dividends. Therefore, double taxation can be avoided under a standard return rule by adopting the section CG 16(6) approach and deeming a foreign dividend not to constitute a dividend, thereby removing such distributions from the ambit of the DWP rules.

¹⁰ Section NH 1 of the Income Tax Act.

¹¹ If the company does not operate a DWPA, then the DWP paid is credited to the company's imputation credit account.

Treatment of underlying foreign taxes

- 6.117 Currently, in certain circumstances a New Zealand resident company may be allowed an underlying foreign tax credit (UFTC) to offset DWP liabilities arising from dividends derived from the foreign company. The UFTC is available for all controlled interests in foreign companies of 10% or greater. It is also available for non-controlled interests in foreign companies of 10% or greater, if the interest is a grey list investment or is subject to the FIF rules and the investor applies the branch equivalent income calculation method. The UFTC represents the underlying tax paid by the foreign company in the foreign jurisdiction.
- 6.118 Under a standard return rule, UFTCs would not be allowed. This is because, as noted earlier, no DWP liability will arise in respect of dividends derived from qualifying assets under a standard return rule.¹²

¹² However, as noted earlier, the current rules would apply for investors using the branch equivalent method.

Entry and exit from a standard return rule

Under this option, as a general rule, qualifying assets would enter and exit the standard return rule at market value. However, for assets where ascertaining a market value is not practical or appropriate, and therefore must be approximated, we suggest entry and exit rules as follows:

- Assets entering the standard return rule from other rules in the Income Tax Act would enter at their tax-book value.
- Qualifying assets such as interests in foreign superannuation schemes and foreign life insurance policies that newly enter the standard return rule and for which no tax-book value exists would enter at the aggregate value of the contributions (and premium payments) made.
- Assets exiting the standard return rule would exit at their tax-book value, calculated for standard return purposes.

6.119 Rules to cater for the various situations where an asset becomes subject, or stops being subject, to the standard return rule will be necessary. These situations can occur as a result of changes in the tax status of the asset, the taxpayer, or the entity into which the investment is made. The main function of such entry and exit rules would be to assign a value to the asset when it moves in and out of the rule. Ascribing appropriate values for such assets would enable the standard return rule, and other tax rules to which the asset may become subject, to function properly.

6.120 As with the current FIF rules, it is considered that entry and exit from a standard return rule should, where possible, occur at market value.

Entry and exit of assets for which market values are not ascertainable and must therefore be approximated

6.121 There will, however, be assets for which ascertaining market values may not be practical or appropriate. These assets will include:

- Interests in certain foreign superannuation schemes
- Interests in certain foreign life insurance policies

6.122 For these assets the appropriate value for entry and exit will depend on whether the asset is entering the standard return rule or exiting, the type of asset and on the particular circumstances of the entry or exit.

Entry

- 6.123 An asset for which it is not appropriate or practical to ascertain a market value could enter the standard return rule from another set of New Zealand tax rules that required a value to be ascribed to the asset in order to operate. For these assets it would be appropriate to continue applying the same value for the purposes of the standard return rule. The clearest example where this could occur in the context of the standard return rule is entry into the rules from the FIF rules. This could arise if, for example, a person holding a FIF asset ceases to meet the business test in relation to the asset. In these circumstances, given that the market value of the asset will not be readily ascertainable, it is likely that the person would have used the deemed rate of return method under the FIF rules. If this is the case, the rules should treat the person as having sold the asset at book value immediately before entry into the rules, with a subsequent purchase having occurred immediately after entry into the rules.
- 6.124 There will also be situations when neither a market nor tax-book value exists for an asset. This could occur in a number of circumstances, including when a person holding such an asset becomes a New Zealand resident. In such a situation it will be necessary to approximate the asset's market value. A number of approaches could be used when making such an approximation.
- 6.125 One approach that could be used to value an interest in a foreign life insurance policy or a foreign superannuation scheme is to use surrender values (for an insurance policy) or the account value (for superannuation schemes). As noted earlier, we are currently considering whether it would be possible to determine a mechanism whereby surrender values and account values could be used to approximate the value of policies and schemes. Even if this proves to be possible for some interests, there will be others for which these values cannot be used.
- 6.126 Another approach is to determine an entry value simply by aggregating a person's gross contributions to a superannuation scheme and premium payments to a foreign life insurance policy. This approach has the advantage of simplicity and should be relatively easy for people to comply with. This is the method currently used in the FIF rules for interests in foreign superannuation when it is not reasonably practicable to ascertain a market value in any other manner.¹³
- 6.127 Clearly, the main problem with this approach is that it will, in many cases, be a very crude approximation of an asset's market value. This is because earnings from the scheme, sales of part of the asset, or distributions from the scheme will not be taken into account. Depending on the circumstances, this would result in either undertaxation or overtaxation. While more accuracy could be achieved if sales, distributions and earnings were taken into account when ascertaining a value, this would add a significant layer of complexity and result in additional compliance costs.

¹³ Section CG 23(9)(b) of the Income Tax Act 1994.

6.128 Therefore, for assets entering the standard return rule, for which it is not practical or appropriate to ascertain a market value, or if no tax-book value is available, we would favour a rule whereby the value of the asset, for standard return purposes, was equal to the aggregate gross contributions made by or on behalf of the person holding the asset.

Exit

6.129 The appropriate exit value of these assets would be the asset's tax-book value as determined under the standard return rule. The person holding the asset should be treated as if they had sold the asset immediately before exit and reacquired the asset immediately following the exit from the rule at the asset's tax-book value.

Submission point

We invite submissions on an approach that would determine an entry value for assets when it is not practical or appropriate to ascertain a market value by aggregating gross contributions.

Evaluation

- 6.130 The key objective of a standard return rule is to tax capital account offshore investments in a manner broadly similar to that of equivalent domestic investment. The standard return rule would achieve this by deeming qualifying offshore investment held in a non-business context to yield a real risk-free return of 4% per year. The 4% rate is broadly consistent with average domestic dividend yields.
- 6.131 As well as meeting this broad objective, a standard return rule would also address many of the key problems identified with the current tax rules for non-controlled offshore investment in equity. These are outlined below.

The grey list

Low effective tax rate

- 6.132 The application of a standard return rule would address the low effective New Zealand tax rate that can arise in respect of capital account grey list investment. Under the standard return approach, taxable income of 4%, equivalent to a reasonable dividend yield, would arise in respect of these investments each year, independently of whether a dividend was paid. In addition, by deeming a standard rate of return each year, the rule would remove the tax incentive to invest in assets that yield capital gains rather than dividend returns.

Tax-advantaged offshore investments

- 6.133 This approach would also address the current tax advantage that arises in respect of capital account investments into certain United Kingdom managed trusts and Australian unit trusts. By taxing these investments at the rate prescribed under the standard return rule, much of the tax incentive that currently exists to invest in these vehicles over equivalent New Zealand vehicles would be reduced. This should assist to level the playing field for New Zealand managed funds operating in similar markets.

Passive funds

- 6.134 A standard return rule should, to some extent, also ensure that the investments of funds that track passively offshore indices in grey list countries are subject to a more appropriate level of New Zealand tax. Because these funds are considered not to be in business, the standard return rule would apply.
- 6.135 We acknowledge that there is a risk that, following the introduction of a standard return rule, certain passive funds may deliberately restructure in order to meet the definition of “business” and, thereby, be subject to the current revenue account rules rather than the standard return. This may be preferable for some funds because, depending on the dividend yield and the degree to which their portfolio of assets is realised each year, the effective

tax rate under the revenue account rules may be lower than a 4% standard return rate.

- 6.136 It is difficult to predict the number of passive funds that would deliberately restructure in this manner. It would depend on a number of things such as the average dividend yield for the index that is tracked and the volatility of the particular index (the more volatile the index the more likely that a fund will realise its assets). In addition, there are a number of non-tax factors that might result in a fund not restructuring even though the effective tax liability would be less if it did. One of the most significant of these is the fact that, for accounting purposes, the fund would need to account for tax on an accrued basis every year if it held its assets as part of a business. This might have a negative effect on the fund's reported rates of return.
- 6.137 Even if a passive fund did restructure to hold its investments as part of a business, the effective tax rate would be higher than it is currently. This is because profits on realisation would be taxed as well as dividends under the revenue account rules. If a standard return rule was introduced, however, Inland Revenue would monitor the extent to which any passive funds restructured with a view to strengthening the business test if necessary.

