

## A special report by the Policy Advice Division of Inland Revenue

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### **NEW TAX RULES FOR OFFSHORE PORTFOLIO INVESTMENT IN SHARES**

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*This report will form the basis of an article to appear in the Tax Information Bulletin.*

The Income Tax Act 2004 has been amended to provide new rules for taxing offshore portfolio investment in shares. The new rules generally apply to an investment by a New Zealand resident in a foreign company when the investor owns less than 10 percent of the company.

The main changes are that the “grey list” exemption in the foreign investment fund rules has been removed and a new fair dividend rate method – which broadly taxes 5 percent of a portfolio’s opening value each year – generally applies to interests of less than 10 percent in foreign companies. If the total return on the share portfolio is less than 5 percent then individuals and family trusts pay tax on the lower amount (they pay no tax if the shares make a loss).

Under the new rules, investments in Australian-resident companies listed on an approved index of the Australian Stock Exchange, such as the All Ordinaries index (the 500 largest listed companies) are taxed the same as New Zealand investments: they are taxable on dividends if the investment is held on capital account or on dividends and realised gains if held on revenue account.

There is a NZ\$50,000 cost threshold for investments in offshore companies outside Australia held by individuals, below which these investments continue to be taxable under general income tax rules (for example, on dividends only if held on capital account).

Under the new rules, offshore portfolio investment in shares is taxed consistently, regardless of the country where the investment is located and whether the investment is made by an individual directly or through a collective investment vehicle. The new rules manifest the government’s policy that New Zealand residents should be taxed on their world-wide income.

#### **Background**

The previous tax rules for offshore portfolio investment in shares favoured investment in the eight “grey list” countries (Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States). Investments in companies resident in these countries were taxed only on dividends if they were held on capital account (which was the case for most individuals). Dividend-only taxation was, in many instances, an inappropriate tax base because many foreign companies have a policy of

paying low or no dividends. The investor could still, however, derive an economic gain from the investment via an increase in the share price. It was therefore quite easy to achieve a low tax or no tax result for direct portfolio investment in shares outside New Zealand. This could give higher income or more sophisticated taxpayers significant scope to minimise their tax burden by investing offshore.

On the other hand, portfolio investment in some high growth and lower tax countries, including trading partners in Asia and Latin America, were over-taxed relative to investment in countries such as the United States and the United Kingdom. In particular, investors faced significant tax barriers to investment in these countries as a result of the application of the previous foreign investment fund rules, which generally taxed full accrued capital gains (and captured the full effect of currency fluctuation and share price volatility). This inhibited connections with these newer and increasingly important investment destinations. The tax rules for offshore portfolio investment in shares therefore operated very unevenly.

A further problem with the previous “grey list” exemption was the difference in tax treatment between investments in those jurisdictions made directly and those made through a collective investment vehicle. Under the “grey list” exemption, individuals were typically taxed only on dividends because they held their shares on capital account. On the other hand, collective investment vehicles were taxed on their “grey list” investments mostly on a revenue account basis (dividends and realised gains) because they were normally in the business of trading in shares. As was the case with investment in New Zealand companies, collective investment vehicles faced a tax disadvantage under the previous tax rules for offshore portfolio investment in shares.

The new rules are aimed at creating more consistent and coherent tax rules for offshore portfolio investment in shares by type of investment (direct versus investment through a collective investment vehicle) and jurisdiction (grey list versus non-grey list and New Zealand). In particular, the changes reflect the need to ensure that investments via portfolio investment entities and other managed funds are not tax disadvantaged relative to direct investment; this is important from the perspective of encouraging investment through KiwiSaver.

Overall, the new rules attempt to levy a reasonable level of tax on offshore share investments. The exemption for investments in Australian-resident listed companies reflects the fact that Australian dividend yields, like those in New Zealand, are relatively high. The exemption also takes into account the special relationship between New Zealand and Australia under Closer Economic Relations. Consequently, dividend-only taxation is a reasonable approach for Australian-resident listed companies because the Australian tax system encourages distributions, as the New Zealand tax system does. Dividend-only taxation is not feasible for taxing investments in companies resident in jurisdictions whose tax systems do not encourage the payment of dividends. For these investments a reasonable level of tax should be collected each year. The new fair dividend rate method, which broadly taxes 5 percent of a portfolio’s opening value each year, seeks to do so.

Proposals to reform the tax rules for offshore portfolio investment in shares were outlined in the government discussion document, *Taxation of investment income*, released in June 2005. This discussion document built on the work carried out in earlier reviews, including the Tax Review in 2001. The new offshore tax rules have

been the subject of extensive consultation and reflect a number of amendments in the course of policy development, to take into account various concerns raised during consultation.

### **Key features**

The new tax rules for offshore portfolio investment in shares mainly involve changes to the foreign investment fund rules in the Income Tax Act 2004. The main features of the new rules are:

- The previous exemption in the foreign investment fund rules for investments of less than 10 percent in companies resident in “grey list” countries has been abolished. (The “grey list” countries are Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States.)
- Investments in Australian-resident companies listed on an approved index of the Australian Stock Exchange, such as the All Ordinaries index (the 500 largest listed companies), are exempt from the foreign investment fund rules. The general income tax rules will continue to apply to these Australian investments: that is, taxable only on dividends if the shares are held on capital account and on dividends and realised share gains if the shares are held on revenue account. However, investments in Australian-resident listed companies held by portfolio investment entities are generally taxable only on dividends.
- A NZ\$50,000 minimum threshold applies to an individual’s investments in foreign companies other than Australian-resident listed companies. If the original cost of these shares totals NZ\$50,000 or less, the foreign investment fund rules do not apply to the individual. This threshold does not generally apply to trusts.
- Investments in certain Australian unit trusts that meet minimum investment turnover requirements and use the RWT proxy rules are exempt from the foreign investment fund rules.
- There are two temporary exemptions for investments in certain grey list companies for five years and two years respectively. Investments in Guinness Peat Group plc qualify for the five-year exemption (that is, for the 2007-08 to 2011-12 income years) and investments in the New Zealand Investment Trust plc qualify for the two-year exemption (that is, the 2007-08 and 2008-09 income years). Investors who hold shares in these companies on revenue account may elect for the exemption not to apply to them.
- There is an exemption for venture capital investments in which grey list companies that were previously resident in New Zealand and maintain a significant New Zealand presence.
- There is a limited exemption for offshore shares acquired through employee share purchase schemes if there are restrictions on the disposal of the shares. The exemption applies only for the duration of the restrictions.

- The “grey list” exemption will continue to apply for non-portfolio investments of 10 percent or more in foreign companies. However, because of their widely held nature, the following entities do not qualify for this grey list exemption: portfolio investment entities, superannuation schemes, unit trusts, life insurers and group investment funds.
- Two new income calculation methods under the foreign investment fund rules – the fair dividend rate and cost methods – have been introduced to apply generally to less than 10 percent interests in foreign companies.
- Under the fair dividend rate method:
  - Tax is paid on 5 percent of the share portfolio’s opening market value each year.
  - If the investor is an individual or family trust and the total return (dividends and capital gains) on the portfolio is less than 5 percent then tax can be paid on the lower amount with no tax payable when the total return is nil or negative.
  - Paying tax on an amount lower than 5 percent is achieved by allowing individuals and family trusts to use the comparative value method. Individuals and family trusts have the ability to switch freely between the fair dividend rate and comparative value methods between income years.
  - Within the same income year an individual or family trust must apply either the fair dividend rate method or the comparative value method. It is therefore not possible to use the fair dividend rate method for shares which produce a total return of over 5 percent (thereby getting the benefit of the 5 percent cap under that method) and use the comparative value method for shares which produce a total return of less than 5 percent in the same year.
  - Generally only shares held at the start of an income year are taken into account and therefore purchases and sales of shares during a year are ignored.
  - However, shares that are both purchased after the start of an income year and sold before the end of the same income year are taxed on the lower of 5 percent of their cost or the actual gains made on these “quick sales”.
  - Dividends are not taxed separately; however, foreign withholding tax deducted from dividends is still available as a foreign tax credit.
  - There are no foreign investment fund losses.
- The fair dividend rate method cannot be used for “guaranteed return”-type investments. The comparative value method must be used for these investments.
- The cost method taxes 5 percent of the cost of a person’s investments, with the cost base increased by 5 percent each year to proxy for an increase in the value of the investment. This method is available for investments for which it is not possible to obtain market values (except by

independent valuation) and therefore it is not practical to apply the fair dividend rate method. The cost base can be reset by independent valuation every five years.

