# Supplementary Order Paper 220: Taxation (Tax Administration and Remedial Matters) Bill

*Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill*

**May 2011**

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

# CONTENTS

# Foreign investment PIE rules

## FOREIGN INVESTMENT PIES – BACKGROUND

Supplementary Order Paper (SOP) No 220 to the Taxation (Tax Administration and Remedial Matters) Bill contains a proposal to amend the portfolio investment entity (PIE) tax rules to remove the current over-taxation of non-resident investment in PIEs.

The changes are intended to ensure that non-resident investors in portfolio investment entities (PIEs) are taxed on their foreign-sourced and New Zealand-sourced income in roughly the same way that they would be taxed if they invested directly. This will significantly reduce the tax rates that apply to non-residents investing into PIEs, thereby making investment in PIEs more attractive to non-residents. In turn, this could facilitate the establishment of an international investment funds domicile in New Zealand.

Currently, non-resident investors in PIEs are taxed at 28 percent on their PIE income, irrespective of whether the income is earned from foreign or New Zealand assets. This means that they are over-taxed in comparison with the tax rates that they would face if they invested directly in those assets. In particular, in the case of direct investment by a non-resident into foreign-sourced assets, the income is not subject to New Zealand tax. This is because of the general principle underlying the tax system that non-residents should only be subject to tax on their New Zealand-sourced income.

The SOP seeks to amend the bill by effectively introducing two new categories of PIEs that entities can elect into (and which both residents and non-residents could invest in). The first category of foreign investment PIE is one that invests the vast majority of its funds offshore (a "zero rate foreign investment PIE"). Foreign investors in this category of PIE face a 0% tax rate on all of their attributed income. The second category is one that invests its funds both in New Zealand and offshore (a "variable rate foreign investment PIE"). Foreign investors in this category of PIE face various tax rates, depending on the source and type of the income.

The rationale for having two categories is that it provides flexibility to both PIEs and non-residents in terms of deciding whether to invest into foreign or New Zealand assets. A further reason for having two categories is to accommodate the wide range of systems that PIEs use to administer their investments.

## OVERVIEW OF SUBMISSIONS

The following 14 parties made submissions on the bill:

- AMP Capital
- Appello
- Corporate Taxpayers Group (CTG)
- Ernst & Young
- Fonterra
- Investment Savings & Insurance Association of NZ (ISI)
- Kiwi Bank
- KPMG
- MinterEllisonRuddWatts
- New Zealand Institute of Chartered Accountants
- New Zealand Law Society
- New Zealand Superannuation Fund
- PwC
- Russell McVeagh

All submissions supported the policy underlying the proposed changes and the direction of the proposed reform. A number of substantive policy issues were raised. These are discussed in the first section of this report. In addition, submitters recommended numerous other changes in order to address technical issues with the proposed rules and to ensure that PIEs can make the proposals work without too much difficulty. These are discussed in second section to our report.

# MAIN POLICY ISSUES RAISED IN SUBMISSIONS

## Issue: Approved Issuer Levy

***Clause 18H***

**Submission**

*(ISI, Fonterra, KPMG, Russell McVeagh, New Zealand Law Society, New Zealand Institute of Chartered Accountants, PwC, MinterEllisonRuddWatts & New Zealand Superannuation Fund)*

The 1.44% rate that approximates the Approved Issuer Levy (AIL) on financial arrangements should be reduced to 0%. This would be consistent with proposed legislation in the Taxation (International Investment and Remedial Matters) Bill to exempt AIL from certain widely held bonds.

Alternatively, if this is not accepted, AIL should only be applied to the interest that is attributable to non-residents. Both realised and unrealised gains on financial arrangements should be treated as foreign sourced income and not subject to tax.

If AIL is applied to the capital gains on financial arrangements (as in the current bill), it should only be imposed on the net amount derived from all financial arrangements.

**Comment**

Officials do not agree that the 1.44% that approximates AIL on financial arrangements should be reduced to 0%. The proposal to apply 0% AIL on certain widely-held bonds that is contained in the Taxation (International Investment and Remedial Matters) Bill is deliberately narrow in its scope. Applying a 0% rate to interest attributable to non-residents in foreign PIEs would extend the scope of the proposal and give rise to some fiscal risk.

However, officials agree that the 1.44% that approximates AIL should only apply to interest that is attributable to non-residents and should not apply to the capital gains on financial arrangements. This reflects the treatment that non-residents would have received if they had received the interest directly.

**Recommendation**

That the submission to extend the 0% AIL proposal to interest attributable to non-residents in foreign PIEs be declined.

That the submission to apply the 1.44% that approximates AIL to interest only be accepted.

## Issue: NRWT Option – pass unimputed dividends on to investors within two days

***Clause 18D***

**Submission**
*(ISI, KPMG, New Zealand Institute of Chartered Accountants & CTG)*

In order to withhold non-resident withholding tax (NRWT) from unimputed dividends received by foreign investment PIEs, the proposed supplementary order paper requires that such dividends are paid on to non resident investors within 2 days of receipt.

The requirement to pass on the unimputed dividends so soon after they are received may impose significant compliance costs on some funds.

The two day requirement should be extended to allow time for funds to pool dividends and pay these amounts out as part of a single distribution quarterly or six monthly rather than immediately post receipt.

