# Allowing a zero percent tax rate for non-residents investing in a PIE

*An officials' issues paper*

April 2010

*Prepared by the Policy Advice Division of Inland Revenue and by The Treasury*

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# 1. Introduction

1.1 The Capital Market Development Taskforce recommended pursuing opportunities to develop New Zealand as an exporter of high-value middle and back-office services for fund management companies in its final report to Government in December 2009. One of the areas the Capital Market Development Taskforce identified where New Zealand could export financial market services was an Asia Pacific funds domicile.[1] Our location in the Asia-Pacific region gives us the opportunity to develop a regulatory and tax regime that will support high-value middle and back-office functions to parts of the international financial services industry, such as funds management, and raise New Zealand's profile as a successful niche player in financial services.

1.2 The Government has therefore established a private sector advisory group to report back on how New Zealand can successfully position and market itself as an international funds domicile. The Government is also interested in how this positioning might create opportunities for strengthening New Zealand's funds management industry and capital markets, and raise New Zealand's profile as a successful niche player in financial services.

1.3 New Zealand generally operates a source-based taxation system where residents are taxed on their worldwide income and non-residents are taxed on their New Zealand-sourced income. However, non-residents investing in foreign assets through a portfolio investment entity (PIE) are currently taxed on income from the PIE as if they were residents. This treatment is inconsistent with how those investors would be taxed if they invested directly in those foreign assets and so is conceptually inconsistent with New Zealand's source-based taxation system.

1.4 A proposal to exempt foreign-sourced income derived by a non-resident through a PIE from New Zealand tax was raised in the report, *Creating Wealth for New Zealanders*.[2] This proposal was again raised during the Job Summit in January 2009.

1.5 Any decision to proceed with a proposal to allow a zero percent tax rate for non-resident investing in a PIE will need to weigh up potential benefits, costs and risks.

[1] A domicile is the legal "home" of a managed fund. These domiciles play a critical role in the international funds management infrastructure and generate local economic activity in funds administration.
[2] Stobo C., September 2008.

1.6 This issues paper seeks feedback on the benefits, costs and risks of options for allowing a zero percent tax rate for non-resident investors in a PIE. Under the changes suggested, non-resident investors would be taxed in the same way as investments that are made directly. This would be consistent with applying a source-based taxation model.

Officials are interested in feedback on the perceived benefits and compliance costs of the options outlined. In particular:

- Whether the funds management industry has a preferred option.
- Whether and why a minimum level of New Zealand-sourced income is useful under an option that is generally restricted to vehicles investing in foreign-sourced income.
- The appropriate level for the minimum threshold exemption.
- Whether the minimum threshold level should be an income or asset test.
- Whether the risks outlined in pages 4–7 to exempt foreign-sourced income derived by non-residents through a PIE are real risks, and the perceived likelihood of them occurring.
- The likelihood of the proposed benefits outlined in pages 3–4 occurring.

## How to make a submission

1.7 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for officials from Inland Revenue and the Treasury to contact you about your submission to discuss the points it raises. Submissions should be made by 4 June 2010 and be addressed to:

Allowing a zero percent tax rate for non-residents investing in a PIE
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington 6140

Or e-mail policy.webmaster@ird.govt.nz with "Zero percent PIE rate" in the subject line.

1.8 Submissions may be the source of a request under the Official Information Act 1982, which may result in their publication. 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 think any part of your submission should properly be withheld under the Act, you should indicate this clearly.

# 2. Benefits and risks of applying source-based taxation to non-resident PIE investors

2.1 Certain sectors of the financial services industry consider that, with the appropriate tax treatment in place, they could market investments in foreign assets through New Zealand PIEs to non-resident investors, resulting in the following benefits.

## Consistency with New Zealand's source-basis taxation model

2.2 Introducing a tax exemption for foreign-sourced income derived by a non-resident through a PIE would ensure consistency with New Zealand's source-basis taxation model.