- Investors can use the other methods for calculating foreign investment fund income or loss – branch equivalent, accounting profits, comparative value and deemed rate of return – if they satisfy the conditions for using these methods.
- The previous ring-fencing rules for foreign investment fund losses (other than those calculated under the branch equivalent method) have been repealed.
- The rules for converting amounts from foreign currency into New Zealand currency have been made consistent. In particular, the changes require taxpayers to be consistent in their use of currency conversion methods.
- The rules dealing with when a person enters into or exits from the foreign investment fund rules, such as when a person becomes a resident of New Zealand or the \$50,000 minimum threshold is exceeded so a person enters into the rules, have been amended to cater for the new fair dividend rate and cost methods.
- Offshore investments which become subject for the first time to the new foreign investment fund rules enter the new rules at their market value on the start date of the new rules (which for most individuals will be 1 April 2007).

### **Application date**

The new tax rules for offshore portfolio investment in shares apply for income years beginning on or after 1 April 2007. For the large majority of individuals who have a standard balance date of 31 March, this means that the new rules apply from the start of their 2007-08 income year on 1 April 2007. For early balance date taxpayers, the new tax rules apply from the start of their 2008-09 income year; for example, for a person with a 31 December balance date, the new rules apply from the start of their 2008-09 income year on 1 January 2008. For late balance date taxpayers, the new tax rules apply from the start of their 2007-08 income year; for example, for a person with a 30 June balance date, the new rules apply from the start of their 2007-08 income year on 1 July 2007.

A special application date rule applies for companies, group investment funds, or superannuation funds that intend to be portfolio investment entities. These entities may choose to delay the application of the new offshore tax rules until 1 October 2007 when the new tax rules for portfolio investment entities come into force. This deferral is effected by the entity giving a notice to the Commissioner before 1 April 2007 (if the entity exists before that date) or within one month of the day on which the entity comes into existence (if the entity comes into existence between 1 April 2007 and 1 October 2007). This special application date rule for prospective portfolio investment entities is intended to align the start dates of the new offshore tax rules and the new tax rules for portfolio investment entities.

It is intended that the special application date rule of 1 October 2007 for entities intending to become portfolio investment entities also applies to early balance date taxpayers that choose to become portfolio tax rate entities (other than those choosing to pay provisional tax under section HL 22) because of the operation of section HL 12(2) and section 38(1B) of the Tax Administration Act 1994. Such early balance taxpayers are treated as having a late balance date of 30 September 2007; this means that the new offshore tax rules can also apply to such entities from 1 October 2007.

## **Detailed analysis**

### ***Interests subject to the new foreign investment fund rules (sections EX 29 to EX 31)***

The foreign investment fund rules apply to a wide range of interests in foreign entities. The rules broadly seek to tax the income earned by foreign entities on interests held by New Zealand residents. The rules provide a mechanism for attributing the income of a foreign entity to a New Zealand resident who has an interest in that entity.

In particular, the following interests, subject to certain exemptions discussed below, are subject to the foreign investment fund rules:

- Interests in a foreign company (including a foreign unit trust). These interests are measured by reference to direct income interests as defined in section EX 31.
- Rights to benefit from a foreign superannuation scheme.
- Rights to benefit from a foreign life insurance policy.

The main change to the scope of the previous foreign investment fund rules is that the general exemption for interests in grey list companies no longer applies to less than 10 percent (that is, portfolio) interests.

### ***\$50,000 minimum threshold for application of foreign investment fund rules (sections CQ 5 and DN 6)***

A minimum threshold applies to an individual's investments in foreign companies below which the foreign investment fund rules do not apply. The term "individual" is used here to refer to a natural person. If the original cost of these shares totals NZ\$50,000 or less at all times in an income year, the foreign investment fund rules do not apply for that year. The individual investor will continue to pay tax only on dividends if they hold the shares on capital account. This minimum threshold also encompasses interests in foreign superannuation schemes and life insurance policies.

It should be noted that this rule is a threshold rather than an exemption. Therefore, if the cost of a person's offshore shares exceed \$50,000 all their shares are subject to the foreign investment fund rules and not just the excess costing more than \$50,000.

The \$50,000 minimum threshold takes into account brokerage fees if these form part of the cost of acquiring any shares.

The exchange rate on the date of purchase of any shares in foreign currency should be applied for the purposes of the NZ\$50,000 minimum threshold. This information can be obtained from websites which contain on-line currency conversion calculators – for example, [www.oanda.com/convert/classic](http://www.oanda.com/convert/classic), which goes back to January 1990. The New Zealand Reserve Bank's monthly exchange rate data is also acceptable to Inland Revenue for this purpose: [www.rbnz.govt.nz/statistics](http://www.rbnz.govt.nz/statistics). Exchange rate information is also available from all major trading banks.

A married couple or a couple in a de facto relationship or civil union can qualify for a total NZ\$100,000 threshold. This can be achieved by half of the shares costing \$100,000 being held in each spouse's name, the shares being wholly jointly owned, or a combination of individual and joint ownership. Each spouse would have to add half the cost of the jointly owned shares to their individual shares to ascertain if they come under or over the threshold. For example, if each spouse holds shares in their own name costing \$20,000 and jointly own shares costing \$60,000, then both spouses would qualify for the threshold. Each spouse's \$50,000 total is calculated by adding the shares they individually own (\$20,000) and half (\$30,000) of the shares they jointly own. However, if one spouse in this example instead individually owned shares costing \$40,000 then that spouse would not qualify for the threshold: the spouse's total would be \$70,000 (\$40,000 plus \$30,000 share of jointly owned shares). The other spouse would still qualify for the threshold.

A special rule is available for establishing whether investments that were acquired before 1 January 2000 fall within the minimum threshold. For these shares, the market value at 1 April 2007 may be halved and used to calculate the amount to be added to the cost of investments acquired on or after 1 January 2000 to determine whether the minimum threshold is exceeded. The rule is designed to assist investors who have no record of the cost of investments they have held for many years. Treating the cost of pre-2000 interests as half of the market value is optional but, once elected, the treatment cannot be changed in subsequent income years. Also, if this option is chosen it must be used for all investments acquired before 1 January 2000.

The NZ\$50,000 minimum threshold for the application of the new offshore tax rules also applies to the following small range of trusts:

- The settlor of the trust is a relative or legal guardian of the beneficiary, or a person associated with a relative or legal guardian of the beneficiary, and is required by a court order to pay damages or compensation to the beneficiary.
- The settlor is the ACC.
- The trust is of the estate of a deceased person and the current income year begins before the date that is five years after the person's death.
- The settlor of the trust is the estate of a deceased person and a court order requires the proceeds of damages or compensation to be settled on the trust for the beneficiaries of the trust.

Family trusts that are not within the limited range outlined above, such as discretionary trusts, do not get the benefit of the \$50,000 minimum threshold because of the risk of multiple trusts being used for the benefit of the same individuals.

If an investor holds shares in a year costing more than the NZ\$50,000 threshold and disposes of a sufficient quantity of them during the same year to bring the cost of shares held under the threshold, they will still be subject to the new offshore tax rules in that year (as they have held shares costing greater than NZ\$50,000 for part of the year). They will, however, qualify for the threshold in the following year, assuming they do not purchase any additional shares in that year.

Shares in foreign companies, that are covered by the various exemptions from the foreign investment fund rules, such as those for investments in Australian-resident listed companies and certain grey list companies, do not count towards the NZ\$50,000 minimum threshold.

The NZ\$50,000 minimum threshold is based on the cost of offshore shares held rather than their market value. This is so taxpayers can refer to actual cost when determining whether the threshold applies to them, rather than having to track changing market values over time.

The NZ\$50,000 minimum threshold is designed to reduce compliance costs. The threshold attempts to strike a balance between accuracy and simplicity for individual investors with relatively small amounts invested offshore and recognises that any additional accuracy gained from applying the more complex foreign investment fund rules (compared with dividend-only taxation) may be outweighed by the compliance costs.