**Comment**

Officials agree with the submission. PIEs should be given more flexibility to distribute and withhold NRWT on unimputed dividends. An amendment should be made that allows foreign investment PIEs to withhold NRWT from unimputed dividends if the dividends are paid to non resident investors before the PIE is required to pay its tax liability. In most cases this means the dividends would need to be distributed within 1 month of the end of the tax year. If the distribution of the unimputed dividends is not made within 1 month of the end of the tax year the PIE would be liable to pay tax on dividends (rather than withholding NRWT).

**Recommendation**

That the submission be accepted.

---

## Issue: Making the FITC regime available for foreign investment PIEs

**Submission**
*(Fonterra, KPMG, CTG & New Zealand Institute of Chartered Accountants)*

The foreign investor tax credit (FITC) regime should be made available to foreign investment PIEs. This would provide foreign investors with the same tax treatment on fully imputed dividends received from New Zealand resident companies as they would have received if they had invested directly.

**Comment**

In principle officials agree that the FITC regime should be recreated in the foreign PIE rules as it would provide consistency with direct treatment. However, the FITC tax rules are technically complex. In essence, they ensure that, for certain equity investments in New Zealand resident companies by non-residents, New Zealand tax is limited to 28%.

To achieve the same result for non-resident investing through a foreign investment PIE, would be very complicated. Therefore, given this complexity and the short timeframe, we are not confident that it is feasible to design rules that would work appropriately and could be administered by PIEs. To do this properly would require more time and consultation. Submitters have provided officials with some useful material that could form the basis of a proposal for future consultation. It is recommended that officials consult on a proposal to recreate FITC through foreign investment PIEs with a view to including it in a later tax bill.

**Recommendation**

That the proposal to extend FITC to investments through foreign investment PIEs not be proceeded with at this stage but is considered for inclusion in a future tax bill.

---

## Issue: Land investment companies

***Clause 18H***

**Submission**
*(ISI, KPMG, New Zealand Law Society, New Zealand Institute of Chartered Accountants & Ernst & Young)*

A foreign investment variable rate PIE should be allowed to invest in land investment companies.

**Comment**

Officials agree that foreign investment variable rate PIEs should be able to have some exposure to New Zealand land investments. This can be achieved through investments in "land investment companies" (essentially companies that have land as their only asset). However, officials have some concerns if a foreign investment PIE were allowed to hold 100% of a land investment company resident in New Zealand. The concern is that the foreign investment PIE could find methods to transfer otherwise non-deductible expenditure to an entity it owns that is able to utilise the deduction.

Therefore it is recommended that an amendment be made that allows a foreign investment PIE to hold up to 20% of a land investment company resident in New Zealand. This is consistent with the general principle in the PIE rules that PIEs can generally own up to 20% of any entity invested into. Foreign investment PIEs would be able to own up to 100% of a land investment company resident outside of New Zealand.

For similar reasons, it is also recommended that PIEs should only be allowed to own up to 20% of an entity that is not PIE but could qualify for PIE status.

**Recommendation**

That a foreign investment PIE be allowed to:

- hold up to 20% of a land investment company or an entity that is not a PIE but qualifies for PIE status; and
- hold up to 100% of land investment company resident outside new Zealand.

---

## Issue: Increased de minimis – 5% and 1%

***Clause 18H***

**Submission**
*(CTG, New Zealand Institute of Chartered Accountants, Appello & New Zealand Institute of Chartered Accountants)*

The proposed de minimis thresholds should be increased to ensure that foreign investment PIEs can successfully operate within the regime.

Specifically, the 1% de minimis for New Zealand equities that track a global index should be increased to 5% regardless of whether the fund tracks a global index, and the 5% de minimis for assets producing New Zealand sourced interest income should be increase to at least 10%.

**Comment**

The proposals as currently drafted would allow a foreign investment PIE that has the vast majority of its investments offshore to apply a zero percent rate for its offshore investors. This represents a big simplification benefit for these PIEs. However, there are two de-minimis concessions in the rules as currently drafted. The first would allow the PIE to have up to 5% of its assets as New Zealand sourced financial arrangements – provided that they provide a return that is short-term or cash in nature. This is designed to provide the PIE with sufficient liquidity to run its day-to-day operations (e.g. funding redemptions, paying expenses etc). The second de-minimis concession allows the PIE to have up to 1% of is assets as New Zealand equity. This would allow a PIE that tracked a global index (of which New Zealand makes up less than 0.1%) to continue to apply a zero percent rate to all the returns to non-residents.

Officials do not agree with the submission to increase the 5% de-minimis for New Zealand financial arrangements. Officials consider that the 5% de minimis for assets producing New Zealand sourced interest income is sufficient to ensure the foreign investment PIEs can hold enough cash reserves to meet applications, redemptions and day-to-day expenses, without disqualifying the foreign investment PIE.

Furthermore, officials consider the current 1% de minimis for New Zealand equities that track a global index is generous given New Zealand's share of the global index is only about 0.06% (according to MSCI indices).

**Recommendation**

That the submission be declined.

---

## Issue: Wholesale fund – incoming flowing through should retain character

**Submission**
*(KPMG, ISI, Fonterra & New Zealand Institute of Chartered Accountants)*

The supplementary order paper does not address the "flow through" of income from a wholesale PIE to a retail PIE. The income of the wholesale fund should retain its character when allocated to the retail PIE.