FIF rules

- 6.138 A standard return rule would address, to a large extent, the liquidity problem that can currently arise under the comparative value method in the FIF rules. This problem can occur when the value of an investment rises steeply over a year with tax levied on the increase on an accrued basis. Although the standard return rule would still tax the investment on an accrued basis, it would be levied on the asset's value at the beginning of the year. This would ensure that the change in value of steeply appreciating assets would not be brought to tax. Instead, the increased value would be reflected in an increased opening value for the following year.
- 6.139 Furthermore, in most cases the fact that an investor's tax liability would essentially be known at the beginning of an income year should allow taxpayers to better plan for their tax liability. In addition, the non-taxation of actual dividends will assist in providing sufficient cash-flow to meet an investor's tax liability under a standard return rule.

Business investment not affected

- 6.140 The standard return approach would confine any changes to tax rules to non-controlled offshore investment in a non-business context. When such investment occurred in a business context, the rules would not change.

Losses

- 6.141 Under a standard return rule an investor holding a qualifying asset would be subject to a standard return of 4%, each year, even if the asset declined in value. This could be perceived as unfair because the rule will have the effect of deeming the asset to have returned a gain of 4% to an investor when, in fact, the investor may have incurred an economic loss.
- 6.142 Although this argument has some merit, the same result can occur under the current tax rules that tax an investor on dividends derived. That is, a company whose share price declines during a year is still likely to pay a dividend that is currently taxed at the shareholder level. In addition, in most years investors would expect to derive a greater than 4% return from qualifying assets. Returns in excess of the 4% would not be subject to tax.

Chapter 7

OFFSHORE PORTFOLIO INVESTMENT RULES

Under this option:

- Investments in non-controlled offshore equity would be subject to the same set of tax rules, no matter the country of investment or whether the investment was held on capital or revenue account.
- Broadly, investors holding a 10% or greater interest in a foreign company would have the following four methods to determine taxable income:
 - the branch equivalent method;
 - a method based on the accounts of the foreign company as prepared in the foreign jurisdiction;
 - a revised comparative value method (under which 70% of the change in value of the interest plus distributions would be taxable); and
 - an imputed rate of return method (broadly the same as the standard return approach but with a nominal rather than a real statutory rate of return).
- Broadly, investors holding less than a 10% interest in a foreign company or interests in other types of assets would be restricted to the last two methods.
- For interests above and below 10%, the imputed rate of return method would be available only when the other methods could not be used or when the total cost of an investor's portfolio of offshore assets was less than NZD\$50,000.
- The restrictions on offsetting FIF losses against other income would be removed for interests in foreign companies listed on a recognised exchange.
- Investors holding interests totalling less than NZD\$15,000 in cost would be exempt from the rules.

7.1 As seen in chapter four, the current rules relating to non-controlled offshore investment in equity give rise to significant compliance costs, have a significant influence on investment decisions and provide opportunities to avoid the payment of New Zealand tax. The largest area of economic distortion arises as a result of the grey list treatment of capital account investments, which are subject to a low effective New Zealand tax rate on the economic return to the domestic economy. The compliance and economic costs associated with these rules would be reduced if a consistent set of tax rules applied to all non-controlled investment, whether within or outside the grey list.

- 7.2 The option presented in this chapter has the following objectives:
- to provide tax rules that do not influence an investor's decision as to whether to invest in offshore or onshore investments that provide the same return to the domestic economy (the return after foreign taxes);
 - to provide tax rules that do not influence an investor's decision as to where to locate offshore investment or the legal form of that investment – in particular, the rules would apply within and outside the grey list; and
 - to reduce the current tax-favoured treatment of investments undertaken through certain offshore managed funds.
- 7.3 Furthermore, these objectives should be achieved in a way that does not impose undue compliance costs on investors.
- 7.4 The first two of these objectives would be implemented if income from an investment was subject to the same effective tax rate on the return to the domestic economy (after foreign tax) no matter where that investment was located or the legal structure through which that investment was made. The most effective way to achieve these objectives would at first appear to be to apply domestic tax rules in the offshore context. However, in the case of non-controlled interests, two main difficulties prevent the full application of domestic laws offshore.

The domestic versus the offshore rules

- 7.5 To tax the full return to the domestic economy (economic income) from investments, tax could either be levied at the level of the entity invested into or in the hands of the investor. In the domestic context, investments treated as companies for tax purposes are first taxed at the entity level. In this sense the company tax acts as a withholding tax paid on behalf of the ultimate investor. To the extent that the entity level tax is comprehensive, this brings the economic income from such investment within the tax base on an accrued basis.
- 7.6 At the investor level, the tax treatment depends on whether an investment is held on capital account or revenue account. Capital account investments are taxed only on dividends derived, with an imputation credit given for tax paid at the entity level. Investments held on revenue account are also taxed on the gains obtained on the sale of the asset.
- 7.7 In order to levy equivalent New Zealand tax on the after-foreign tax return to non-controlled offshore investments on an entity basis, the after-foreign-tax income of the entity into which an investment is made, as calculated under New Zealand tax rules, would need to be calculated and attributed to the New Zealand resident. (This is referred to as “entity level taxation”.) However, in the case of non-controlled interests, taxpayers would often not have access to enough information to enable them to recalculate entity level

tax. This means that the domestic entity level tax rules cannot simply be transported to the offshore environment.

- 7.8 When entity level taxation is not possible, investments can still be taxed at the level of the investor. However, in the absence of entity level taxation, the mechanism to calculate tax on an investor level basis needs to ensure that income is taxed when it is earned. If this is not the case, the effective tax rate applying to the economic income from different investments would differ depending on how long the investment was held. Neither domestic revenue nor capital account treatment at the investor level provide for taxation on an accrued basis, however. This is because capital account treatment taxes only a portion of economic income (dividends), and revenue account treatment allows for the payment of tax on changes in value to be deferred until realisation.
- 7.9 Therefore, when it is not possible to approximate entity level taxation for non-controlled offshore investments, the aim is to provide mechanisms that tax a reasonable portion of the economic income investors earn from offshore investments on an accrued basis. These mechanisms will be based on the value of the investment. (This is referred to as “investor level taxation”.)

Suggested approach

- 7.10 Given the information constraints in the non-controlled offshore environment and the differential treatments that exist domestically, this option takes a two-step approach.
- 7.11 Investors holding interests of 10% or greater in foreign companies would have four income calculation mechanisms available – the branch equivalent method, a method based on foreign accounts, a revised comparative value method and an imputed rate of return method. The first two of these methods provide proxies for company taxation (entity level taxation) and thus require access to detailed information. The second two methods provide taxation at the investor level and require access to a lesser amount of information.
- 7.12 Investors with holdings of less than 10% in a foreign company, or those who have investments in entities other than companies, however, would be restricted to the use of the last two methods.
- 7.13 Holdings of less than 10% are generally considered to be portfolio holdings for statistical purposes. Investors with portfolio holdings are unlikely to have access to detailed and reliable information on the income of the company into which they invest. As very few of these investors would be able to use the accurate income calculation methods, we consider it desirable to limit the methods they could use to the less accurate methods, in order to treat these investors consistently and reduce compliance issues associated with choosing between methods.

- 7.14 The income interest test in the CFC rules (section CG 5 of the Income Tax Act 1994) would be used to calculate whether an investor held an interest of 10% or greater in a foreign company.
- 7.15 Under this test, the interest held by a person at a particular time would be taken as the highest percentage of certain specified rights held in the company at that time. These rights are:
- the available shares of the foreign company (calculated by reference to the available subscribed capital);
 - the percentage of the total rights to vote or participate in decision-making;
 - the percentage of income of the foreign company that the investor would be entitled to receive or control; and
 - the percentage of net assets of the foreign company that the investor would be entitled to receive or control.

Submission points

What problems or advantages would arise from applying one set of rules to all non-controlled offshore equity investments – no matter the country of investment and no matter whether it is a business or non-business investment?