***Exemption for investments in Australian-resident listed companies (section EX 33C)***

Investments in Australian-resident listed companies are generally exempt from the foreign investment fund rules. This means that investors, other than portfolio investment entities, who invest directly in Australian-resident companies listed on the Australian Stock Exchange will continue to be taxed under general income tax rules – they will be taxed on dividends only if the share is held on capital account, and on dividends and realised share gains if held on revenue account.

Investments in Australian-resident listed companies by portfolio investment entities will be taxable only on dividends, subject to the portfolio investment entity having full equity risk in the Australian share. This is because any realised share gains are treated as excluded income under section CX 44C.

The exemption for Australian-resident companies is restricted to companies listed on an approved index of the Australian Stock Exchange (ASX). The approved ASX indices include the ASX All Ordinaries (the 500 largest listed companies), ASX 50 Leaders and ASX 200. The exemption should cater for most New Zealanders' portfolio share investments in Australia.

The following website contains a list of companies on the ASX All Ordinaries index:

[http://www2.standardandpoors.com/portal/site/sp/en/au/page.topic/indices\\_asxallo/2,3,2,8,0,0,0,0,0,0,3,0,0,0,0,0.html](http://www2.standardandpoors.com/portal/site/sp/en/au/page.topic/indices_asxallo/2,3,2,8,0,0,0,0,0,0,3,0,0,0,0,0.html)



The exemption applies only to interests in Australian-resident companies that are required to have a franking account in accordance with Australian tax law.

Generally, a New Zealand investor that receives a “franked” dividend from a company that is listed on the ASX All Ordinaries index will be entitled to this exemption from the foreign investment fund rules. The exemption should therefore be relatively easy to self-assess.

Interests in Australian unit trusts do not generally qualify for the Australian exemption because they are not required to have a franking account and will therefore be subject to the new foreign investment fund rules (an exception for interests in certain Australian unit trusts is discussed below).

The exemption does not apply to an investment in an Australian-resident company whose residence tie-breaks to a country other than Australia or New Zealand under an Australian tax treaty. This is because such a company may not be subject to full Australian or New Zealand tax.

New Zealand’s Inland Revenue has a close working relationship with the Australian Tax Office, which will allow the use of this exemption to be monitored.

#### ***Australian unit trusts (section EX 33D)***

Investments in certain Australian unit trusts that turn over a sufficient proportion of their investments each year and use the RWT proxy rules for meeting the tax obligations of its New Zealand investors are exempt from the new foreign investment fund rules.

For the exemption to apply the Australian unit trust is required to turn over a minimum of 25% of its profit-making assets each year. This requirement would encourage distributions to be made to New Zealand-resident unit holders. The minimum turnover requirement does not take into account investments in loss because otherwise there could be an incentive to dispose only loss-making investments to meet the minimum turnover requirement.

Inland Revenue has no problem with shares being sold and immediately repurchased for the purpose of satisfying the turnover requirement (aka “bed and breakfast” arrangements).

The exemption is only available to those investors in the qualifying Australian unit trust who elect to use the RWT proxy mechanism. This is because this mechanism gives assurance that New Zealand tax liabilities will be satisfied. It is also expected that the RWT proxy, who will generally be a New Zealand-based agent, will be able to advise investors on whether an Australian unit trust meets the turnover requirements.

The exemption for investments in Australian unit trusts that meet minimum turnover requirements and where the investor elects to use the RWT proxy mechanism is meant to accommodate current arrangements, where investors in certain Australian unit trusts have their tax liabilities satisfied under the RWT proxy rules, thereby reducing compliance obligations.

Australian unit trusts were not generally included in the exemption from the foreign investment fund rules in section EX 33C for Australian investments because they could be used as roll-up vehicles to invest outside Australia in companies that pay little or no dividends (and therefore avoid the new offshore tax rules). New Zealand investors could invest in these vehicles and derive income in the form of capital gain, without a tax liability arising on this income in either Australia or New Zealand. The minimum turnover requirement in the limited exemption in section EX 33D addresses this concern.

***Temporary exemptions for investments in certain grey list companies (section EX 33B)***

There are two temporary exemptions from the foreign investment fund rules for five years and two years respectively for investments in certain grey list companies (that is, companies resident in Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States).

*Five-year exemption for investments in New Zealand-owned grey list companies*

Under this temporary exemption, investments in companies that meet certain criteria would continue to be taxable under the general income tax rules for a period of five years, that is, for the 2007-08 to 2011-12 income years.

The main criteria for this temporary exemption are that the investment is in a grey list company that on 17 May 2006 (the date of introduction of this legislation):

- is listed on a recognised exchange in both New Zealand and a grey list country;
- is liable to income tax in a grey list country;
- has more than 20,000 shareholders who have addresses in New Zealand on the company's New Zealand share register and these shareholders hold shares in the company carrying voting interest of more than 50 percent; and
- has assets of which more than 50 percent in total value are shares in other companies carrying voting interest of more than 50 percent.

For this exemption to apply the grey list company must within 30 days after the date of enactment (18 December 2006) of this legislation, give to the Commissioner of Inland Revenue notice that on 17 May 2006 the company satisfied the above criteria.

The rationale for this temporary exemption is to allow time for completion of the government's review of the controlled foreign company tax rules. Pending the outcome of this review, which includes consideration of whether the controlled foreign company rules should exempt income from active investment while continuing to tax income from passive investment, some grey list companies may

consider relocating to New Zealand. If this were the case, the offshore tax rules for portfolio investments would not apply to investments in such companies. The outcome of this review would be important for a company like Guinness Peat Group plc in its consideration of whether to relocate, as its primary investment would likely be an active investment in a controlled foreign company.

*Two-year exemption for investments in grey list companies investing in Australasian shares*

There is also a temporary exemption of two years (that is, the 2007-08 and 2008-09 income years) from the new foreign investment fund rules for interests in grey list companies that invest primarily in Australasian equities.

For investors to qualify for this two-year holiday, the grey list company would need to have at least 90 percent of its assets (by value) invested in New Zealand-resident listed companies and Australian-resident listed companies; also at least 50 percent of the grey list company's assets (by value) must be invested in New Zealand resident companies. This Australasian investment requirement would have to be maintained throughout the two-year exemption period.

Further criteria for this exemption are that the grey list company must, on 17 May 2006 (the date of introduction of this legislation):

- be listed on a recognised exchange in both New Zealand and in a grey list country;
- have shareholders of which more than 40 percent have addresses in New Zealand on the company's New Zealand share register;
- be liable to income tax in a grey list country;
- have assets of which at least 50 percent in total value are shares in New Zealand-resident companies; and
- have assets of which at least 90 percent in total value are shares in New Zealand-resident listed companies and Australian resident listed companies.

It is also necessary for the grey list company in the 30-day period after the date of enactment (18 December 2006) of this legislation to give the Commissioner of Inland Revenue notice that on 17 May 2006 it satisfied the above criteria.

The purpose of this temporary exemption is to allow the relevant grey list companies time to relocate to New Zealand and become portfolio investment entities. This is because New Zealand investors in grey list entities that have a predominantly Australasian investment policy would benefit if this happened. Such entities would benefit under the portfolio investment entity tax rules from not having their capital gains from trading Australasian shares taxed.

### *Revenue account investor election (section EX 33B(3))*

Investors who hold shares on revenue account that qualify for the temporary exemptions from the new foreign investment fund rules can elect that the exemption not apply, which means that such shares will be taxed under the foreign investment fund rules. The election is made in a return of income for an income year; the election is irrevocable and applies for that income year and the remaining years of the exemption period.

Institutional investors (that is, portfolio investment entities and other managed funds) would generally hold their investments on revenue account, and would be taxable on any gains that are realised. In many cases, the fair dividend rate method would result in a lower tax liability for such investors. A fair dividend rate method would also be easier for managed funds to apply under the portfolio investment entity tax rules.

This election is likely to be particularly beneficial for portfolio investment entities as attribution of income to investors would be simple under the fair dividend rate method. In contrast, if the general tax rules were to apply, investors would be subject to tax on realised gains on these investments. This would require deferred gains and losses to be allocated across tax years and current and future investors, which would be difficult for portfolio investment entities to manage.

### *Publication of list of qualifying companies*

An amendment has been made to the secrecy provisions to allow Inland Revenue to publish the names of companies that it has received notification from that they meet the criteria for the temporary exemptions from the foreign investment fund rules (section 81(4)(mc) of the Tax Administration Act 1994).