**Comment**

Officials agree with the submission. The income allocated to a foreign investment PIE from a wholesale PIE should be treated as if the foreign investment PIE earned the income directly. This prevents income earned from foreign investments made by the wholesale PIE in New Zealand being re-classified as New Zealand sourced income when it is allocated to the foreign investment PIE.

However, officials understand that some wholesale PIEs will not be able to provide this 'flow through' treatment of income. Therefore, an amendment to allow this treatment should be elective.

**Recommendation**

That the submission be accepted.

---

## Issue: Exclusion from the source rules should be broadened

***Clause 18H***

**Submission**
*(NZ Law Society & Russell McVeagh)*

A further exemption from the source rules should be made so that income of a foreign investment PIE does not have a New Zealand source merely because a contract is made or performed in New Zealand.

**Comment**

Officials do not consider a further exemption from the source rules is necessary. While it is possible that the current source taxation rules do not operate appropriately in all cases, aspects of these rules are being considered separately as part of the current review of non-resident investment in New Zealand limited partnerships.

The exemption as currently drafted would prevent offshore income earned by a foreign investment PIE being given a New Zealand source simply because the PIE operates a business in New Zealand. This exemption would appear to be sufficient to enable the new foreign PIE regime to operate.

**Recommendation**

That the submission be declined.

## MINOR POLICY ISSUES RAISED IN SUBMISSIONS

### Issue: Relaxing the restriction on expense deductibility for non-resident investors

***Clause 6B***

**Submission**
*(Fonterra & KPMG)*

As currently drafted, a foreign investment PIE will not be allowed to claim a deduction for expenses incurred in relation to its foreign investors. This mirrors the treatment of a non-residents investing directly in New Zealand equities and debt.

However, this may not be the appropriate comparator. Instead a more appropriate comparison is a non-resident investors investing in a New Zealand company. Non-resident investors in a New Zealand company will incur costs from making and holding investments – including fund administration and management costs. These costs will predominantly be incurred by the company in relation to the shareholder and the company will be able to claim a deduction for them.

Therefore, deductions should be allowed for expenditure relating to non-resident investors in foreign investment PIEs.

**Comment**

Officials disagree with the submission. The appropriate comparator is if the non-resident had invested in the New Zealand securities directly and had directly incurred administration and holding costs. These costs would not be deductible against the income derived from the securities (e.g. dividends or interest) as the income would be taxed on a gross basis (e.g. NRWT or AIL). It is therefore not appropriate to allow a deduction for these costs if the person chooses to incur the expenses via the PIE rather than directly.

**Recommendation**

That the submission be declined.

## Issue: Broaden the allowable amounts of income that have a New Zealand source

***Clause 18H***

**Submission**
*(Russell McVeagh & New Zealand Law Society)*

For the purposes of the 5% de-minimis that applies to zero rate foreign investment PIEs, the allowable amounts of income that have a New Zealand source should be broadened to include all income from financial arrangements, and not only interest income.

Furthermore, amounts from call accounts should be included as allowable amounts. Currently drafted, the supplementary order paper allows only interest income from financial arrangements with a term 90 days or less. A call account has no term, and therefore arguably does not meet this requirement.

**Comment**

Officials consider that the foreign investment PIE should be allowed to hold New Zealand sourced derivatives and other similar financial arrangements (separate from the 5% de-minimis) if they relate to its foreign holdings (for example, a derivative that removes currency risk in relation to foreign shares). This is appropriate as the financial arrangement can be seen as part and parcel of the offshore investment.

Officials also agree that call accounts should be included as an allowable amount in the 5% de-minimis as the income from these is likely to be used for managing day-to-day expenses.

**Recommendation**

That the submission allow foreign investment PIEs to hold New Zealand sourced derivatives be accepted in part. The derivatives that should be permitted are those that relate to the foreign investment PIEs foreign holdings.

The submission to allow an amount from a call account to be included as an allowable amount in the 5% de-minimis also be accepted.

---

## Issue: Rules should allow non-residents to invest in other widely held investment vehicle

**Submission**
*(New Zealand Institute of Chartered Accountants & New Zealand Superannuation Fund)*

The proposed rules should allow non-residents to invest in other widely held investment vehicles such as limited partnerships and unit trusts.

**Comment**

The submission is beyond the scope of the current proposals and raises a number of complex policy issues.

**Recommendation**

That the submission be declined.

---

## Issue: The definition of what a foreign investment PIE can invest in should be extended

***Clause 18H***

**Submission**
*(New Zealand Superannuation Fund)*

The definition of what a PIE can invest in should be extended to cater for private market activity like private equity and infrastructure investments where a fund may hold greater than 20% interest in a particular investment.

**Comment**

PIEs are designed to be passive investment vehicles and are therefore generally restricted to owning only portfolio interests in companies. This is to prevent PIEs from earning active income from running businesses. We do not consider this rule should be any different for foreign investment PIEs.

**Recommendation**

That the submission be declined.