2.3 New Zealand generally operates a source-basis taxation system where residents are taxed on their worldwide income and non-residents are taxed on their New Zealand-sourced income. However, non-residents investing in foreign assets through a PIE are currently taxed as if they were a New Zealand resident. This treatment is inconsistent with the way that investors would be taxed if they invested directly, and is inconsistent with our source-basis taxation system.

## Cost reductions for existing New Zealand firms who manage foreign funds

2.4 Currently, very few New Zealand firms manage investments for non-resident investors. This is due to the intensely domestic orientation of the local financial services industry. However, the financial services industry estimates that a tax exemption, such as that suggested in this issues paper, would result in $1 million a year cost savings based on the difference between foreign and local administration costs.

## Creation of new firms and relocation of foreign-based activity to New Zealand

2.5 It has been suggested that the tax exemption (in combination with some other regulatory measures) could lead to a percentage of global market back-room and administrative services being migrated to New Zealand. New Zealand is seen as being a suitable base for these services because of the regulatory framework, political stability, lack of corruption and exchange controls, and the difference in time zones which allows New Zealand to process overnight transactions which are made that day in Europe or the United States.

2.6 The financial services industry estimates that New Zealand could gain a market share of these activities after 10 years of development. Assuming revenues of 1 percent of assets under management and a 30 percent profit margin, this could create approximately NZ$1 billion of profits and approximately NZ$300 million in taxes.

## Spin-offs for local investors

2.7 The development of an "export"-focussed investment industry could have positive spin-off effects for New Zealand investors accessing the benefits of scale in the new funds. This could lead to a decrease in aggregate fees charged for fund administration and investment management services.

2.8 The potential benefits and costs of the suggested changes require further investigation. They include weighing the value of these potential back-room and administrative services against the fiscal costs and potential fiscal risks of implementing an exemption for foreign-sourced income derived by a non-resident through a PIE.

## Fiscal implications

2.9 The estimated fiscal cost of exempting foreign-sourced income derived by a non-resident through a PIE from New Zealand tax will depend upon the amount of foreign-sourced income currently derived by non-residents through managed funds.

2.10 Information provided by the funds management industry indicates that as at December 2008, overseas investments accounted for 40 percent ($22 billion) of total funds invested of $56 billion. With respect to the residency of investors, officials understand that less than 1 percent of investors in the New Zealand funds management industry are non-residents. Therefore, using the fair dividend rate of 5 percent as a measure of the returns earned on these investments, the estimated fiscal cost would be less than $10 million per annum.[3]

2.11 In carrying out a cost-benefit analysis, thought needs to be given to administrative and compliance costs associated with the suggested changes. These will depend on the detail of the particular option selected, should the Government decide to proceed.

[3] Estimated fiscal cost = $21,000,000,000 foreign investments made by managed funds * 5% FDR * 1% non-resident investors * 30% current NZ tax rate. In addition to the cost of exempting the foreign-sourced income of non-residents from New Zealand tax, some of the proposals include a de minimis exemption for certain investments in New Zealand assets. Allowing non-residents to have a zero percent tax rate in respect of New Zealand-sourced income will have an additional fiscal cost, depending on the de minimis limit selected.

## Ability for investors to re-characterise New Zealand-sourced income

2.12 Generally, income derived by an investor from a PIE is excluded income. This means an investor is able to claim tax deductions relating to that income – for example, management fees and interest incurred in borrowing to purchase units in the PIE.

2.13 In order to provide an exemption for foreign income derived by a non-resident investor in a PIE, PIE income that relates to offshore investments and that is allocated to a non-resident investor could be deemed to be foreign-sourced income of the investor. This would not be assessable income for New Zealand tax purposes. As a result, there would be no allowable deductions arising from the PIE investment to offset against any other New Zealand-sourced income. The technical position achieved would be consistent with a non-resident investing directly in foreign investments and with source-based taxation.