Guinness Peat Group plc has given notice to the Commissioner under section EX 33B(1)(b) that it meets the criteria for the five-year exemption. New Zealand Investment Trust plc has given notice to the Commissioner under section EX 33B(2)(b) that it meets the criteria for the two-year exemption.

### *Venture capital exemption (section EX 33(3) and (4))*

There is an exemption from the new offshore tax rules that is designed for venture capital investments in New Zealand-resident start-up companies that migrate offshore to gain access to additional equity financing. Without this exemption the New Zealand investors could end up holding portfolio interests subject to the foreign investment fund rules. The policy basis for this exemption is that venture capital investments do not compete with investment via New Zealand managed funds and therefore are not the target of the new rules.

The criteria for the venture capital exemption are:

- The investment is shares in a grey list company that was previously a New Zealand-resident company.

- The investor acquired the shares before the company migrated from New Zealand and before the shares were listed on a recognised exchange. It is intended that these investors will be able to continue to invest in the company after it has listed without losing the exemption.
- The grey list company has a fixed establishment in New Zealand, which has at least \$1 million of expenditure (not including interest) each year or 10 full-time employees or contractors providing services.
- Before migrating, the company had been tax-resident in New Zealand for a minimum of 12 months and had the majority of its assets and employees in New Zealand for at least a year.
- The exemption lasts for 10 income years from the income year in which the company migrates.
- The shares would enter the foreign investment fund rules at market value at the end of the 10-year exemption period.

The exemption also applies to shares purchased in a grey list company that owns a New Zealand company that meets the above criteria. This variation to the exemption caters for situations where shares in a grey-list company are received in exchange for shares in a New Zealand-resident company. The 10-year exemption period starts from the income year in which the grey list company acquires a majority of the shares of the New Zealand-resident company.

***Employee share purchase scheme exemption (section EX 33(5))***

There is a limited exemption from the new foreign investment fund rules for individuals who hold shares in a foreign company acquired through an employee share purchase scheme that satisfies the following criteria:

- The foreign company is resident in a grey list country and is the employer of the employee or owns, directly or indirectly, the New Zealand-resident employer of the employee.
- The shares are acquired through employment under a share purchase agreement (as defined in section CE 7).
- There are restrictions in the share purchase agreement applying to the disposal of the shares for a period that satisfies the requirements in section CE 3.

Employees have up to six months from the date the restrictions on disposal no longer apply to dispose of their shares before the foreign investment fund rules apply to the shares. After this period, the shares would enter the foreign investment fund rules at their market value.

***Non-portfolio grey list exemption (section EX 33(1) and (2))***

Interests of 10 percent or more, (non-portfolio interests) in grey list companies (those resident in Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States) are exempt from the new foreign investment fund rules. The

company must be liable for income tax in the grey list country it is resident in for this exemption to apply.

The investor's interest in the grey list company must be 10 percent or more at all times in the relevant income year for the exemption to apply. If the interest falls below 10 percent after the start of the income year and the fair dividend rate method can be applied to the interest there will be no foreign investment fund income in that year.

The grey list exemption for interests of 10 percent or more in grey list companies does not apply if the interest is held by a portfolio investment entity, superannuation scheme, unit trust, life insurer or a group investment fund. This exception is because of the widely held nature of such investors.

### ***Other exemptions from the new rules***

Other exemptions from the foreign investment fund rules which existed before these changes, such as those for interests covered by the controlled foreign company rules and employment-related pensions continue to apply, other than the previous general grey list exemption.

### ***Methods for calculating foreign investment fund income or loss***

The amendment Act introduces two new methods for calculating foreign investment fund income – the fair dividend rate method and the cost method.

It is expected that the fair dividend rate method will be the primary method for calculating foreign investment fund income for less than 10 percent interests in foreign companies. The only significant exceptions to this would be when individuals and family trusts choose to use the comparative value method when the total annual return from an investment is less than 5 percent and when the comparative value method (or deemed rate of return method) is required to be used for portfolio investments which have a guaranteed return nature. These exceptions are discussed further below.

The comparative value method takes into account the full economic returns (capital gains and dividends) from an investment. The deemed rate of return method is the back-up method to the comparative value method and can be applied when current market value information about an investment is not available and is based on the original cost of the investment.

The branch equivalent and accounting profits methods remain available for use by taxpayers who satisfy the conditions for their use. Significant information is required to use these methods, which are designed to tax investors on their share of a foreign company's underlying earnings.

### ***Fair dividend rate method (sections EX 44B to EX 44E)***

Under the new fair dividend rate method tax is paid on 5 percent of the opening market value of an investor's offshore portfolio share investments held at the start of an income year. However, if the investor is an individual or family trust and the actual

return is less than 5 percent, tax can be paid on this lower amount with no tax payable when the total return is negative.

On-line calculators will be available on the Inland Revenue website to assist people to calculate their foreign investment fund income using the fair dividend rate method.

Non-natural person investors (other than family trusts) are taxed on 5 percent of the value of shares held each year. There is no variation to this rate in years where the investor earns less than 5 percent.

#### *General features of fair dividend rate method*

The fair dividend rate method:

- taxes 5 percent of the market value of offshore shares held at the start of an income year;
- applies only to portfolio investments in offshore shares – that is, interests of less than 10 percent in a foreign company – that have verifiable market values;
- works on a pooled approach, rather than on an investment-by-investment approach, for shares that qualify;
- ignores purchases and sales of shares during a year, except when the shares are bought and sold in the same year – separate “quick sale” rules, described below, apply for these. Therefore, there is no foreign investment fund income in the year of purchase in relation to shares that are acquired after the start of an income year. Conversely, there is no reduction in foreign investment fund income in relation to shares held at the start of an income year that are sold during the year;
- does not tax dividends separately (this is achieved through section EX 47). However, foreign withholding tax deducted from dividends is still available as a foreign tax credit under section LC 1(1) and (4); and
- does not result in foreign investment fund losses.

The primary formula for the fair dividend rate method is:

5% x opening market value (total for all shares for which method is used) plus quick sale adjustment (for shares bought and sold in same year, discussed below).

#### *Application of method to individuals and family trust investors*

For individual investors and family trusts, a variation to the fair dividend rate approach outlined above is allowed. Under this variation if investors can show that their total return on all their offshore shares, for which the fair dividend rate method is allowed to be used, is less than 5 percent of the opening market value they are taxable on the lower amount. If the total return for the year is nil or negative, no tax would be payable (and no loss recognised). The total return is calculated using the comparative value formula in section EX 44:

*(closing market value of shares held + total sales proceeds + dividends received) – (opening market value of shares held + total value of purchases)*

### **Example 1**

*When an individual makes a total return of more than 5 percent*

John holds offshore shares that have a market value of \$100,000 at the start of the year. These shares are worth \$115,000 at the end of the year. John also derives a \$10,000 dividend.

Under the fair dividend rate method, John pays tax on 5 percent of \$100,000 or a lower amount if his return for the year is less than 5 percent. No tax is payable if he makes a negative return.

John's total return for the year is the \$15,000 capital gain on his shares and the dividend of \$10,000. His total return is therefore \$25,000. However, his taxable income for the year is limited to 5 percent of the opening value of his shares. This would result in taxable income of \$5,000. (Under the fair dividend rate method the \$10,000 dividend is not separately taxed.)

### **Example 2**

*When an individual makes a total return of less than 5 percent*

Mary also holds offshore shares that have a market value of \$100,000 at the start of the year. These shares increase in value to \$102,000 at the end of the year. Mary also receives a \$1,000 dividend.

As in the previous example, Mary would pay tax on 5 percent of \$100,000 (her opening value) unless she can show that she made a return of less than this.

Mary's total return for the year is \$3,000 (comprising a capital gain of \$2,000 and a dividend of \$1,000), which is less than 5 percent of her opening value of \$100,000. Therefore, Mary is only taxed on \$3,000.

### **Example 3**

*When an individual makes a loss*

Judy holds offshore shares that have a market value of \$100,000 at the start of the year, which decrease in value to \$75,000 at the end of the year. She also receives a \$10,000 dividend.

As in the previous examples, Judy would be taxable on 5 percent of the opening value of her shares unless she can show that her total return for the year is less than 5 percent.

Judy's total return for the year comprises a capital loss of \$25,000 and the dividend of \$10,000. Her net return is therefore a loss of \$15,000. Because Judy has made a



negative return on her offshore shares, no tax is payable under the fair dividend rate method.