Does it make sense to distinguish between investors that have small and large holdings?

Investors with limited access to information

- 7.16 The treatment of investors with limited access to information would provide taxation on an investor level basis – that is, based on the value of the investment as opposed to the actual income of the entity. This category would cover:
- investors with holdings of less than 10% in foreign companies;
 - investors with holdings of 10% or greater in foreign companies who could not use more accurate income calculation measures; and
 - investors with holdings in assets other than companies.
- 7.17 The income calculation mechanisms available for these investors would not be subject to the same information requirements as mechanisms which attempt to proxy the actual income of the entity into which an investment is made.

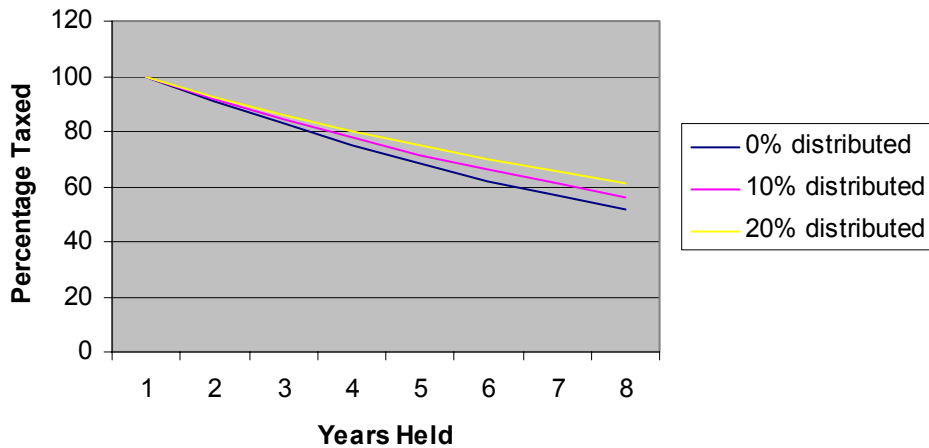
- 7.18 In the absence of taxation at the entity level, taxation at the level of the investor needs to apply to income as it is earned, in order to ensure consistency of treatment between different investments.
- 7.19 The main income calculation mechanism available for these investments would be a revised comparative value method. This method would tax 70% of income as calculated using the comparative value method in the current FIF rules. An imputed rate of return method, similar to the risk-free return method proposed by the Tax Review, would also be available for smaller taxpayers or when taxpayers had insufficient information to comply with the revised comparative value method.
- 7.20 We would expect that the vast majority of taxpayers would use the revised comparative value method.

Revised comparative value method

- 7.21 The comparative value method in the FIF rules currently taxes the full change in value of an interest, on an accrued basis, and distributions received from that interest. This mechanism is likely to provide the best unbiased estimate of the full return (economic income), after foreign taxes, of the foreign entity invested into. However, fluctuations in share values mean that the method is not accurate in all cases. This is one reason why it is perceived by many as not being a fair way to tax offshore income. For this reason we do not recommend applying the current comparative value method more widely under this option.
- 7.22 As discussed earlier, we see the current treatment of offshore revenue account investment in the grey list as *broadly* appropriate. We consider that it would be reasonable to assume that the average offshore revenue account investment is subject to tax on a basis equivalent to taxing 70% to 90% of economic income on an accrued basis. Although these investments are taxed on realised changes in share value, most of the investments are held by institutions that turn over their portfolios reasonably frequently. Note that taxation of realised changes in value would not tax a reasonable portion of the income from grey list capital account investments as these investments are often held for long periods of time.
- 7.23 Figure 4 shows how much the effective tax rate on economic income (changes in value on an accrued basis and distributions) reduces by as a result of the deferral of realisation. Assume investors discount future income at a rate of 10%. Assume that there are three investors, investing in three different companies. The companies distribute either, 0%, 10% or 20% of income earned in a particular year. This is taxed in the year of distribution. The remaining income is reinvested in the company and this is reflected in its share value. This is taxed when the shares are sold (on realisation) – the longer the investor holds the shares, the lower the effective tax rate on economic income. For example, if a company distributes 20% of its income and the investor holds the investment for four years, the effective tax rate

will be reduced to around 75% of the effective tax rate that would have applied under annual taxation on an accrued basis.

Figure 4: Percentage of economic income taxed



7.24 Offshore investment outside the grey list will often be taxed at a higher effective tax rate than offshore revenue account investment within the grey list. This is because the majority of this investment is taxed on the full annual change in value of shares plus distributions. Offshore capital account grey list investment is taxed at a lower effective tax rate than offshore revenue account investment, as this investment is only taxed on distributions. As discussed, this differential treatment gives rise to economic and compliance costs.

7.25 Given that we have concluded that the average offshore revenue account investment is taxed at an acceptable rate, we consider it reasonable to seek to align the effective tax rate on all offshore investments with that applying to the average revenue account investment, in order to achieve a consistent treatment of non-controlled offshore investment. This would result in consistent treatment between revenue account, capital account and non-grey list investments offshore.

7.26 We suggest that this be achieved by allowing all taxpayers to use a revised comparative value method. Taxing accrued gains is preferable to taxing realised changes in value as it ensures a consistent tax treatment of the full returns to offshore investments by taxing those returns as they arise. This would be important for a method that would apply to a diverse range of investment products, such as passive and active funds.

7.27 As discussed, we consider that it would be reasonable to assume that the average offshore revenue account investment is subject to tax on a basis equivalent to taxing 70% to 90% of economic income on an accrued basis. The revised comparative value method would be available for all non-controlled offshore investments at a rate of 70% of the sum of the change in

share value and distributions. This is at the low end of what we consider would be the effective rate applying to offshore investments held on revenue account at the moment but we consider that acceptable as it is “high enough” so as not to result in a large incentive to invest offshore rather than onshore or in a large incentive to invest in equity as opposed to debt. Furthermore, this rate would result in this option being broadly revenue neutral.

Further issues

7.28 The formula for calculating taxable income under the revised comparative value method would be:

$$0.7[(a+b) - (c+d)] + e$$

where

- a is the market value of the interest at the end of the income year (or nil if the interest is no longer held);
- b is the aggregate of all gains, including dividends, derived by the person during the income year (after foreign taxes for which foreign tax credits are available);
- c is the market value of the interest at the end of the preceding income year (or nil if the interest was not held then);
- d is the aggregate of all expenditure incurred by or on behalf of the person in acquiring the whole or any part of the interest during the income year;
- e is the value of any tax for which foreign tax credits are available.

7.29 Dividends would not be separately taxable. Foreign tax credits would remain available for non-resident withholding tax on dividends.

7.30 An example follows:

John (who has a 39% personal tax rate) owns 100 shares in a foreign company as at 1 April 2005. At that date the shares are valued at NZD\$2.00 each. The value of John’s investment is thus NZD\$200.

Over the year the shares increase in value to NZD\$3.00 each. As at 31 March 2006, the value of the holding is NZD\$300. During the year the company also makes a distribution of NZD\$0.50 per share, which is subject to non-resident withholding tax in the foreign country at a rate of 15%. This means the taxpayer receives an after-foreign-tax dividend of NZD\$42.50 and is eligible for foreign tax credits to the value of NZD\$7.50.

John's taxable income at the end of the year, calculated under the preceding formula, will be:

$$0.7[(NZD\$300 + NZD\$42.50) - NZD\$200] + NZD\$7.50 = NZD\$107.25$$

and John's tax liability for the year will be:

$$(NZD\$107.25 \times 39\%) - NZD\$7.50 = NZD\$34.32$$

- 7.31 This approach could be applied when a market or arm's length value was available. In most cases, the method should be simple to apply, as the information necessary to make the calculation is readily available.
- 7.32 The 70% comparative value rate would not flow through to New Zealand investors who hold investments in New Zealand entities that then invest in offshore qualifying interests. This retains the current treatment of these investments.
- 7.33 We also suggest that losses be made more widely available. However, the desirability of treating losses and gains in the same way must be balanced against policy-makers' need to be confident that reported losses are real losses.
- 7.34 Under the current legislation, taxpayers are allowed to offset a FIF loss in any given year against FIF income from that year and, when the loss does not exceed prior years' FIF income, other non-FIF income. Currently, taxpayers are not able to deduct the loss in the year it arises if the FIF loss is more than the FIF income earned in current or previous years, even if they have other income sources.
- 7.35 We consider that when taxpayers invest in shares listed on a recognised stock exchange the risk that losses are being fabricated is low. We therefore suggest extending the ability to use losses under the revised comparative value method, such that when taxpayers hold shares in a company listed on a recognised stock exchange they will be able to offset those losses against non-FIF income, whether or not the losses exceed past years' FIF income.