2.14 However, because of the fungibility of money, exempting foreign-sourced income derived by a non-resident through a PIE from New Zealand tax could still give rise to a practical fiscal risk. Even if a deduction is not technically available, it may be difficult to trace where funds have been applied.

2.15 This risk exists already with branch activities and is not an issue specific to exempting foreign-sourced income derived by a non-resident through a PIE from New Zealand tax.

## The ability for New Zealand investors to re-characterise as non-resident investors

2.16 There are also concerns that New Zealand investors could restructure to take advantage of the exemption.

2.17 A New Zealand investor who invests in a PIE that invests in foreign investments would currently have a prescribed investor rate (PIR) based on their marginal tax rate up to a maximum of 30%. However, if the changes suggested in this issues paper were to go ahead, the New Zealand investor could establish a foreign company which then invests in the PIE. The foreign company would be a controlled foreign company (CFC).

2.18 Under the new international tax rules, passive income derived by a CFC is attributable to and taxed in New Zealand. The definition of passive income does not include PIE income. As a result, it would constitute active income and no New Zealand tax would be collected.

2.19 This issue could be addressed by amending the definition of "passive income". However, if the CFC were an Australian company, it would be a grey list entity and therefore not subject to the attribution rules.

2.20 One potential solution to this issue could be to limit the exemption to individual non-resident investors or to exclude CFCs and non-resident trustees of trusts with a New Zealand settlor.

2.21 This solution could be viewed as undesirable as it would prevent the zero percent rate applying to many investors to whom it should apply – for example, foreign companies with no New Zealand shareholders.

## Manipulation of expenses between investor classes

2.22 There are also concerns that investors could restructure their apportionment of deductible expenses to take advantage of the exemption. This is unlikely to be possible within an investor class because of the comprehensive rules regarding attribution of income and expenses to individual investors. However, it may be possible between investment classes. This would occur where deductible expenses are disproportionately applied to investor classes which hold New Zealand-sourced assets as against classes which invest in foreign assets.

## International tax policy concerns with a tax exemption for offshore funds

2.23 The 1998 OECD report, *Harmful Tax Competition – An Emerging Global Issue*, outlined the factors used to identify harmful tax practices as:

- A low or zero effective tax rate on the relevant income.
- Ring-fencing to restrict the tax benefits to non-residents or prevent non-residents from accessing the domestic market. Ring-fencing effectively protects the sponsoring country from the harmful effects of its own incentive regime, so that the regime only has adverse effects on foreign tax bases. As a result, the country offering the regime may bear little or none of the financial burden of its own preferential tax legislation.
- A lack of transparency in the way the regime is designed and administered. Non-transparency is a broad concept that includes favourable application of laws and regulations, negotiable tax provisions, and a failure to make administrative practices widely available.
- A lack of effective exchange of information in relation to taxpayers benefiting from the operation of the preferential tax regime.

2.24 The OECD report recommended that member countries refrain from adopting new measures or extending the scope of existing measures that constitute harmful tax practices. As an OECD member, New Zealand is obligated to refrain from introducing any tax regime that contravenes the principles set out above.

2.25 The proposal to have a zero percent tax rate for non-resident investors in a PIE also raises wider international relationship issues. One of the conclusions from the April 2009 G20 summit was that member countries agreed to enforce sanctions on "tax haven" countries that are noncompliant with Article 26 of the OECD model tax convention for income and capital. Article 26 deals with tax information-sharing agreements between countries. Member countries also asked the OECD to publish a list of tax havens and their compliance with the information-sharing regulations. Therefore, the ramifications of introducing a harmful tax practice are wider than New Zealand's OECD membership responsibilities, and we should adopt a cautious approach in this area as:

- the boundaries of what is harmful tax competition are not clear cut;
- there is more scrutiny when introducing new regimes compared with extending or retaining existing regimes; and
- the proposals raise concerns about New Zealand's ability to meet its disclosure of information obligations.

2.26 The risks associated with New Zealand's international tax obligations will need to be considered carefully when suggesting different options for exempting foreign-sourced income derived by a non-resident through a PIE from New Zealand tax.