*Application of method to managed funds and other non-natural person investors*

For New Zealand managed funds, including portfolio investment entities, and other non-natural persons (except family trusts) the variation outlined above does not apply. This means that tax payable is on a fixed 5 percent return irrespective of how investments perform.

A fixed fair dividend rate is more consistent with the portfolio investment entity rules than a variable rate. For most managed funds – referred to in the legislation as “unit valuers” – the 5 percent fair dividend rate applies to the average value of the entity’s offshore portfolio share investments for the year. That is, for investment vehicles, such as unit trusts and superannuation funds, that calculate the value of their investments and their investors’ units on a regular basis, the taxable income for each valuation period (which could range from a day to a quarter) would be calculated using the following formula:

$$5\% \times \text{market value of investments at start of period} \times \frac{\text{the number of days in the period}}{\text{number of days in the income year}}$$

The values that are used by unit valuers for unit pricing purposes are acceptable to Inland Revenue for purposes of applying the fair dividend rate method provided a consistent approach is taken. This policy should cater for daily unit valuers in relation to the treatment of weekends and public holidays.

*Rules for shares that are bought and sold in the same income year (“quick sales”)*

Shares that are purchased after the start of the income year and then sold before the end of the same income year are taxed on the lower of 5 percent of the cost of the purchase or the actual gains made on these “quick sales”.

The so-called “quick sale” rules are designed to tax shares that are bought and sold within the same income year – that is, for a taxpayer with a standard income year, shares that are purchased after 1 April and sold before the following 31 March. Without these rules, no tax would be payable on these shares as they would not be reflected in the value of shares held at the start of the year or in the value of shares held at the start of the following year.

The quick sale rules for investors (other than daily valuers) allow them to pay tax based on the lower of 5 percent of the average cost or the actual gains made on any “quick sales”.

In the legislation the amount which is added to the standard fair dividend rate formula (5% x opening market value) to take account of shares bought and sold in the same income year is referred to as the “quick sale adjustment”.

The quick sale adjustment is calculated as the lower of 5 percent of the cost of shares that are bought and sold in the same year – referred to in the legislation as the “peak

holding adjustment” – and the actual gains made on any such shares – referred to in the legislation as “quick sale gains”.

The peak holding adjustment is the total of the amounts (a pooled approach) calculated for each foreign company using the formula:  $5\% \times \text{quick sales} \times \text{average cost}$ .

The “quick sales” amount in the peak holding adjustment formula is the lower of:

- the difference between the greatest number of shares held in the foreign company during the income year and the number of shares held in the foreign company at the start of the income year; and
- the difference between the greatest number of shares held in the foreign company during the income year and the number of shares held in the foreign company at the end of the income year.

The “average cost” component in the peak holding adjustment formula is the amount of expenditure that the shareholder incurs during the income year in acquiring or increasing their shareholding in a foreign company divided by the total number of shares acquired in the foreign company during the income year. Using the average cost approach takes account of the situation when different parcels of shares in the same company are purchased during the year at different prices. Taking the average cost of all such share parcels purchased in the year is easier than requiring investors to track the cost of each share that is subsequently sold.

The “quick sale gains” component of the quick sale adjustment is the greater of zero and the total amount for all shares bought and sold in foreign companies during the year (a pooled approach) calculated by taking the total amount derived from holding (including any dividends) or disposing of the shares in a foreign company and subtracting the total expenditure incurred in acquiring the interest (this would not include holding costs such as interest).

In ascertaining whether shares are bought and sold in the same year for the purposes of the “quick sale gains” part of the quick sale adjustment, a last-in-first-out (LIFO) method applies to determine whether shares in a foreign company sold in a year were purchased in the same year.

Capping the quick sale adjustment to the actual gains made on shares that are bought and sold in the same income year, militates against over-taxation of quick sales that could occur if there was a high turnover of shares.

#### **Example 4**

Jane holds 10,000 shares worth \$30,000 in Co.A and 10,000 shares worth \$50,000 in Co.B on 1 April 2007. On 30 May, she buys another 1,000 shares in Co.A for \$4,000 and on 15 October she buys another 4,000 shares in Co.A for \$20,000. On 30 November she receives dividends of \$1,000 from Co.A. and \$2,000 from Co.B. On

2 February 2008, Jane sells 3,000 of her Co.A shares for \$15,000. At the end of the year, Jane's remaining 12,000 Co.A shares are worth \$48,000 and her 10,000 Co.B shares are worth \$55,000.

Jane would be taxable on \$4,000 (that is, 5% of \$80,000) under the standard fair dividend rate method. However, Jane also bought 3,000 shares in Co.A during the year that she sold before the end of the year. The average cost of these 3,000 shares is \$4.80 (\$24,000 cost of acquiring new shares in the year divided by 5,000, the number of new shares). Her quick sale adjustment for these shares is the lesser of her peak holding adjustment and her quick sale gains. Her peak holding adjustment is:

$$5\% \times 3,000 \text{ (quick sales)} \times \$4.80 \text{ (average cost)} = \$720$$

Jane's quick sale gains takes into account the total proceeds from holding or disposing of shares she bought and sold in Co.A during the year. These proceeds include a \$200 dividend, which is the pro rata share of the \$1,000 dividend paid on the Co.A shares that is attributable to the 3,000 shares bought and sold in the year (the 3,000 shares sold divided by the total 15,000 shares multiplied by the \$1,000 dividend). Jane's remaining proceeds are the \$15,000 sale proceeds from the 3,000 quick sale shares. From the total proceeds she subtracts the expenditure on the quick sale shares, which is the number of quick sale shares (3,000) multiplied by their average cost (\$4.80) as calculated above. Therefore Jane's quick sale gains are:

$$(\$15,000 + \$200) - \$14,400 = \$800$$

Jane's quick sale adjustment is therefore \$720 (being the lesser of the peak holding adjustment of \$720 and the quick sale gains of \$800).

Jane's income under the fair dividend rate method is the sum of the opening value result (\$4,000) and the quick sale adjustment (\$720). This is \$4,720.

Jane could be taxable on a lesser amount if she is able to show that her total return under the comparative value method in section EX 44 is less than \$4,720. This option is only available for natural persons and family trusts. Jane calculates that her actual return is:

$$(\$103,000 + \$15,000 + \$3,000) - (\$80,000 + \$24,000) = \$17,000$$

As Jane's total return is more than \$4,720, she is taxed at her personal tax rate on \$4,720.

### **Example 5**

NZ Co. holds 20,000 shares worth \$120,000 in Foreign Co.A and 10,000 shares worth \$80,000 in Foreign Co.B on 1 April 2007. On 15 May, NZ Co. buys a further 5,000 shares in Foreign Co.A for \$30,000 and a further 5,000 shares in Foreign Co.B for \$40,000. On 1 October NZ Co. receives a \$2,000 dividend from Foreign Co.A. On 1 February 2008, NZ Co. sells 2,000 shares in Foreign Co.A for \$14,000 and 3,000 shares in Foreign Co.B for \$18,000.

NZ Co. would be taxable on \$10,000 (that is, 5% of \$200,000) under the standard fair dividend rate method. However, because NZ Co. also bought 2,000 shares in Foreign Co.A and 3,000 shares in Foreign Co.B during the year that it sold before the end of the year it would also have to calculate a quick sale adjustment.

NZ Co's quick sale adjustment for the shares it has bought and sold during the year is the lesser of its peak holding adjustment and its quick sale gains. NZ Co's peak holding adjustment is the total of the amounts from applying the peak holding adjustment formula for each of Foreign Co.A and Foreign Co.B.

For Foreign Co.A the calculation is:

$$5\% \times 2,000 \text{ (quick sales)} \times \$6.00 \text{ (average cost)} = \$600$$

For Foreign Co.B the calculation is:

$$5\% \times 3,000 \text{ (quick sales)} \times \$8.00 \text{ (average cost)} = \$1,200$$

NZ Co's peak holding adjustment is therefore \$1,800 (\$600 + \$1,200).

NZ Co's quick sale gains is the total of the amounts from applying the quick sale gains formula for each of Foreign Co.A and Foreign Co.B.