---

## Issue: Round tripping – Section EX 29(6), anti-avoidance provision

***Clause 10C***

**Submission**

*(CTG, KPMG, Ernst & Young & New Zealand Institute of Chartered Accountants)*

The current exemptions from the foreign investment fund (FIF) rules exemptions do not apply when the FIF holds an interest in a foreign investment PIE. Due to information constraints this rule should not apply.

An individual investor is not likely to be aware of what investments their Australian company may hold and obtaining the information may be administratively complex. The provision does not set a minimum holding by the FIF in a foreign investment PIE investment and therefore the investment may not be separately identified in the company's publicised accounts.

Officials are concerned that a resident would be able to invest into an Australian company that is exempt from the FIF rules with the FIF then receiving zero-rated offshore income (or 1.44% on NZ based interest), making the resident only liable for income tax on actual dividends received from the Australian company. A better approach would be to address this issue through the avoidance provisions.

In addition, the rules do not work appropriately for transitional residents.

**Comment**

After further consideration, officials agree that proposed section EX 29(6) (and consequentially, section CQ 5(6)) is unnecessary. There is very little risk that investors could gain significant tax advantages through exemptions in the FIF rules by investing in a foreign company that then invests in a foreign investment PIE in practice. However, officials will monitor this.

If this amendment is made, we do not consider that a specific anti-avoidance provision or other replacement for section EX 29(6) would be necessary.

**Recommendation**

That the submission to remove section EX 29(6) be accepted.

---

## Issue: Section HM 55D – Investor requirements

***Clause 18H***

**Submission**

*(New Zealand Law Society & Ernst & Young)*

If an investor does not meet the non-residence requirements, or does not provide the PIE with certain information to ensure the person qualities as a non-resident investor, the PIE must treat the person as a non-resident and apply a 28% tax rate.

This treatment is appropriate when there is a failure to provide the necessary information. However, this treatment is not appropriate in regards to the non-residence requirement. The PIE should not be required to look behind the investor’s representations and determine whether they qualify as a foreign investor.

This treatment should be the same as when resident notifies an incorrect prescribed investment rate - the PIE should apply the rate they have been given.

**Comment**

Officials agree that a PIE should not be required to look behind an investor’s notification of foreign investor status. If a resident notifies a foreign investment PIE that they are a notified foreign investor, the PIE should be able treat the investor according to their notification. The consequences of any misrepresentation should fall on the investor under section CX 56 (where PIE income is taxed to the investor in certain circumstances).

Officials recommend that the submission be accepted.

**Recommendation**

That the submission be accepted.

## Issue: Merge the proposed categories of foreign investor PIEs

**Submission**
*(CTG & MinterEllisonRuddWatts)*

The new foreign investment PIE rules enable funds to elect into two categories of PIE. The first category of PIE is the zero rate foreign investment PIE that can have both resident and non-resident investors and derive mostly foreign-sourced income, but with a de minimis of 5% for New Zealand-sourced interest income and 1% de minimis for holding New Zealand shares. The second category of PIE is the variable rate foreign investor PIE that can have both resident and non-resident investors and both New Zealand and foreign-sourced income.

Much of the complexity with the current proposal derives from the creation of the two classes of foreign investment PIE. A further complication is the need to track different income types and applying different tax rates within the foreign investment variable rate PIE.

Therefore, the two categories of foreign investor PIEs should be merged, with a zero percent rate for all income except unimputed dividends. This would greatly simplify the regime.

Alternatively, the foreign investment PIE rules should apply to classes within a multi-rate PIE. This could be done by extending the definition of foreign investment PIE to include a multi-rate PIE which has an investor class that meets the requirements of that definition.

**Comment**

Officials disagree. The policy rationale for developing the foreign investment PIE proposal was to allow the tax treatment of investors in a PIE to match that of a direct investor. In the case of a PIE that invests in New Zealand assets, this is necessarily complicated due to the range of rates that apply to different direct investments. Merging the two types of PIE so that a 0% tax rate applied to most New Zealand investments would compromise this principle and would amount to a tax concession.

On allowing the foreign PIE rules to apply to classes within a multi-rate PIE, officials note that this is currently possible within the existing proposal. A multi-rate PIE would be able to elect to become a foreign investment PIE but operate only some classes under the new regime to cater for notified foreign investors.

**Recommendation**

That the submission be declined.

---

## Issue: Standard NRWT rate for unimputed dividends

***Clause 18B***

**Submission**
*(CTG)*

Under the current proposal NRWT rate on unimputed dividends will be 15% or 30%, depending on whether the investor is resident in a double tax agreement (DTA) country.

The NRWT rate on unimputed dividends should be 15% regardless of whether the investor is a resident in a DTA country. Given that New Zealand's DTA network is expanding, providing two rates is an over-complication.

**Comment**

The aim of the foreign investment PIE rule was to tax a non-resident investor in a PIE as if they had invested directly. For an investor from a non-DTA country this would mean any unimputed dividends should be taxed at 30%. Officials do not see any reason to depart from this principle.

**Recommendation**

That the submission be declined.

---

## Issue: Exemptions from New Zealand tax

***Clause 18H***

**Submission**
*(New Zealand Superannuation Fund)*

There should be an exemption from New Zealand tax, including AIL, for notified foreign investors' share of New Zealand sourced income that arises from investing any surplus cash with New Zealand financial institutions.