# 3. Potential solutions

3.1 Two high-level options have been identified for exempting foreign-sourced income derived by a non-resident through a PIE:

- A PIE with resident and non-resident investors and only foreign-sourced income. The non-resident investors would have a zero percent portfolio investor rate (PIR) for all income. Resident investors would have standard PIRs.
- A look-through global investment option that would allow a PIE to have both resident and non-resident investors and New Zealand and foreign-sourced income. The PIE would apply a different tax rate to different types of income derived by non-resident investors and it would therefore be necessary to track income from different sources, apportion expenditure to that income and allocate it to investors as if each stream were the only income derived by the PIE.

3.2 These options are discussed in more detail below.

## Option 1: PIE with resident and non-resident investors and foreign-sourced income

3.3 This option would allow resident and non-resident investors to invest in a PIE that derived only foreign-sourced income, with perhaps some allowance for a minimum threshold of investment in New Zealand equity and debt. The non-resident investors would have a zero percent PIR for all income of the PIE, including the minimum income threshold from New Zealand sources discussed below.

3.4 Income that relates to offshore investments and that is allocated to a non-resident would be deemed to be foreign-sourced income. A CFC and non-resident trustee of a trust settled by a New Zealand resident would be treated as residents for the purposes of applying the exemption.

3.5 In exploring the type and level of New Zealand-sourced income that could be allowed under a minimum threshold exemption, officials have compared the treatment a non-resident investor would receive if the investment were made directly with that received if the investment were made through the PIE. If the non-resident would be more favourably treated when investing through the PIE, we propose a restriction on that income. For example:

- **Interests in land.** A non-resident investing directly in an interest in New Zealand land pays New Zealand tax on any lease payments. A non-resident would be more favourably treated if they had a zero rate in a PIE with New Zealand-sourced income derived from an interest in land. Officials therefore propose that a PIE that holds a direct interest in land in New Zealand not be eligible for this treatment.

- **New Zealand equity.** If a non-resident invests directly in shares in a New Zealand company, and receives a fully imputed dividend, the dividend will generally have borne New Zealand tax of 30%. Where a dividend is not fully imputed, the non-resident investor will be subject to NRWT at 15% or 30%, depending on the double tax agreement that applies.

  A non-resident would be more favourably treated if they had a zero rate in a PIE which received non-fully imputed dividends. Officials therefore suggest that investments in New Zealand equities be excluded. However, it may be that a minimum holding would be acceptable if this was required to reduce administrative costs or to allow existing "global equity" or "balanced managed" type funds to participate.

  Any minimum threshold could be based either on the value of assets or on income. If asset-based, the PIE could hold no more than, say, 5 percent of the value of all its assets in New Zealand equities which distribute unimputed dividends. If an income-based test is applied, income from other entities that is neither fully imputed dividends nor excluded income would not be allowed to exceed 5 percent of all income derived by the PIE in a year. The income-based test is more sensitive in targeting investments that do not give rise to a concern but it is more administratively complex.

  Officials are interested in feedback on these alternatives and the possible level of a minimum threshold exemption.

- **NZ financial arrangements.** Interest paid to non-residents investing in New Zealand debt instruments is subject to an approved issuer levy (AIL) of 2 percent or NRWT. A restriction on investments in New Zealand financial arrangements by a PIE with zero-rated non-resident investors is therefore required. Officials propose a minimum level of New Zealand-sourced income from debt for administrative and liquidity purposes.

  The Government is looking at the feasibility of introducing an exemption from AIL and NRWT for New Zealand bonds issued to non-residents. The restriction on investments in New Zealand financial arrangements would be reviewed if the policy in relation to AIL changed.

  Financial arrangements involving hedging instruments, as defined by NZ IAS 39, would not affect the amount of New Zealand assets that the PIE can hold. The policy behind this is to allow for a PIE to hedge against foreign-exchange risk in New Zealand, as this hedging would otherwise occur offshore, with no benefit to New Zealand.