Imputed rate of return method

- 7.36 As the revised comparative value method requires information on the market value of the asset, it could not be used for all assets currently covered by the FIF rules. The comparative value method is also viewed as unfair when shares sharply appreciate in value over a year. This is more likely to be a concern for those with smaller, less diversified holdings.

- 7.37 For these reasons, under this option:
- if a taxpayer is unable to use any other income calculation mechanism for a given investment (for example, if no market value is available) in any given year that taxpayer would calculate income using the imputed rate of return method; and
 - if a taxpayer (or associated persons) held non-controlled offshore equity assets which cost less than NZD\$50,000 that taxpayer may choose to use the imputed rate of return method.
- 7.38 If the NZD\$50,000 threshold is passed all of the taxpayer's investment would be subject to the revised comparative value method (or, if possible, one of the more accurate methods discussed later) unless market values were not available.
- 7.39 It is likely that most individuals who hold their investments directly would have the choice of the revised comparative value method or the imputed rate of return method.
- 7.40 The imputed rate of return method would operate in the same manner as the standard return approach, apart from two differences.
- 7.41 In determining the imputed rate of return to apply to these investments, the aim is to leave taxpayers in a situation where they are more or less indifferent between *ex ante* taxation at an imputed rate and *ex post* taxation of full returns. The aim is also to ensure consistency with the way other forms of income are taxed, which would limit the extent to which tax influences investment decisions.
- 7.42 As previously discussed, in theory and under certain conditions, a taxpayer will be indifferent between *ex ante* taxation which assumes a risk-free imputed rate of return to an asset and *ex post* taxation of the full return actually realised. This is because the reduced tax liability in the former case is offset by the higher risk that the taxpayer bears as a result of the tax liability varying less with the actual performance of the investment. Given that domestic and debt investments are generally taxed on nominal returns, setting a nominal risk-free rate would thus approximate this trade-off for taxpayers.
- 7.43 We suggest that the five-year government stock rate would provide an appropriate risk-free rate. This means that taxpayers investing into offshore equity and using the imputed rate of return method would be taxed at the same rate as if they had, alternatively, invested into government stock with a term of five years. This method thus differs from the standard return approach and that recommended by the Tax Review in that a nominal rather than a real rate of return would apply.

7.44 The second difference between this method and that applying under the standard return approach is that it would also apply to unlisted shares for which no market values can be obtained. Under the standard return approach, the current FIF rules would apply to unlisted shares when a market or arm's length valuation could not be obtained. This means that under the standard return approach these investments would in most cases be subject to the deemed rate of return. It should not be necessary to apply the FIF rules under this option as tax minimisation concerns would be lessened by setting the imputed rate at a nominal rate. Unlisted shares would, therefore, be treated using the imputed rate of return method, with a tax-book value calculated on the basis of cost adjusted for an annual investment return and distributions.

7.45 As with the standard return method, actual returns to the investment – for example, distributions derived – would not be subject to tax. Credits would be granted for foreign non-resident withholding tax withheld on dividends in the source country.

Submission points

What problems would arise from allowing the revised comparative value method (which calculates taxable income as 70% of income calculated under the current comparative value method) to be used by all investors holding non-controlled offshore equity investments?

What advantages are there to relaxing the rules relating to losses under the revised comparative value method?

What problems would arise from allowing taxpayers to use an imputed rate of return method in cases of limited information or when they have smaller holdings?

What problems would arise from applying the imputed rate of return method to unlisted shares?

Investors with access to detailed information

7.46 Investors with holdings of 10% or greater in a foreign company would have the choice of using, in addition to the two preceding methods, income calculation mechanisms that seek to approximate domestic entity level taxation. This would provide consistency with how investments into entities are treated domestically.

7.47 The mechanisms available would be the branch equivalent mechanism and a method based on foreign accounts. We expect that only a very small portion of taxpayers with non-controlled interests would be able to use these mechanisms.

Branch equivalent method

7.48 The retention of the branch equivalent method within the rules for non-controlled interests provides a bridge between the treatment of controlled and non-controlled interests. This would ensure that when there were two interests that were economically equivalent but one was considered a controlling interest and the other was not, each would be able to use the same income calculation method.

Foreign accounts

7.49 We have considered two options here:

- The first option would retain the current approach of basing taxable income on the net, after-foreign-tax accounting profits of the entity invested into.
- The second option would be to modify the accounting profits method so that it is based on the net, after-foreign-tax, taxable income of the entity into which an investment is made, in order to provide greater comparability with how similar entities are taxed domestically. This approach would be restricted to countries that have tax systems similar to New Zealand's, such as the grey list countries.

7.50 A method based on foreign accounts would give rise to higher compliance costs than the revised comparative value method and imputed rate of return method. We are interested in receiving submissions on options to reduce compliance costs associated with methods based on foreign accounts.

7.51 In particular, we are interested in submissions on:

- Whether there is scope to relax the restriction on the use of the accounting profits method whilst still ensuring the integrity of the accounting information used. The current restrictions for use of the accounting profits method require that:
 - the taxpayer hold an interest in a foreign company;
 - the interest in the company be quoted on a recognised stock exchange;
 - the interest in the company be offered widely to the public;
 - the net after-tax profits of the company be calculated according to generally accepted accounting principles;
 - the net after-tax profits be detailed in financial statements audited and verified by a chartered accountant;
 - the net after-tax accounting profits or losses be calculated on a consolidated basis;
 - the net after-tax accounting profits include any extraordinary items; and
 - the taxpayer has no reason to believe that the net after-tax accounting profits or losses of the company do not fairly represent the net after-tax profits or losses of company.

- Whether making dividends paid from the foreign entity exempt from New Zealand tax would simplify the accounting profits method. Given the aim of a method based on foreign accounts is to tax on an entity level basis, to the extent that this is done, dividends do not need to be taxed.
- Whether there is scope to simplify the income interest test.

Submission points

What problems would arise from restricting the use of the accounting profits and branch equivalent methods to interests in foreign companies of 10% or greater?

Why do few investors currently use the accounting profits method?

What problems would arise if the accounting profits method was changed to a method based on foreign accounts but restricted to countries with tax systems similar to New Zealand?

How could the compliance costs associated with a method based on foreign accounts be reduced?

Further issues

Under this option:

- Investors with non-controlled offshore holdings that cost less than NZD\$15,000 would not be subject to the offshore portfolio investment rules.
- Once an income calculation method has been chosen, investors would be required to continue using that method subject to specific exclusions.
- Assets entering the rules would be valued at market value when available.
- Investors would have the option to offset their tax liability using any imputation credits allowed for New Zealand tax paid.

Exempting very small holdings

7.52 The *de minimis* threshold would be lowered to exempt only holdings that cost less than NZD\$15,000. Once the cost of an investor's holding exceeded NZD\$15,000, the entire holding would be subject to the new rules. The *de minimis* threshold would thus exist to minimise compliance costs associated with only very small holdings. The holdings of most unsophisticated investors are likely to fall below the threshold.

7.53 Smaller investors with holdings that exceed the threshold would have the imputed rate of return method available to them. If they chose this treatment they would be taxed at broadly the same rate as unsophisticated investors who invest in government stock in the domestic context. Given that this treatment is considered to be appropriate for onshore investment, we do not consider it to be harsh in the offshore context.

Requirement to use method

7.54 As under the current FIF rules, once a taxpayer chooses to use a particular method that taxpayer will be required to continue to use it except when:

- the taxpayer cannot obtain the information to use the method;
- the taxpayer no longer meets the criteria to use the method;
- the taxpayer applies to the Commissioner of Inland Revenue and is changing to or from the branch equivalent method for the first time; or
- there has been a change in factual circumstances.