**Comment**

For a zero rate foreign investment, officials consider that the 5% de minimis should adequately cater for investment of surplus cash.

For other foreign investment PIEs that have a portfolio that includes investment in New Zealand debt, officials consider that New Zealand tax should continue to apply. This is consistent with the treatment of a direct investor investing in New Zealand debt.

**Recommendation**

That the submission be declined.

## TECHNICAL ISSUES RAISED IN SUBMISSIONS

### Issue: Application date for the variable rate option

**Submission**
*(KPMG)*

There are two application dates for entities choosing to be a foreign investment PIEs, date of enactment for the zero rate foreign investment PIEs and 1 April 2012 for the variable rate foreign investment PIEs. An entity that can implement the relevant system changes by 1 April 2012 should be allowed to apply the foreign investment PIE rules from the start of a quarter for example 1 October 2011.

**Comment**

To correctly apply the foreign investment PIE rules the entity would need to have its system changes made from the day they become a foreign investment PIE. It would not be enough for a PIE to have the necessary upgrades in place by 1 April 2012, as investors may wish to leave the PIE during the year, which would trigger a tax calculation. An earlier application date would also place additional pressure on Inland Revenue to release its specifications and upgrade its systems which would increase administrative costs.

**Recommendation**

That the submission be declined.

### Issue: Flexibility of application of denying deductions

***Clause 6B***

**Submission**
*(KPMG & MinterEllisonRuddWatts)*

The PIE industry uses different systems and therefore there needs to be flexibility to allow the PIE to achieve the end result of denying deductions for notified foreign investors. The current drafting requires the PIE to deny the deduction before the income is attributed to an investor. This forces the PIE to make two different calculations and drives the need to identify and split the income and deduction up front. Some existing PIEs would prefer to be able to make the adjustment for the deductions by way of add back.

The denial of deductibility comes at the wrong stage of the calculation because, under the calculation rules, it is not until there is a net amount of income in each class that amounts can be attributable to each investor. To correct this, we suggest that section DB 54B(1) is modified to deny the deductibility at the investor class level.

Alternatively, a PIE should be able to apply the variable rates directly to the unimputed dividends and interest income.

**Comment**

Officials agree that foreign investor PIEs should have flexibility in how the effective denial of deductions is achieved.  How the denial of deductions is achieved will clearly differ depending on the systems of the PIE.  The legislation is not intended to prescribe how a foreign investment PIE derives the correct result, provided the end result is equivalent to the result that would be achieved by applying proposed section HM 35C.

Officials will clarify this in the Tax Information Bulletin that is published after the legislation is enacted.

**Recommendation**

That the submission be noted.

---

## Issue: Zero rate on unimputed dividends attributed to notified foreign investors

***Clause 18B***

**Submission**
*(KPMG)*

A foreign investment PIE that attributes unimputed dividends to a notified foreign investor will be required to calculate tax on that income, a 15% rate for investors in countries with which we have a double tax agreement and a 30% rate for other investors. The unimputed dividends will be sourced from untaxed (i.e. capital gains) or foreign income that exceeds the FIF income calculated under the fair dividend rate.

This type of income, if earned directly by non-residents, would not be taxed in the investor’s hands. Further, foreign tax credits associated to foreign sourced income may not be fully utilised.

**Comment**

Officials do not agree with this submission. If unimputed dividends attributable to a non-resident investor and derived by a foreign investment PIE were taxed at zero percent, it would make the tax treatment of such dividends derived by a foreign investment PIE tax favoured compared to unimputed dividends derived directly.

**Recommendation**

That the submission be declined.

---

## Issue: Transitional residents investing in variable rate foreign investment PIEs

**Submission**
*(KPMG)*

There does not appears to be any policy reason why a transitional resident investing in a foreign investment variable rate PIE should not be afforded notified foreign investor treatment.

**Comment**

Officials disagree. Transitional residents (essentially new residents to New Zealand) are provided a four year exemption on their foreign sourced investment income. New Zealand sourced investment income is fully taxed to transitional residents from day one. Therefore, if a transitional resident invests in a foreign investment PIE that derives New Zealand sourced income, the PIE should pay tax in relation to the transitional resident on the basis they are a New Zealand resident.

**Recommendation**

That the submission be declined.

---

## Issue: Non-resident trustees be notified foreign investors

**Submission**
*(KPMG & Ernst & Young)*

There is no reason why a non-resident trustee of a trust that is not a foreign trust (a "New Zealand trust") should barred from being a notified foreign investor in income years where there is no New Zealand settlor of the trust.

**Comment**

Officials do not agree. If the submission were accepted, New Zealand resident beneficiaries could receive the benefit of the treatment designed to apply to non-residents. For example, if the trust had offshore investments that would normally be subject to tax on an imputed 5% return under the fair dividend rate rules, because the trustee was treated as a notified foreign investor the tax would be reduced to zero. This is not the correct result.

**Recommendation**

That the submission be declined.

---

## Issue: Change of residency status

***Clause 18H***

**Submission**
*(MinterEllisonRuddWatts, KPMG, Ernst & Young, New Zealand Law Society, New Zealand Institute of Chartered Accountants, & PwC)*

The treatment of change of residency status in the supplementary order paper is not clear.