NZ Co's quick sale gains for Foreign Co.A takes into account NZ Co's total proceeds from holding or disposing of the 2,000 shares in Foreign Co.A that it bought and sold during the year. These proceeds include a \$160 dividend which is the proportion of the \$2,000 dividend paid on the Foreign Co.A shares that is attributable to the 2,000 shares sold during the year (the 2,000 shares sold divided by the total of 25,000 shares multiplied by the \$2,000 dividend). NZ Co's other proceeds from Foreign Co.A are the \$14,000 sale proceeds from the 2,000 quick sale shares. From the total proceeds (\$14,160) NZ Co. subtracts the expenditure on the quick sale shares which is \$12,000 (the 2,000 quick sale shares multiplied by their average cost of \$6.00). Therefore, NZ Co's quick sale gains calculation for Foreign Co.A is:

$$(\$14,000 + \$160) - \$12,000 = \$2,160$$

NZ Co's quick sale gains calculation for Foreign Co.B takes into account the total proceeds from holding or disposing of the 3,000 shares in Foreign Co.A that it bought and sold during the year, that is the \$18,000 sale proceeds. From this amount NZ Co. subtracts the expenditure on the quick sale shares, which is the number of quick sale shares (3,000) multiplied by their average cost (\$8.00). Therefore, NZ Co's quick sale gains calculation for Foreign Co.B is:

$$\$18,000 - \$24,000 = \$6,000 \text{ loss}$$

Combining the quick sale gains results for Foreign Co.A (\$2,160) and Foreign Co.B (\$6,000 loss) produces a \$3,840 loss. Because the final result cannot be less than zero, NZ Co's quick sale gains amount is zero.

NZ Co's quick sale adjustment is therefore zero, being the lesser of its peak holding adjustment (\$1,800) and its quick sale gains (zero). NZ Co's foreign investment fund income under the fair dividend rate method is therefore \$10,000 (based on the \$200,000 opening market value of its interests).

The quick sale rules do not apply to entities that value their investments daily. Where the valuation period is more than a day (for example, a month or a quarter) the entity needs to apply the quick sale rules to shares bought and sold during the respective valuation period. For example, a unit trust that values its investments quarterly would apply the quick sale rules to any shares that are bought after the start of the quarter and sold before the end of the quarter.

#### *Share reorganisations*

There are also rules to deal with situations where an investor buys and sells shares during an income year (or valuation period for managed funds) and there is a share split between when the shares were purchased and when they were sold. This is described as a "share reorganisation" in the legislation. The rules establish the average cost of the "equivalent interest" that is sold for the purposes of the applying the fair dividend rate method.

#### *Foreign investment fund losses*

No foreign investment fund losses can be produced under the fair dividend rate method (section EX 44B(4)).

A matching restriction on foreign investment fund losses has been included in the comparative value method which applies when individuals and family trusts choose to use that method instead of the fair dividend rate method for their less than 10 percent interests in foreign companies in an income year because the total return from all such investments in the year is less than 5 percent of opening market value. If a person has a total foreign investment fund loss under the comparative value method from all their less than 10 percent interests in the year the loss is reduced to zero (section EX 44(6B) and (6C)).

#### **Example 6**

Joe has portfolio interests (less than 10 percent interests) in Foreign Co A and Foreign Co B. Joe elects to use the comparative value method (instead of the fair dividend rate method) in a year. His investment in Foreign Co A produces a foreign investment fund loss of \$1,000 and his investment in Foreign Co B produces foreign investment fund income of \$400. Joe's total foreign investment fund loss for the income year is \$600. Section EX 44(6C) reduces this total foreign investment fund loss to zero. This rule ensures a similar treatment of foreign investment fund losses for less than 10 percent interests in foreign companies under both the fair dividend rate and comparative value methods.

The above restriction on foreign investment fund losses does not apply if the less than 10% interest in a foreign company is a "guaranteed return" investment of a type listed in section EX 40(8)(a) (discussed below). The foreign investment fund loss restriction

does not apply to these interests because they are subject to comprehensive taxation under the comparative value method (which means they are not allowed the benefit of the 5 percent cap under the fair dividend rate method).

### ***Cost method (section EX 45B)***

A cost-based method is available for offshore portfolio investments for which it is not possible to obtain market values (except by independent valuation) and therefore it is not practical to apply the fair dividend rate method. This back-up method taxes 5 percent of the cost of a person's investments, with the cost base increased by 5 percent each year to proxy for an increase in the value of the investment.

The main features of the cost method are:

- It taxes 5 percent of the cost of the portfolio investment each year plus an uplift of 5 percent to account for investment growth.
- No tax is payable in the year in which the investment is acquired, as there would be no cost base at the start of the year.
- The cost base for each subsequent year (referred to as the "opening value" in the legislation) is adjusted by any sales and purchases in the previous year and increased by the foreign investment fund income for the previous year (5 percent of the "opening value" in the previous year), to account for investment growth.
- Any dividends derived are not taxed separately (this is achieved through section EX 47). However, foreign withholding tax deducted from dividends is still available as a foreign tax credit under section LC 1(1) and (4). Any dividends are not subtracted from the opening value in the next year (this is because 5 percent deemed growth is likely, on average, to underestimate the actual increase in the value of the investment).
- The rules for shares bought and sold within the same income year ("quick sales") apply to portfolio investments for which the cost method is used.
- The method applies on an interest-by-interest basis rather than on a pooled basis.
- No foreign investment fund losses can be produced under the cost method.

Investors also have the ability to use an independent valuation as the initial cost base if there is no readily available market value for the investment (for example, because the company is not listed). This would be a one-off valuation requirement to allow these investments to access the cost method.

Investors also have the ability to re-value their interests in companies subject to the cost method through an independent valuation and adjust their opening value accordingly. This allows investors to lower their cost base if the capital value of their investment has decreased. This resetting of the cost base through an independent valuation can be done once every five income years.

The main example of an interest for which the cost method is allowed to be used would be shares in a foreign company that are not listed on a recognised exchange and

for which a verifiable market value is therefore not readily available (meaning it is not practical to apply the fair dividend rate method).

#### **Example 7**

On 1 April 2007, Peter holds an interest in a family company that is resident in the United Kingdom. He put in capital of \$20,000 for which he received an 8 percent shareholding. The market value of his holding cannot be obtained without an independent valuation. Therefore, Peter is allowed to use the cost method. Under this method, his taxable income for the 2007-08 year would be calculated as 5 percent of \$20,000 = \$1,000. In the 2008-09 year, assuming Peter has not acquired or disposed of any interests in the company, his cost base is deemed to have increased by 5 percent (that is, by \$1,000). His taxable income in the 2008-09 tax year would therefore be 5 percent of \$21,000 = \$1,050. His taxable income in the 2009-10 year would be 5 percent of \$22,050 = \$1,102 (again assuming he has not acquired or disposed of any interests in the company).

#### *Rules for shares that are bought and sold in the same income year (“quick sales”)*

Shares that are purchased after the start of the income year and then sold before the end of the same income year are taxed at 5 percent of their average cost. As with the fair dividend rate method, these rules are necessary because without them no tax would be payable on such shares as they would not be included in the opening value.

The quick sale rules in the cost method are similar to those in the fair dividend rate method except that the actual gains on quick sales are not taken into account. Therefore, the rules are simpler to apply as they are based simply on 5 percent of the average cost of quick sale shares.

The term “quick sales” in the legislation refers to shares that are bought and sold during the income year. The “average cost” of these quick sale shares is calculated by dividing the total expenditure incurred on acquiring new shares in the year by the total number of shares acquired in the year. Using the average cost approach takes account of the situation when different parcels of shares in the same company are purchased during the year at different prices.

#### *Other foreign investment fund calculation methods*

Although the new fair dividend rate and cost methods will be the primary methods for calculating foreign investment fund income for less than 10 percent interests in foreign companies, investors have the option of using the other methods for calculating foreign investment fund income or loss - branch equivalent, accounting profits, comparative value and deemed rate of return - if they satisfy the conditions for using these methods.

***Removal of foreign investment fund loss ring-fencing rules (sections DN 5, DN 8, IE 4 and IG 5)***

The previous ring-fencing rules in section DN 8 for foreign investment fund losses (other than foreign investment fund losses calculated under the branch equivalent method) have been repealed.

If a taxpayer has a ring-fenced foreign investment fund loss from the 2006-07 or an earlier income year that has previously not been used, it will become deductible in 2007-08 as foreign investment fund losses are no longer ring-fenced (other than those arising under the branch equivalent method).