Entry and exit

7.55 Under the revised comparative value method or imputed rate of return method, rules would be needed to determine the value of an interest upon entry or exit.

- 7.56 On entry into or exit from the rules, an investor who used the revised comparative value method would be considered to have purchased or sold the interest at market value, respectively.
- 7.57 The same rules would apply under the imputed rate of return method as under the standard return rule. For assets entering the imputed rate of return method, the value of the asset would be calculated as:
- market value, or if no such value exists:
 - the previous year's tax-book value, or if no such value exists:
 - the aggregate of gross contributions made by or on behalf of the person holding the asset.
- 7.58 The exit value under the imputed rate of return method would be the asset's tax-book value.
- 7.59 When the accounting profits or branch equivalent method was used, taxable income for that year would be equal to the total income of the entity for the year multiplied by the proportion of days in the accounting year that the interest was held.

Trans-Tasman recognition of imputation credits

- 7.60 The changes introduced in the recent reform of New Zealand and Australian imputation laws to address the double taxation of certain trans-Tasman investments would be preserved under this option. Namely, New Zealand investors would still be able to offset their tax liability under these rules with imputation credits representing New Zealand tax paid.

Evaluation

- 7.61 This option is expected to be broadly revenue neutral, although it would result in a redistribution of tax liabilities. In particular, there would be a reduction in tax collected from non-grey list investments and an increase in the amount of tax collected from grey list investments.
- 7.62 The option would provide a consistent treatment of non-controlled offshore investment income whilst reducing the distortion between the domestic and offshore boundary by taxing a portion of economic income that is reasonably comparable to that taxed domestically. The main gains are expected to arise through:
- a reduction in the incentive (from the point of view of the domestic economy) to locate capital account investment offshore rather than onshore; and
 - a consistent tax treatment of the economic income of different offshore investments. This would be achieved because:
 - The tax rules would be neutral as to which country an investment was made into, since there would be no grey list exemption under this option.
 - The tax rules would be neutral as to whether the investment was considered to be on revenue or capital account (or business or non-business), which would reduce the extent to which the tax system favours investment that provides returns in the form of capital gains, rather than taxable distributions.
 - The tax rules would be neutral as to the holding period of the investment, so investments of different holding periods would be subject to the same effective tax rate on economic income.
- 7.63 A more consistent treatment of offshore investment would reduce the economic costs associated with the tax system distorting investment choices.
- 7.64 Applying one set of rules irrespective of the country of investment or type of investment would also reduce compliance costs associated with, for example, changing between tax treatments when a company migrates and determining whether an investment should be held on revenue or capital account.
- 7.65 The application of tax on an accrued basis would also remove opportunities for investors holding investments on capital account to avoid the payment of New Zealand tax through the use of offshore entities.
- 7.66 This option does not address problems associated with the differential treatment of various investment forms domestically. For example, it does not address the issue of the differential treatment of direct investments by individuals in relation to investments through entities such as managed funds. Nor does it address issues associated with the differential tax rates applying to different savings and investment entities.

Non-grey list investment

- 7.67 This option would clearly result in non-grey list investment being treated more favourably than at present. We expect that tax collected from outside the grey list would decrease by around NZD\$20 million per year.
- 7.68 We see the advantage of the option for non-grey list investment as consistency of tax treatment between grey list and non-grey list investments. Apart from removing the disincentive to invest in entities outside the grey list, this is expected to reduce compliance costs. As links between non-grey list countries and New Zealand increase, it is becoming more important to treat investment in these countries in a similar manner to investment in grey-list countries.

Grey list revenue account investment

- 7.69 Grey list revenue account investments are currently taxable on the realised change in value of an asset and on distributions. Our expectation is that if the revised comparative value method were applied to revenue account investment, much of this investment would be subject to a similar or more favourable treatment than at present. This is because the majority of this investment is held by institutions, which can be expected to turn over their portfolios reasonably frequently.
- 7.70 Funds and investors at the conservative end of the spectrum may, however, be subjected to a higher effective tax rate under this method than at present.
- 7.71 We would expect that the amount of tax collected from this sector would decrease by around NZD\$20 to NZD\$30 million per year.

Grey list capital account investments

- 7.72 Grey list capital account investments are currently taxed on distributions only.
- 7.73 Larger investors, such as passive funds, would generally be subject to the revised comparative value method under this option. These investors account for around NZD\$2 billion worth of investment. It is likely that around NZD\$20 to NZD\$25 million extra tax revenue would be collected from these funds each year. From an economic perspective, the advantage of bringing these funds within this mechanism is that it would align the tax treatment of these funds with that applying to active funds investing offshore. Furthermore, this option would better align the effective tax rate on the return to the domestic economy from investment in offshore passive funds with that applying to investments made in domestic entities (which are taxed under the company tax rules).

- 7.74 Investors with smaller holdings, who in the main would be individuals, would be subject to either the imputed rate of return or the revised comparative value method. These investors hold around NZD\$6 billion worth of investment. We would expect that around NZD\$15 to NZD\$20 million extra tax revenue would be collected from this group. However, the economic gain from the option is that it provides a similar tax treatment of the domestic returns to international investments as to domestic investments, which are taxed at the entity level within the New Zealand tax base. Furthermore, the option would provide a more consistent treatment between investments because tax liability would not depend on the distribution policy of the company invested into. It would also remove the incentive that currently exists for individuals to invest offshore directly, rather than through an institution.
- 7.75 Applying this method to individuals would also remove the current incentive that exists to invest in certain offshore vehicles that are free from both New Zealand and offshore tax. For example, under the imputed rate of return method taxpayers would be indifferent between investing in New Zealand government stock directly or through an offshore managed trust.

Appendix 1

TAXATION OF DOMESTIC SAVINGS VEHICLES

The suggestions outlined in this issues paper focus on the low or zero tax that can apply to investments in offshore-based funds rather than the inconsistencies in the tax treatment of domestic savings entities.

A working group made up of representatives from the savings industry and officials has considered the broader issues facing the savings industry. As outlined here, one possible method of evening up the tax treatment of offshore and domestic funds could be to apply the risk-free rate of return method to domestic savings vehicles.

Both the government and industry representatives recognise that there will be problems with this approach that will need to be worked through and at this stage cannot reach a firm conclusion as to its desirability.

It is an option that is considered to be worth exploring, however, and for that reason an account of those discussions is set out here for people to comment on.

Current state of domestic taxation of savings vehicles

The savings industry is currently subject to a number of different tax rules that depend on several factors, including the following:

- whether an investment is made indirectly through a savings vehicle or directly;
- whether an investment is onshore (domestic) or offshore;
- the type of investment (capital or revenue);
- the type of investor; and
- the type of savings vehicle.

The extent of these differences means that tax costs or benefits will vary across investment stakeholders, some having a competitive advantage in some circumstances and others having that advantage in others. This means that all vehicles face competitive pressure to develop tax-effective savings products in order to defend or expand market share. Examples of these products include passive funds, UK open-ended investment companies, the targeted Australian unit trusts, wrap accounts and partnership-structured investments. This state of affairs poses a significant risk that the tax system distorts the quality of savings by ushering resources to relatively inferior investments. Taxes can artificially cause a ranking of investments different from that based on pre-tax returns. In addition, these tax-effective solutions are affecting the size of the New Zealand tax base.

The industry would prefer a more consistent tax treatment of savings vehicles, irrespective of:

- whether they are direct or through a savings vehicle;
- whether onshore or offshore;
- the type of investor;
- the type of savings vehicle; and
- capital-revenue distinction.

At the same time, the industry is conscious of feasibility and practical constraints. The industry accepts that the tax problems identified cannot be eradicated, only mitigated. An optimal reform should involve appropriate trade-offs and an acceptance that some anomalies will remain.

Key tax issues

The following issues are considered by industry representatives to be the most important to be addressed by tax reform, namely:

- differing tax treatment across savings vehicles;
- tax rate alignment between savings vehicles and investors;
- the capital-revenue boundary; and
- the treatment of cross-border investment.