**Comment**

It is important that the foreign investment PIE rules handle situations where investors change their status midway through a year. This can happen in two main ways. First, a resident investor can change part-way through a year to being a non-resident investor (entitled to be a notified foreign investor). The second is that a notified foreign investor can become a New Zealand resident investor part-way through a year.

The policy underlying the bill as currently drafted is designed to strike an appropriate balance between accuracy of tax treatment and sufficient flexibility for foreign investment PIEs. The intention of the rules as drafted is that, for resident investors that become non-resident, the PIE upon notification of the change of status should be able to treat the investor as a notified foreign investor from the day of notification, if they are able to do so, but no later than the start of the next tax year.

If the investor has misrepresented their status to the PIE by indicating that they are a non-resident when in fact they are a resident, the rules should ensure that the income attributable to the period where the PIE has treated them as a notified foreign investor should be taxable to the investor as if they were a resident (with credits for any tax paid at the PIE level).

For a non-resident investor that becomes a resident investor, the policy of the rules as drafted is that, upon notification, the foreign investment PIE has the choice of changing the investor's status immediately or waiting until the beginning of the next tax year to do so. If the PIE waits, the investor can continue to be treated as a notified foreign investor for the tax year and any income that is attributed to the investor during this transitional period is not subject to further tax at the investor level. Amongst other things, this is to handle situations when residency applies retrospectively, i.e. due to the application of the 183-day rule.

A number of very useful submissions have been received on clarifying the provisions to ensure that they meet these policy objectives. These will be taken into account in redrafting these provisions to clarify the policy intention.

**Recommendation**

That the submissions be noted and taken into account when the provisions are redrafted.

---

## Issue: Non-portfolio FIF exclusion from notified foreign investor status

**Submission**
*(KPMG & New Zealand Institute of Chartered Accountants)*

The exclusions for persons who cannot be a notified foreign investor should also include persons that hold 10% or more interest in a non portfolio FIF.

**Comment**

Investors that are not subject to the current FIF rules, because they own more than 10% of the foreign company and are not subject to the CFC rules because they do not have a controlling interest, currently have an exemption from the FIF rules for investments in eight of our biggest trading and investment partners (e.g. USA, UK, Australia). Under the rules, as currently drafted, it would be possible for these investors to invest into a foreign company who is resident in, for example, Australia, which in turn invests in a foreign investment PIE. The foreign investment PIE could apply a 0% rate to this investment and the New Zealand resident investor could ultimately pay no New Zealand tax.

**Recommendation**

That the submission be accepted.

---

## Issue: Reporting amounts inclusive of non-deductible expenses

**Submission**
*(KPMG)*

There is no tax effect when the zero rate is applied to either the gross assessable income or net taxable income so the PIE should not need to adjust for denied expenditure.

**Comment**

The PIE income tax return contains a declaration to the correctness of the information. Allowing the PIE to record non-deductible expenses would not be appropriate.

**Recommendation**

That the submission be declined

---

## Issue: Section HM 71B is overreaching

***Clause 20F***

**Submission**
*(Ernst & Young, New Zealand Institute of Chartered Accountants & KPMG)*

In order to become a foreign investment PIE an entity must currently meet the conditions of HM 8 to 17 and HM 20. This requirement is much stricter than the entry rules for normal PIEs, which only requires the conditions of sections HM 8 to HM 10, HM 17, HM 18 and HM 20 to be met.

It is unclear if the exemptions to sections HM 14 and HM 15 provided by sections HM 21 and HM 22 are taken into account for the entry rule.

The reference to HM 55B in the entry rules is confusing as only section HM 55(2)(f) is relevant to entry into the foreign investment PIE regime.

**Comment**

HM 71B should be amended to be more consistent with the current PIE entry rules. This would address the concerns raised in submissions.

**Recommendation**

That the submission be accepted.

---

## Issue: Section HM 55H(3)(b)

***Clause 18H***

**Submission**
*(Ernst & Young)*

The proposed rules provides breach rules if a foreign investment PIE fails to meet the modified criteria of section HM 55B. However, there does not appear to be any rules governing when a foreign investment PIE breaches the normal PIE rules.

**Comment**

A foreign investment PIE is a type of PIE, consequently the normal breach rules that apply to PIEs will also apply to foreign investment PIEs. No specific rules are required.

**Recommendation**

That the submission be noted.

---

## Issue: Section HM 71B – electronic elections

***Clause 20F***

**Submission**
*(Ernst & Young)*

An entity that is not currently a PIE is able to electronically elect to be a foreign investment PIE under section 31B of the Tax Administration Act. However, this option is not available to entities that are already PIEs. They are required to ring or write to Inland Revenue to elect to become a foreign investment PIE.

In addition, the cancellation of foreign investment PIE status should also be able to be performed electronically.

**Comment**

A foreign investment PIE is only a type of PIE and so does not warrant the development of a specific election system. The costs of such a system would outweigh the benefits.

Cancellation of PIE status is currently done electronically. While a notification of a PIE changing its type is done manually. Officials see no reason to change this for foreign investment PIEs.

**Recommendation**

That the submission be declined.