***Currency conversion rules***

The rules for converting amounts from foreign currency into New Zealand currency have been standardised for all foreign investment fund calculation methods (other than the branch equivalent method which has separate currency conversion rules).

For the fair dividend rate, cost, comparative value and deemed rate of return methods, investors have two options for performing exchange rate conversions:

- conversion using the exchange rate on the day for which market value is determined or on which each amount is derived or incurred; or
- conversion at the average of the close of trading spot exchange rates for the fifteenth day of each month that falls in the year.

For a person using the accounting profits method, the person must choose for all the calculations of the net after-tax accounting profits to be in:

- the currency of the foreign investment fund's accounts, with the result then converted at the average of the close of trading spot exchange rates for the fifteenth day of each complete month that falls in the accounting period; or
- New Zealand currency.

Having chosen a currency conversion method for an attributing interest in a foreign investment fund, a person must use the same method for that interest in subsequent income years. Therefore, it will no longer be possible to change currency conversion methods from year to year for the same attributing interests.

A person is also required to use the same currency conversion method for all attributing interests for which they use the same foreign investment fund calculation method. For example, if a person chooses to use only the fair dividend rate method for their offshore portfolio share investments they must use the same currency conversion method – the actual (spot) exchange rates or an annual average rate – for all those investments.

These changes, which require consistency in the use of currency conversion methods, are intended to prevent taxpayers changing their currency conversion method in order to reduce their income tax liabilities.



### ***Restrictions on choice of calculation methods***

Subject to certain restrictions, anyone with attributing interests in foreign investment funds may choose to use any of the six methods of calculating foreign investment fund income or loss – fair dividend rate, cost, accounting profits, branch equivalent, comparative value and deemed rate of return – by completing their return of income accordingly (section EX 38).

The rules dealing with the restrictions on choosing the particular calculation methods have been amended to incorporate the new fair dividend rate and cost methods.

*Restrictions on using the fair dividend rate method (sections EX 40(7), (8) and (9), and EX 40B and section 91AAO of the Tax Administration Act 1994)*

The fair dividend rate method may generally only be used for interests of less than 10 percent in foreign companies (section EX 40(7)(b)).

In determining whether a person's shareholding in a foreign company is less than 10 percent they are treated as holding any interests held by associated persons. This rule prevents persons holding 10 percent or more interests in foreign companies disaggregating their interests amongst associated persons to inappropriately access the fair dividend rate method.

The requirement that a person's interest in a foreign company must be less than 10 percent must be met at all times during the income year if the foreign company is not a grey list company. However, if the foreign company is a grey list company (that is, a company resident in Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States) the requirement has only to be met at one point in time in the income year. The reason for this lesser restriction for investments in grey list companies is to allow a person to continue to use the fair dividend rate method for the year they are increasing their interest in a grey list company from less than 10 percent to 10 percent or more instead of requiring them to use the comparative value method for that transitional year before they become entitled to the exemption from the foreign investment fund rules for 10 percent or more interests in grey list companies.

An exception to this less than 10 percent rule is that a portfolio investment entity, an entity eligible to be a portfolio investment entity (such as a superannuation fund that does not elect) or a life insurance company can use the fair dividend rate method for any level of interest they hold in a foreign investment vehicle. This is generally defined as a non-resident collective investment vehicle that meets the requirements in section HL 5. Because of the widely held nature of these investing entities, investments by these entities can be regarded as being in-substance portfolio investments and therefore should be entitled to have the fair dividend rate method apply to them (section EX 40(7)(a)).

A person is allowed to use the fair dividend rate method for an attributing interest for an income year only if the person does not use the comparative value method for any other attributing interest that is a share in a foreign company and for which the person would be allowed to use the fair dividend rate method – for example, it is a less than

10 percent interest (section EX 40(8)(b)). This requirement provides the mechanism which prevents persons (including individuals and family trusts) from selectively using the fair dividend rate method for their shares to produce a total return (dividends and capital gains) of over 5 percent (thereby gaining advantage of the 5 percent cap under that method) and using the comparative value method for their shares to produce a total return of less than 5 percent (which would tax that lesser amount). Therefore, individuals and family trusts must choose between using either the fair dividend rate method or the comparative value method for all their less than 10 percent shareholdings in foreign companies and cannot “cherry pick” between these methods. In other words, investors must take a portfolio approach to applying the fair dividend rate or comparative value methods.

The fair dividend rate method does not apply to certain offshore portfolio share investments which effectively offer New Zealand investors “guaranteed returns”. These investments are more akin to debt investments than equity investments and it is New Zealand’s policy to tax debt investments in full. For example, a portfolio investment in a company resident in a low-tax jurisdiction that invests in high-yield debt or other guaranteed return instruments would be taxable on a maximum return of 5 percent under the fair dividend rate whereas if they had invested directly in these instruments they would be taxable on the full return.

There are five types of investments of a “guaranteed return” nature that do not qualify for the fair dividend rate method (sections EX 40(8)(a)(i) to (v)) and EX 40(9)):

1. Fixed rate share investments in foreign companies (a “fixed-rate share” is defined in section LF 2(3) of the Income Tax Act 2004).
2. Non-participating redeemable share investments in foreign companies (a “non-participating redeemable share” is defined in section CD 14(9) of the Income Tax Act 2004).
3. Investments which involve an effectively non-contingent obligation, directly or through an arrangement, to return an amount to the investor that exceeds the issue price of the investment. The Commissioner has a discretion under section 91AAO of the Tax Administration Act 1994 to make a determination that an investment that is caught by this non-contingent obligation restriction but is not substantially debt in nature, still qualifies for the fair dividend rate method.
4. The Commissioner has the discretion to make a determination under section 91AAO of the Tax Administration Act 1994 that an investment that is not excluded from the fair dividend rate method by the above restrictions, but is still substantially debt in nature, does not qualify for the fair dividend rate method.
5. Investments in non-resident entities whose assets comprise 80% or more New Zealand dollar denominated financial arrangements (debt instruments) also do not qualify for the fair dividend rate method. This is necessary, as the rule in category 3 above may not be effective in instances when the investment is in a foreign bond fund that invests back into New Zealand government debt. This is because the obligation to provide a return in excess of the issue price would apply to the foreign fund holding the New Zealand debt, not between the New Zealand investor and the fund.

The principle underlying the Commissioner's making of a determination precluding use of the fair dividend rate method is that the method should not apply to investments in foreign entities that provide investors with a return similar to a New Zealand dollar denominated debt instrument. The determination process is intended to prevent investments that may otherwise be marketed as a New Zealand dollar denominated debt investment being held through an offshore entity to take advantage of the fair dividend rate method. For the purposes of making a determination described under category 4 the criteria that the Commissioner will consider will include:

- The proportion of the foreign entity's assets that comprise debt or other fixed return instruments (such as fixed rate shares).
- The extent to which the entity's investments comprising debt or other fixed rate instruments are denominated in New Zealand currency.
- In relation to investments of the entity that are not denominated in New Zealand currency, the extent to which the exchange rate risk has been removed by swaps, forward currency contracts or other derivatives.

The Commissioner will take into account the whole arrangement, including any interposed entities or financial arrangements, in ascertaining whether the investment in a foreign entity provides investors with a return similar to a New Zealand dollar denominated debt instrument.

The degree of credit risk of the entity's debt investments is not a relevant factor in the determination process.

In making any determination under section 91AAO of the Tax Administration Act 1994, the Commissioner will take into account the economic relationships created by the whole arrangement and the principle that the fair dividend rate method should only be used for an in-substance equity investment where the investor has an interest in the business profits and losses of a foreign entity. This determination process is intended to provide sufficient flexibility to deal with cases close to the boundary.

Determinations apply on a prospective basis only, unless the taxpayer would, in the absence of the determination, be subject to a shortfall penalty in respect of the investment that is affected by the determination. For investments in place before 18 December 2006 (date of enactment of the new offshore tax rules), the Commissioner will apply any determination from the start of the tax year beginning after the making of the determination. This will also be the general rule for other investments except for those investments designed to circumvent the restrictions on the use of the fair dividend rate method; determinations for these investments may apply from the date they are made.

The Australian "economic substance" test for determining whether an instrument is debt or equity provides guidance for determining whether an investment involves an effectively non-contingent obligation to return an amount to the investor that exceeds the issue price of the investment (as in category 3 above) and therefore should not have the fair dividend rate method applied to it, because the investment is essentially

debt. Contingencies that are immaterially remote are ignored for the purposes of this rule. Guidelines issued by the Australian Tax Office provide guidance on understanding what an “immaterially remote contingency” is.