Differing tax treatment across savings vehicles

Industry representatives have identified the following widely held savings vehicles, many of which are taxed in different ways:

- unit trusts (both open-ended and closed);
- superannuation schemes (including schemes available to retail investors, employee sponsored schemes and master trusts);
- category A group investment funds;
- category B group investment funds (both designated source funds and designated investments);
- life insurance entities;
- companies;
- non-entity vehicles (for example, partnerships and wrap accounts); and
- foreign vehicles.

Unit trusts

Unit trusts are taxed as companies. Capital gains are not specifically taxed but depend on common law principles, which means in practice that tax is paid on realised and unrealised capital gains in most circumstances. Distributions, including unit redemptions, are taxed as dividends, which gives rise to many issues.

Superannuation schemes

Superannuation schemes are taxed as qualifying trusts with benefits and distributions being free of tax to the recipients. Capital gains are not specifically taxed but depend on common law principles, which means in practice that tax is paid on realised and unrealised capital gains in most circumstances.

Group investment funds

The taxation of group investment funds depends on the nature of investments and the source of the funds invested.

Category A group investment funds are taxed as companies. Capital gains are not specifically taxed but depend on common law principles. Distributions, including unit redemptions, are taxed as dividends giving rise to many issues.

Category B group investment funds are taxed as qualifying trusts, whereby income distributed during the income year or six months following is taxed to the recipients (less resident withholding tax, where applicable). Income not distributed and taxable capital elements not distributed are taxed to the trustee at 33%.

Life insurance

Life insurance companies are taxed on a two-tier tax base system. The first, being the life office base, taxes the life insurer on elements that include investment income. On the second base, being the life insurance company, tax is a proxy for policyholders and amounts distributed to policyholders are not taxable to them.

Companies

Companies that are regarded as savings vehicles are taxed according to ordinary principles, including the imputation system. This allows credits to be provided to investors in such savings vehicles for taxes paid.

Non-entity vehicles

The income of non-entity vehicles such as partnerships and wrap accounts is taxed in the hands of the investors.

Offshore vehicles

New Zealand generally has no taxing rights over offshore vehicles unless they can be regarded as New Zealand tax resident. Tax is usually payable at the individual investor level. Other countries have different ways of taxing savings vehicles, which can create tax arbitrage opportunities but further complexity where these vehicles are accessible by New Zealand investors.

Tax rate alignment between savings vehicles and investors

There is no specific tax rate alignment between savings vehicles and investors. Individual tax rates (adjusted for the low income earner rebate) are as follows:

<i>Income threshold</i>	<i>Tax rate</i>
Income to NZD\$9,500	15%
Income from NZD\$9,501 to NZD\$38,000	21%
Income from NZD\$38,001 to NZD\$60,000	33%
Income above NZD\$60,000	39%

Savings vehicle tax rates are as follows:

<i>Unit trusts:</i>	33% company tax and imputation
<i>Superannuation schemes:</i>	33% final tax
<i>Group investment funds:</i>	33% company tax and imputation
<i>Category A:</i>	Beneficiary income: taxed at investor rate
<i>Category B:</i>	Trustee income: 33% final tax
<i>Life insurance:</i>	33% final tax
<i>Companies:</i>	33% and imputation
<i>Non-entity vehicles:</i>	Taxed at investor rate
<i>Foreign vehicles:</i>	No entity tax. Distributions taxed at investor rate.

There is a problem aligning the tax rate of individual investors with the underlying fund vehicle, as can be seen from the tables above. Most collective investment vehicles are taxed at 33%. Where distributions are exempt, and the underlying income is taxed at 33% (such as superannuation schemes and certain group investment funds), the 33% rate paid by the fund is a final tax. Because imputation credits distributed by unit trusts are not refundable, the 33% tax can, effectively, become a minimum tax in practice.

The treatment of cross border investments

Although New Zealand residents are taxed on their worldwide income, the treatment of domestic investment and offshore investment is not identical. As is demonstrated by the Australian unit trust investment scheme, it is possible to invest through certain offshore vehicles in such a way that no tax is payable at the vehicle level, even though the investment may be taxable if it had been made directly by the fund rather than through the offshore vehicle. On the other hand, offshore investment into certain countries may be taxable on the basis of accruing capital gains, even though the gains, if made in New Zealand, may only be taxable on distributions or not at all. These differences in tax treatment are likely to lead to an inefficient allocation of investment funds between New Zealand and offshore, and between alternative offshore investments.

The capital-revenue boundary

Most individual investors are not taxable on capital gains made from direct investments. Most collective investment vehicles (with notable exceptions, such as passive funds) are taxable on most or all of the gains made on the disposal of investment assets because they fall on the revenue side of the common law capital-revenue boundary. Life insurance companies are taxed on some accrued capital gains by the operation of specific statutory provisions.

This causes problems for the savings industry because:

- Different investment vehicles are taxed differently, leading to competitive disparities.
- Collective vehicles generally pay tax on gains that would not be taxable had the investor made a direct investment, discouraging what may otherwise be the efficient pooling of funds and risk.
- Uncertainty as to the operation of the capital-revenue boundary leads to compliance costs for funds and difficulties in properly providing for tax when distributing returns to investors.

The issue of the capital-revenue boundary is connected with rate alignment (since tax revenue is a function of both the tax rate and the base on which it is paid). If the argument that rates between investors and funds should be aligned where possible is accepted (that is, that collective investment vehicles are a proxy for direct investment), there are strong grounds for aligning the tax base of funds with the investors. On this basis, where capital gains would not be taxable to the investor, they should not be taxable to the fund.

Considering the application of RFRM domestically as a starting point

As noted above, the application of the risk-free rate of return method to domestic savings vehicles has, as a starting point, been considered as an option to remove the relative disincentives under the current tax rules. The following matrix is a suggested framework:

	<i>Foreign</i>	<i>NZ</i>
Investment vehicle	RFRM	RFRM
Direct non-business	RFRM	Existing rules
Direct business	Existing rules	Existing rules

RFRM scenario

The base principles developed to consider the application of a domestic RFRM are as follows:

- Funds vehicles would not be subject to tax themselves (only resident withholding).

- Investors in funds vehicles would be subject to tax based on their investment in a funds vehicle at the inflation-adjusted risk free rate.
- The funds vehicle would account to Inland Revenue for resident withholding tax (RWT) at 33% for tax on the RFRM income. Imputation credits and credits for foreign withholding tax received by the funds vehicles would offset the RWT liability.
- Investors would return their RFRM income and claim a credit for the RWT paid on their behalf to Inland Revenue by the funds vehicle.

Example:

- An investor contributes NZD\$250,000 to a funds vehicle at the start of the year.
- Over the year the investor receives NZD\$15,000 as dividends and has a NZD\$7,000 increase in the value of the investment. No imputation credits are attached to the dividends or foreign withholding tax deducted.
- The inflation-adjusted risk free rate is 4%.
- The investor's taxable income on an RFRM basis is NZD\$10,000. The funds vehicle accounts for RWT of NZD\$3,300 to Inland Revenue. The investor returns this NZD\$10,000 for tax purposes and claims a credit for the RWT against the tax liability on this.

Other

Distributions made by a savings vehicle would be ignored in calculating RFRM except they would, in effect, reduce RFRM in the following year through reducing the opening market value of the investment upon which RFRM is calculated.

In general terms, units acquired or disposed of during the income year would attract a time-based apportionment. With daily unit pricing, RFRM income would be calculated daily.

Revenue and expenses of savings vehicles generally should not directly affect the RFRM calculation, other than through a valuation impact in the following period. This would apply to foreign taxes as well.

Significant RFRM application considerations

A number of issues have been identified in relation to applying RFRM to investments in domestic savings vehicles. While applying RFRM domestically is a starting point for removing the current tax anomalies associated with domestic savings vehicles, its practical application raises similar issues that will require further consideration along with other options. While some of the issues are more detailed, the following issues are significant.

Savings vehicles subject to RFRM

A significant issue is the scope of a domestic RFRM in terms of those savings vehicles that would be subject to it. As noted above, savings vehicles include the following:

Unit trusts

- open-ended and closed;
- listed and unlisted; and
- wholesale and retail.

Superannuation schemes

- wholesale and retail;
- employee based schemes; and
- master trusts.

Category A group investment funds

- wholesale and retail.