---

## Issue: Section HM 55B – restrictions on non-New Zealand investments

***Clause 18H***

**Submission**
*(Ernst & Young)*

Section HM 55B(2)(a) states that a foreign investment PIE cannot hold land in New Zealand and that section HM 11(a), which provides that a PIE can invest into land, does not apply. Section HM 11(a), however, does not have any territorial limitation. It is therefore unclear whether a foreign investment PIE is allowed to own non-New Zealand land. A similar issue arises with sections HM 55B(2)(c) and (d), which also relate to income from land.

**Comment**

Officials agree that, as drafted, these restrictions are unclear. The intention is that a foreign investment PIE should not be able to own New Zealand land directly but should be able to own non-New Zealand land directly. We recommend that the section be amended to clarify this.

**Recommendation**

That the submission be accepted.

---

## Issue: Section HM 55B – no prohibition on rights or options in land

***Clause 18H***

**Submission**
*(Ernst & Young)*

As drafted, there is no prohibition on a foreign investment PIE having a right or option in land. Given the general restrictions on direct investment in land, whether this is intended or not should be clarified.

**Comment**

Officials consider that a foreign investment PIE should not be able to directly own rights or options over land. The scheme of the PIE rules is that rights or options over assets are allowed only if investing in the underlying asset is also allowed. Foreign investment PIEs are unable to own land, therefore they should also be unable to own options or rights in land.

**Recommendation**

That the rules be amended so foreign investment PIEs are unable to own rights or options in land.

---

## Issue: Section HM 55B – no restrictions on type of income for certain foreign investment PIEs

***Clause 18H***

**Submission**
*(Ernst & Young)*

A general requirement for a PIE is that is must only earn passive income. This requirement is turned off for certain kinds of foreign investment PIEs. Whether this is intended should be clarified.

**Comment**

Officials agree that all foreign investment PIEs should essentially be portfolio investors.

**Recommendation**

That the submission be accepted.

---

## Issue: Section HM 55D – Requirement to provide information

***Clause 18H***

**Submission**
*(Ernst & Young)*

Entities that are non-natural persons should be able to invest in foreign investment PIEs but may be prevented from doing as they are unable to provide the required information – they cannot provide a date of birth, for example. This should be accommodated.

The meaning of “country code” is not clear and should be clarified.

**Comment**

Officials agree and will clarify the rules accordingly.

**Recommendation**

That the submission be accepted.

---

## Issue: Section HM 55D – restriction on resident trustees of foreign trusts

***Clause 18H***

**Submission**
*(Ernst & Young, Fonterra & MinterEllisonRuddWatts)*

New Zealand resident trustees of foreign trusts should be able to be notified foreign investors.

**Comment**

Officials disagree. If the submission were accepted, New Zealand resident beneficiaries of foreign trusts could in certain circumstances effectively pay no tax on investment income earned through foreign investment PIEs. This is not appropriate.

It is acknowledged that in certain situations this will not produce the correct result for non-resident beneficiaries of foreign trusts. It is difficult to see how this could be addressed given that trusts can have a mixture of New Zealand resident and non-resident beneficiaries.

Furthermore, officials recommend that non-New Zealand resident trustees of foreign trusts also be unable to elect notified foreign investor status for the same reason.

**Recommendation**

That the submission be declined and that the legislation be amended so that non-New Zealand resident trustees of foreign trusts cannot elect notified investor status.

---

## Issue: Section HM 55E – ceasing to be a transitional resident

***Clause 18H***

**Submission**
*(Ernst & Young)*

A provision is required that sets out how to treat an investor that ceases to be a transitional resident partway through a year.

**Comment**

The problem highlighted by the submitter occurs when a transitional resident ceases to be a transitional resident part-way through a tax year. Strictly, if such a transitional resident had invested in a zero rated foreign investment PIE, they would move to a 0% PIE tax rate that applied to resident investor at the same time. This would give rise to compliance costs for foreign investment PIEs and the taxpayer.

Therefore, officials recommend that transitional residents that cease to be eligible for the 0% tax rate can continue to use the 0% tax rate until the beginning of the next tax year.

**Recommendation**

That the submission be accepted.

---

## Issue: Interaction with double tax agreements

**Submission**
*(Ernst & Young)*

There should be an express provision providing how New Zealand's domestic law and double tax agreement residence provisions work, especially in dual residence situations.

**Comment**

It is considered that the relationship between New Zealand's domestic law and the application of its double tax agreements in relation to determining residence (in particular, in dual residence situations) is clear under existing law.

**Recommendation**

That the submission be declined.

---

## Issue: Section HM 55G – meaning of interest income

***Clause 18H***

**Submission**
*(Ernst & Young)*

The meaning of "interest income" and how it interacts with the financial arrangement rules and the concept of "interest" in the NRWT rules should be clarified.

**Comment**

The submission is noted but officials do not consider that this will give rise to issues in practice.

**Recommendation**

That the submission be noted.

---

## Issue: Section HM 55G – how interest income should be measured and valued

***Clause 18H***

**Submission**
*(Ernst & Young)*

Clarification is needed on the time or times the types of interest income must be valued and how this should be done.

**Comment**

Officials note that the test is an asset test, not an income test. It is not necessary to measure income in order to meet the requirements of the de minimis. However, officials agree that the 5% de minimis test should only be required to be satisfied at the end of each quarter. If a breach occurs, the foreign investment PIE should have another quarter to rectify the breach. This is consistent with the other breach provisions in the PIE rules.