3.6 Provisions would be required to deal with a breach of the requirement to have only foreign-sourced income (outside the allowed minimum levels).

## Option 2: Look-through global investment option

3.7 This option would allow a PIE to have both resident and non-resident investors and New Zealand and foreign-sourced income. There would be no restriction on the New Zealand-sourced income but the PIE would apply a different PIR to different types of income derived by non-resident investors, as follows:

| Type of income | Prescribed investor rate to apply to non-resident investors |
| --- | --- |
| Foreign-sourced income | 0% PIR |
| Income from New Zealand equity | 0% PIR if the income has borne tax at a 30% rate<br>In other cases, the PIE would apply a PIR of 15% or 30%, depending on the appropriate double tax treaty rate |
| New Zealand financial arrangements | PIR of 2% on interest allocated to the non-resident |
| Income from interest in New Zealand land and other types of New Zealand sourced income | 30% PIR |

3.8 Income that relates to offshore investments and that is allocated to a non-resident would be deemed to be foreign-sourced income. A CFC and non-resident trustee of a trust settled by a New Zealand resident would be treated as residents for the purposes of applying the exemption.

3.9 It would be necessary to track income from different sources, apportion expenditure to that income and allocate it to investors as if each stream were the only income derived by the PIE. However, the PIE may establish its own rules (restrictions on the types of investors or investments) to reduce the number of permutations. The rules could also allow the use of minimum rather than actual PIRs. For example, a PIE which invested in New Zealand equity could apply a PIR of 15% (in relation to income of a non-resident of a treaty country) rather than separating income taxable at 15% from that taxable at 0%.

3.10 Despite the fact that there will be no tax liability in relation to foreign-sourced income under this option, the PIE would still be required to calculate and attribute net income, losses and tax credits to investors as if there were a tax liability. This is required to enable New Zealand to meet its exchange of information obligations under double tax agreements, to enable Inland Revenue to verify that the income of the PIE is from a foreign-source, and to cater for those taxpayers who have been incorrectly treated as non-resident.

## Proposed approach and submission points

3.11 Each option discussed above has a number of advantages and disadvantages.

3.12 Option one is a more flexible vehicle and is still relatively simple. Existing funds are more likely to fit within the criteria and an individual moving from non-resident to resident status can remain with the fund. However, this option has the disadvantage that ensuring the de minimis rules are not breached involves some compliance and administrative costs.

3.13 Option two should maximise marketing opportunities for the funds management industry, allowing non-residents to invest through a PIE in New Zealand assets at the right tax rate and receive the benefit of no New Zealand tax on disposal of New Zealand shares. For example, an Australian investing in New Zealand debt through the PIE, who currently is taxed at 30%, would be taxed at 2%.

3.14 Option two also provides maximum flexibility to use existing funds, allowing fund managers to tailor funds to accommodate the degree of complexity they can handle. There is also no requirement to monitor minimum thresholds under this option.

3.15 Option two does, however, have significant disadvantages. There is administrative complexity for the PIE in tracing different sources of income and apportioning expenditure. The legislation is likely to be complex and this option also has the highest administrative costs for Inland Revenue. Finally, the marketing advantage may be overstated as it is unlikely that the tax paid by the PIE is creditable in a foreign jurisdiction. As a result, there may be a disincentive to invest in New Zealand assets through a PIE.

3.16 Officials are interested in feedback on the perceived benefits and compliance costs of the options outlined. In particular:

- Whether the funds management industry has a preferred option.
- Whether and why a minimum level of New Zealand-sourced income is useful under option one.
- The appropriate level for the minimum threshold exemption under option one.
- Whether the minimum threshold level should be an income or asset test.
- Whether the risks outlined in pages 4–7 to exempt foreign-sourced income derived by non-residents through a PIE are real risks, and the perceived likelihood of them occurring.
- The likelihood of the proposed benefits outlined in pages 3–4 occurring.