Category B group investment funds

- designated investments; and
- designated source funds.

Life insurance companies

- investment linked business; and
- profit participating policyholder business; and
- non-profit participating policyholder business.

Companies

- listed and unlisted;
- open-ended and closed; and
- wholesale and retail.

Non-entity vehicles

- partnerships; and
- wrap accounts.

Foreign vehicles

As an initial proposition, the RFRM could apply to widely held vehicles that manage investments on behalf of shareholders, unitholders and beneficiaries. This would encompass widely held unit trusts, Category A group investments funds and superannuation schemes. This should likely extend to Category B group investment funds and life insurance.

Some companies, such as investment companies, can be described as collective investment vehicles. An issue is whether these companies should be within the regime.

The inclusion of widely held unit trusts would include listed property trusts. On the one hand, vehicles such as these can be considered collective investment vehicles. On the other hand, they are generally closed, which can differentiate them from open-ended vehicles.

Depending on the view taken as to whether closed vehicles and non-entity vehicles should be included within the rules, there is the question of whether investment partnerships should be subject to RFRM. An example could be a forestry partnership comprising loss attributing qualifying companies.

Life insurance

Some industry representatives are of the view that life insurance should be within RFRM. Many investor savings are via life insurance policies. Many superannuation schemes invest in policies of life insurance, which provides added support for their inclusion. The inclusion of life insurance is in line with adopting a consistent approach to the taxation of savings vehicles.

Life insurance is currently taxed via a two-tier tax base system, the life base (tax on the life insurance company) and the policyholder base (the life insurance company taxed as a proxy for the policyholders).

Some industry representatives are of the view the existing two-tier tax base system technically could be subjected to an RFRM.

Category B group investment funds

Some industry representatives consider that Category B group investments funds which attain such status owing to funds being invested in “designated investments” (such as mortgages and cash) should not be taxed via a RFRM. These funds are currently taxed as qualifying trusts (on a flow-through basis). The reason for their exclusion is that they are essentially akin to bank accounts and should be taxed in the same way.

Definition

There would need to be a definition of those vehicles that would be taxed on an RFRM basis. The key criteria are the concept of “widely held” and having an “active business” exemption. A question is whether only open-ended vehicles are subject to RFRM. Given this, the likely component points of the definition would include the following:

- “widely held” (a possibility being 100 or more investors and covering wholesale funds);

- “open-ended”; and
- “eligible investment activity” (the effect of this would be to have an “active business” exemption which would cover vehicles including listed property trusts).

Transitional issues

There are major transitional issues with a change to RFRM, including:

- treatment of existing savings vehicles;
- treatment of savings vehicles withdrawals that include pre and post-RFRM elements; and
- the determination of the opening value upon which RFRM would be based.

The treatment of losses is a significant issue. Many savings vehicles have substantial realised and unrealised losses.

Accounting and market values will have been placed on these losses, which are an asset of particular savings vehicles. Industry representatives consider that for the industry to support RFRM it would need to maintain the value of these realised and unrealised losses.

While realised losses are known, unrealised losses could be quantified by a notional wind-up calculation being made at a particular point in time.

Attribution of RFRM income and RWT

One of the key tax issues noted above for the industry is alignment of the tax rate of savings vehicles with that of investors.

The general proposition should be that either RFRM income and the associated RWT accounted for is attributed to the underlying investors in savings vehicles or RWT is paid at an investor’s marginal rate.

Attribution of RFRM income and RWT raises compliance issues for investors and may have other consequences, such as being attributed what would be taxable income from savings vehicles (like superannuation schemes and life insurance) where they do not receive taxable income from such vehicles under the current rules.

The alternative is having RWT paid at the investor’s marginal tax rate and possibly treating this as a final tax. A consideration is whether information systems could realistically accommodate tax being paid in this way.

Negative returns

The base position is that tax on an RFRM basis continues to be paid even if an investor suffers negative returns. This can pose cash flow problems.

While this outcome is theoretically correct, under an RFRM basis of taxation, a possible high-level modification is whether in periods that an investor suffers negative returns, no RFRM tax arises but rolls up to be paid during a later period of positive returns.

Concluding comment

While, as noted above, neither the government nor the industry are yet in a position to reach a firm conclusion on the merits of a broader application of RFRM to domestic savings vehicles, submissions are invited on the merits of such an approach.

Appendix 2

MAIN APPROACHES CONSIDERED FOR ATTRIBUTING DEBT

The approaches we have considered are:

Debt tracking rules

Under these rules, a taxpayer who has borrowed funds in order to purchase a qualifying asset would apply those borrowed funds to reduce net equity in the asset. The rationale is to directly link the borrowed funds with the purpose for which they were applied and to determine the tax treatment accordingly.

However, for this method to function effectively it would be necessary for a taxpayer and Inland Revenue to be able to identify which funds were applied to fund qualifying assets and which funds were applied to fund other business assets. This would give rise to compliance costs for many taxpayers that do not, in their normal business, track what funds are used for what purpose. For such taxpayers, on any given day, funds can come in from a variety of sources and be applied in a number of different ways. Taxpayers' key concerns are unlikely to be matching debt to particular assets but rather ensuring that the overall debt level is consistent with commercial guidelines.

Debt apportionment rules

This approach would allocate the portion of a taxpayer's tax-deductible debt portfolio to qualifying assets that is equal to the portion calculated by comparing the value of the taxpayer's standard return rule assets to their total gross income producing assets. The portion of the debt portfolio attributable to the qualifying assets would reduce the net equity in those assets and would not attract an interest deduction.

While this method would provide an approximation of a taxpayer's total debt portfolio that should be allocated between qualifying assets and other assets within the tax base, it is likely to give rise to significant compliance costs. It is envisaged that these costs will arise mainly in the area of valuing a taxpayer's assets within the tax base. For example, intangible assets are notoriously difficult to value and Inland Revenue is likely to have problems verifying these valuations.

Deductibility of interest costs only where relationship with asset is clear

This method would require taxpayers to apply debt to reduce net equity in a qualifying asset only where it is very clear that the funds were borrowed to purchase the asset. For example, where taxpayers use qualifying assets as security for borrowed funds, the funds would be applied to reduce net equity in those assets and the interest incurred on the borrowing would not attract a deduction. This is likely to be difficult, however, with offshore equity investments as these assets may not be able to be as easily linked with borrowed funds. For example, it would be unlikely that an offshore investment would be accepted as collateral for a loan.

Debt stacking rules

Under a debt stacking rule, a taxpayer's total portfolio of deductible debt would be allocated, first, to offset the value of any standard return assets, with no deductions for interest costs arising from this debt. If total available debt exceeds the value of standard return assets, any interest costs arising from the excess would be deductible.

The idea behind such a rule is to ensure that any interest costs are allocated, first and foremost, to any qualifying assets. However, like the other three methods, such a rule would impose compliance costs on taxpayers as under a standard return rule that recognises part-year adjustments, investors would be required to track changes to their total debt portfolio after each adjustment.

Appendix 3

EXAMPLE – CALCULATION OF STANDARD RETURN INCOME FOR EASY-TO-VALUE ASSETS

Amanda owns 100 shares in A Co at the start of the 2005-06 income year. A Co is listed on a recognised international stock exchange. At the start of this income year, the shares are quoted on the exchange at NZD\$100 each. During the 2005-06 income year, Amanda makes the following adjustments to her portfolio of these assets:

- On 1/08/05, Amanda increases her portfolio of qualifying assets by 50 units at a cost of NZD\$110 per unit
- On 1/12/05, Amanda reduces her portfolio of qualifying assets by 25 units at a price of NZD\$109 per unit
- On 1/01/06, Amanda increases her portfolio of qualifying assets by 15 units at a cost of NZD\$105 per unit
- On 1/02/06, Amanda reduces her portfolio of qualifying assets by 75 units at a price of NZD\$98 per unit

In the above scenario, Amanda's taxable income under a standard return rule would be calculated by splitting up the year into different periods, with each period being denoted by one transaction, an acquisition or a realisation. The different periods would comprise different part-years. Amanda's sales and purchases during the year are valued at NZD\$100 (the value on 1/04/05)

First part-year (1/04/05 to 31/07/05)

What is the opening value for the part-year?