A person who is not allowed to use the fair dividend rate method for an attributing interest because it comes within one of the five categories of “guaranteed return” investments must use the comparative value method for that interest, or the deemed rate of return method if the comparative value method is not practical because the person cannot obtain the opening market value for the interest (section EX 40B).

*Deemed rate of return method (section EX 40(5))*

A person may not use the deemed rate of return method for an attributing interest if the interest is a less than 10 percent shareholding in a foreign company and the person is not required to use the deemed rate of return method for the interest under section EX 40B (because it is “guaranteed return” form of investment).

*Comparative value method (section EX 40(6))*

A person may use the comparative value method for an attributing interest that is a share in a foreign company only if:

- the interest is 10 percent or more at any time in the income year (for this purpose, a person’s interests are increased by any interest held by associated persons); or
- the interest is a “guaranteed return” form of investment referred to in section EX 40(8)(a) for which the comparative value method or deemed rate of return method must be used under section EX 40B; or
- the person is a natural person or a family trust (defined as a qualifying trust established mainly for the benefit of natural persons related to the settlor or charities and which has no settlor who is not a natural person; the trust must also not be a superannuation scheme).

The main purpose of these restrictions is to prevent persons other than individuals or family trusts from using the comparative value method for less than 10 percent shareholdings in foreign companies and thereby potentially “cherry pick” between the fair dividend rate and comparative value methods by changing their investments between years. The restriction is also consistent with the fair dividend rate method being the primary calculation method for less than 10% interests in foreign companies.

*Cost method (section EX 40(10))*

The cost method is the back-up method to the fair dividend rate method and is designed to cater for less than 10 percent interests in foreign companies for which use of the fair dividend rate method is allowed. For example, it is not a “guaranteed return” form of investment but is not practical because the investor cannot determine the opening market value of the interest except by an independent valuation. An example of where the cost method may be used would be investments in unlisted

foreign companies. This method is therefore intended to cater for offshore portfolio investments for which market values are not readily available.

#### ***Default calculation method (section EX 41)***

The rules which allocate a default calculation method in situations when a person does not choose a particular calculation method for an attributing interest (as required under section EX 38(2)) and the foreign investment fund rules do not have the effect of requiring a particular method to be used, have been amended to cater for the new fair dividend rate and cost methods.

The default calculation method for less than 10 percent interests in foreign companies for which use of the fair dividend rate method is allowed (for example, the interest is not a “guaranteed return” form of investment) is the fair dividend rate method if it is practical to use that method. If it is not practical to use that method for such interests the default calculation method is the cost method.

In practice, the default calculation method rules give the Commissioner a basis for assessing an investor’s income if no tax return is filed.

#### ***Restrictions on change of calculation method (section EX 50)***

The general rule in EX 50(1) is that once a person uses a particular calculation method for an attributing interest in a foreign investment fund they must continue to use the same method for the interest in subsequent periods unless they are allowed a change of method under the other provisions of section EX 50.

The rules in section EX 50 allowing calculation methods to be changed have been amended to allow natural persons and family trusts to change as many times as they choose between the fair dividend rate and comparative value methods (section EX 50(8)). A family trust is defined as a qualifying trust established mainly for the benefit of natural persons related to the settlor or charities and which has no settlor who is not a natural person. The trust must also not be a superannuation scheme.

This ability to switch freely between the fair dividend rate and comparative value methods provides the mechanism for individuals and family trusts to pay tax on an amount lower than 5 percent of opening value under the fair dividend rate method if the total return on the investment, as calculated under the comparative value method, produces a lower amount.

A person may change from the fair dividend rate method if it is not practical to continue with that method because it is impossible to determine the start-of-year market value of the interest except by an independent valuation (section EX 50(2)(f)).

It is also possible to change from the cost method if that method was the default method under section EX 41 (which is the method a person must use for an attributing interest if they failed to choose a calculation method for the interest) and it ceases to be the default method under that provision (for example, if start-of-year market values become available so the fair dividend rate method becomes the default method).

### ***Consequences of change of calculation methods (section EX 51)***

The rules dealing with the consequences of changing calculation methods (if the change allowed under the other foreign investment fund provisions) have been amended to cater for the new fair dividend rate and cost methods.

When changing from the fair dividend rate or cost methods to the branch equivalent or accounting profits methods, or vice versa, there is a deemed disposal and reacquisition of the interest at market value at the start of the foreign investment fund accounting period to which the new method applies (section EX 51(1) and (2)).

When changing from the fair dividend rate method to the cost method there is a deemed disposal and reacquisition of the interest at market value at the start of the income year to which the new method applies. The opening value for the purposes of the cost method will be this market value (section EX 51(3)).

When changing from the cost method to the fair dividend rate or comparative value methods there is a deemed disposal and reacquisition of the interest at the start of the income year to which the new method applies at what would have been the opening value for the year under the cost method. This value will also be the opening value for the purposes of the fair dividend rate and comparative value methods (section EX 51(4)).

### ***Entry into and exit from foreign investment fund rules (sections EX 52, EX 53 and GD 14)***

The rules dealing with circumstances in which a person enters into or exits from the foreign investment fund rules have been amended to cater for the new fair dividend rate and cost methods.

When a person using the fair dividend rate or cost methods for an attributing interest in a foreign investment fund ceases to be resident in New Zealand they are deemed to have disposed of the interest at its market value at the time immediately before they cease to be a New Zealand resident (section EX 52(1) and (2)).

When a person becomes a resident of New Zealand and uses the fair dividend rate or cost methods for an attributing interest in a foreign investment fund for the period after the change of residence, they are deemed to have acquired the interest at its market value at the time of the change of residence (section EX 52(3) and (4)).

When a person holds property which becomes an attributing interest in a foreign investment fund because an exemption in sections EX 32 to EX 37 ceases to apply (or the NZ\$50,000 minimum threshold is exceeded) there is a deemed disposition and reacquisition at market value of the property at the time of its change in status if the person uses the fair dividend rate or cost methods for the interest (section EX 53(1) and (2)).

When a person holds property which ceases to be an attributing interest in a foreign investment fund because an exemption in sections EX 32 to EX 37 starts to apply (or the person falls below the NZ\$50,000 minimum threshold), there is a deemed disposition and reacquisition of the interest at market value at the time of its change in

status if the person used the fair dividend rate or cost methods for the interest before the change (section EX 53(5) and (6)).

When a person using the fair dividend rate or cost methods for an attributing interest disposes of the interest for nil or inadequate consideration they are deemed to have disposed of the interest at its market value at the time (section GD 14(1) and (2)).

When a person acquires an attributing interest in a foreign investment fund for consideration that is not equal to the interest's market value, and they use the fair dividend rate or cost methods for the interest, they are deemed to have acquired the interest at its market value at the time (section GD 14(3) and (4)).

***Transitional rules: values at which offshore interests enter the new rules (section EX 54B)***

All investments which become subject for the first time to the new foreign investment fund rules enter the new rules at their market value on the start date of the new tax rules. For most individuals this will be 1 April 2007.

This entry into the new rules at market value is achieved under section EX 54B(2) by a deemed disposition and reacquisition of the interests at their market value on the start date of the new foreign investment fund rules for the investor. This deemed disposition and reacquisition applies only for transitional purposes and, in particular, it does not set a new cost basis for the purposes of the \$50,000 minimum threshold for application of the foreign investment fund rules in sections CQ 5 and DN 6. The original cost basis applies for the purposes of the NZ\$50,000 threshold.

A person who holds their investments on revenue account, such as a managed fund, and which becomes subject to the new foreign investment fund rules may have a resultant tax liability because of the deemed disposition and reacquisition under section EX 54B(2). This liability can spread over three years beginning with the first year of application of the new foreign investment fund rules. At least one-third of this tax liability must be paid in the first year, half of the balance paid in the second year and the remaining balance paid in the third year (section EX 54B(3)(a)).

A person who has a tax liability because of the deemed disposition and reacquisition under section EX 54B is not liable to pay any penalty or interest for an inaccuracy in an estimate, or shortfall in the payment, of provisional tax if the inaccuracy or shortfall arises because of the deemed disposal (section EX 54B(3)(b)).