Value of assets held at 1/04/05
(100 units @ NZD\$100 per unit) NZD\$10,000

Opening value (part-year 1/04/05 to 31/07/05) NZD\$10,000

What is the length of this part-year?

Period until next transaction 4 months
(the next transaction is a purchase on 1/08/05 – 4 months from the start of the year on 1/04/05)

What is the standard return rate for this part-year?

Standard return rate for part-year 1.33%
(standard return rate of 4% x (period until next transaction / 12 months))

What is the taxable income in this part-year?

Taxable income for part-year (1/04/05 to 31/07/05) **NZD\$133**
(opening value for part-year x standard return rate for part-year)

Second part-year (1/08/05 to 30/11/05)

What is the opening value for the part-year?

Opening value (part-year 1/04/05 to 31/07/05) **NZD\$10,000**

(add) value of purchase on 1/08/05 **NZD\$5,000**
(50 units @ value of asset on 1/04/05: NZD\$100 per unit)

Opening value (part-year 1/08/05 to 30/11/05) **NZD\$15,000**

What is the length of this part-year?

Period until next transaction **4 months**
(the next transaction is a sale on 1/12/05 – 4 months from the start of the current period on 1/08/05)

What is the standard return rate for this part-year?

Standard return rate for part-year **1.33%**
(standard return rate of 4% x (period until next transaction / 12 months))

What is the taxable income for this part-year?

Taxable income for part-year (1/08/05 to 30/11/05) **NZD\$199.50**
(opening value for part-year x standard return rate for part-year)

Third part-year (1/12/05 to 31/12/05)

What is the opening value for the part-year?

Opening value (part-year 1/08/05 to 30/11/05) **NZD\$15,000**

(less) value of sale on 1/12/05 **NZD\$2,500**
(25 units @ value of asset on 1/04/05: NZD\$100 per unit)

Opening value (part-year 1/12/05 to 31/12/05) **NZD\$12,500**

What is the length of this part-year?

Period until next transaction **1 month**
(the next transaction is a purchase on 1/01/06 – 1 month from the start the current period on 1/12/05)

What is the standard return rate for this part-year?

Standard return rate for part-year **0.33%**
(standard return rate of 4% x (period until next transaction / 12 months))

What is the taxable income for this part-year?

Taxable income for part-year (1/12/05 to 31/12/05) **NZD\$41.25**
(opening value for part-year x standard return rate for part-year)

Fourth part-year (1/01/06 to 31/01/06)

What is the opening value for the part-year?

Opening value (part-year 1/12/05 to 31/12/05) NZD\$12,500

(add) value of purchase on 1/01/06 NZD\$1,500
(15 units @ value of asset on 1/04/05: NZD\$100 per unit)

Opening value (part-year 1/01/06 to 31/01/06) NZD\$14,000

What is the length of this part-year?

Period until next transaction 1 month
(the next transaction is a sale on 1/02/06 – 1 month from the start the current period on 1/01/06)

What is the standard return rate for this part-year?

Standard return rate for part-year 0.33%
(standard return rate of 4% x (period until next transaction / 12 months))

What is the taxable income for this part-year?

Taxable income for part-year (1/01/06 to 31/01/06) **NZD\$46.20**
(opening value for part-year x standard return rate for part-year)

Fifth part-year (1/02/06 to 31/03/06)

What is the opening value for the part-year?

Opening value (part-year 1/01/06 to 31/01/06) NZD\$14,000

(less) value of sale on 1/02/06 NZD\$7,500
(75 units @ value of asset on 1/04/05: NZD\$100 per unit)

Opening value (part-year 1/02/06 to 31/03/06) NZD\$6,500

What is the length of this part-year?

Period until next transaction / end of year 2 months
(there are no transactions until the start of the next income year – 2 months from the start of the current period on 1/02/06)

What is the standard return rate for this part-year?

Standard return rate for part-year 0.67%
(standard return rate of 4% x (period until next transaction / 12 months))

What is the taxable income for this part-year?

Taxable income for part-year (1/02/06 to 31/03/06) **NZD\$43.55**
(opening value for part-year x standard return rate for part-year)

Total taxable income under the standard return rule

$$\text{NZD\$133} + \text{NZD\$199.50} + \text{NZD\$41.25} + \text{NZD\$46.20} + \text{NZD\$43.55} = \text{NZD\$463.50}$$

Appendix 4

EXAMPLE – CALCULATION OF STANDARD RETURN WHERE THERE IS A BONUS ISSUE OF “UNITS” FOR NIL CONSIDERATION

James owns 500 shares in B Co at the start of the 2005-06 income year. B Co is listed on a recognised international stock exchange. At the start of the income year, the shares are quoted on the exchange at NZD\$20 each. During the 2005-06 income year, James makes the following adjustments to his portfolio of these assets:

- On 1/09/05, James increases his portfolio of qualifying assets by 150 units at a cost of NZD\$25 per unit
- On 1/11/05, James receives a bonus issue of 650 shares. The issue is for no consideration, consequently, the value of shares in B Co falls to NZD\$12.50
- On 1/02/06, James reduces his portfolio of qualifying assets by 300 units at a price of NZD\$11 per unit

First part-year (1/04/05 to 31/08/05)

What is the opening value for the part-year?

Value of assets held at 1/04/05 *NZD\$10,000*
(500 units @ NZD\$20 per unit)

Opening value (part-year 1/04/05 to 31/08/05) *NZD\$10,000*

What is the length of this part-year?

Period until next transaction *5 months*
(the next transaction is a purchase on 1/09/05 – 5 months from the start of the year on 1/04/05)

What is the standard return rate for this part-year?

Standard return rate for part-year *1.67%*
(standard return rate of 4% x (period until next transaction / 12 months))

What is the taxable income in this part-year?

Taxable income for part-year (1/04/05 to 31/08/05) ***NZD\$167***
(opening value for part-year x standard return rate for part-year)

Second part-year (1/09/05 to 31/01/06)

What is the opening value for the part-year?

Opening value (part-year 1/04/05 to 31/08/05) NZD\$10,000

(add) value of purchase on 1/09/05 NZD\$3,000
(150 units @ value of asset on 1/04/05: NZD\$20 per unit)

Opening value (part-year 1/09/05 to 31/01/06) NZD\$13,000

What is the length of this part-year?

Period until next transaction 5 months
(the next transaction is a sale on 1/02/06 – 5 months from the start of the current period on 1/09/05)

What is the standard return rate for this part-year?

Standard return rate for part-year 1.67%
(standard return rate of 4% x (period until next transaction / 12 months))

What is the taxable income for this part-year?

Taxable income for part-year (1/09/05 to 31/01/06) **NZD\$217.10**
(opening value for part-year x standard return rate for part-year)

Third part-year (1/02/06 to 31/03/06)

What is the opening value for the part-year?

Opening value (part-year 1/09/05 to 31/01/06) NZD\$13,000

(less) value of sale on 1/02/06 NZD\$3,000
(300 units @ price per unit after bonus issue: NZD\$10)

Opening value (part-year 1/02/06 to 31/03/06) NZD\$10,000

What is the per-unit value of the asset after the bonus issue?

Value of asset prior to bonus issue: NZD\$13,000
(opening value in part-year 1/09/05 to 31/01/06)

Value of asset after bonus issue: NZD\$13,000
(value of holding is unchanged)

Number of units held after bonus issue: 1300
(500 units held on 1/04/05 + purchase of 150 units on 1/09/05 + bonus issue of 650 units on 1/02/06)

Price per unit after bonus issue NZD\$10
(value after bonus issue / number of units held after bonus issue)

What is the length of this part-year?

Period until next transaction / end of year **2 months**
*(there are no transactions until the start of the next income year
– 2 months from the start the current period on 1/02/06)*

What is the standard return rate for this part-year?

Standard return rate for part-year **0.67%**
(standard return rate of 4% x (period until next transaction / 12 months))

What is the taxable income for this part-year?

Taxable income for part-year (1/02/06 to 31/03/06) **NZD\$67**
(opening value for part-year x standard return rate for part-year)

Total taxable income under the standard return rule

NZD\$167 + NZD\$217.10 + NZD\$67 = NZD\$451.10