**Recommendation**

That the 5% de minimis test will only be required to be satisfied at the end of each quarter and if a breach occurs, the foreign investment PIE will have another quarter to rectify the breach .

---

## Issue: Section HM 55G – PIE income cannot be foreign sourced

***Clause 18H***

**Submission**
*(Ernst & Young)*

It is unclear how attributed PIE income could be a foreign sourced amount.

The introduction to proposed section HM 55G refers to allowable amounts of New Zealand sourced income, however paragraph (c)(i) includes foreign-sourced amounts.

**Comment**

Officials agree and recommend the section be clarified.

**Recommendation**

That the submission be accepted.

---

## Issue: HM 55H(3) reversion to a multi-rate PIE

***Clause 18H***

**Submission**
*(Ernst & Young)*

All foreign investment PIEs should lose foreign investment PIE status (i.e. become ordinary multi-rate PIEs) if they fail to meet the relevant criteria of proposed section HM 55B.

**Comment**

Officials agree. Proposed section HM 55H(3), as written, only applies to foreign investment PIEs that derive New Zealand and foreign sourced income. It does not apply to foreign investment PIEs that derive only foreign sourced amounts. This is incorrect.

**Recommendation**

That the submission be accepted.

---

## Issue: HM 44 – Partially imputed dividends

***Clause 18D***

**Submission**
*(Ernst & Young, New Zealand Institute of Chartered Accountants & Fonterra)*

It should be clarified that the NRWT option is available for partially imputed dividends as well as entirely unimputed dividends.

If a foreign investment PIE does not use the NRWT option for a partially imputed dividend, a 0% rate should apply to the extent the dividend is imputed and a 15% or 30% rate should apply to the extent it is unimputed.

**Comment**

Officials agree that should be clarified.

**Recommendation**

That the submissions be accepted.

---

## Issue: Sections HM 41 and HM 44: Incidence of NRWT liability

***Clauses 18B and 18D***

**Submission**
*(Fonterra)*

Proposed section HM 44B and proposed table 1B of Schedule 6 need to be redrafted to clarify that a notified foreign investor is liable for the NRWT charged, not the foreign investment PIE.

**Comment**

Officials agree. It should be clear that if the NRWT option is selected, the tax is withheld from the payment.

**Recommendation**

That the submission be accepted.

---

## Issue: NRWT option – labelling of the dividend on-paid

***Clause 18D***

**Submission**
*(Fonterra)*

The proposed option for foreign investment PIEs to deduct NRWT on unimputed dividends rather than paying tax at the PIE level should be reworded so that it is clear that when the foreign investment PIE pays the dividend that it receives to its investors, the amount paid is an amount equivalent to the dividend received (rather than the dividend itself).

**Comment**

Officials agree.

**Recommendation**

That the submission be accepted.

---

## Issue: PIE timing rule

**Submission**
*(Fonterra)*

A listed multi-rate PIE is not able to access the special timing rule available to multi-rate PIEs.

**Comment**

Officials consider that the result sought by the submitter is already achieved in the current PIE rules.

**Recommendation**

That the submission be noted.

---

## Issue: Tax calculation – notional classes

***Clause 16E***

**Submission**
*(New Zealand Law Society)*

When calculating their tax liability foreign investment PIEs should treat notified foreign investors in a particular class separately from other investors in that class. As currently drafted, the notified foreign investors in all separate classes of the foreign investment PIE would be treated as part of the same class for the purposes of the tax calculation.

**Comment**

Officials agree.

**Recommendation**

That the submission be accepted.

---

## Issue: Portfolio investor proxies (nominees)

***Clause 16D***

**Submission**
*(New Zealand Law Society)*

As currently drafted portfolio investor proxies (PIPs) (essentially nominees acting on behalf of investors) that invest into a foreign investment PIE on behalf of a non-resident investor would be required to undertake the same tax calculations and perform the same obligations as if the PIP were a foreign investment PIE. Given some PIPs will not have the requisite systems to do this, this should be made optional.

**Comment**

Officials agree.

**Recommendation**

That the submission be accepted.

---

## Issue: Consequences if zero rate PIE breaches criteria before 1 April 2012

***Clause 18H***

**Submission**
*(PwC)*

It is unclear what the consequences are for a zero rate PIE that breaches the zero rate PIE criteria after formation and before 1 April 2012.

**Comment**

Officials agree that the rules as currently drafted are unclear in certain circumstances. If the zero rate foreign investment PIE breaches the relevant criteria after 1 April 2012 it is clear that they become a variable rate foreign investment PIE. However, variable rate foreign investment PIEs cannot exist until 1 April 2012. Therefore, it is recommended that the rules be amended that if a zero-rate PIE breaches the relevant criteria before 1 April 2012 they should become a multi-rate PIE.

**Recommendation**

That the submission be accepted.

---

## Issue: Tax rate for non-residents that are not notified foreign investors

**Submission**
*(PwC)*

A new provision should be created to ensure that it is clear that a foreign investment PIE must apply the 28% rate to income attributed to a non-resident until the time they elect to become a notified foreign investor.

**Comment**

Officials consider that it is already clear, under the rules as currently drafted, that that a non-resident would have a 28% rate applied before they elected to be a notified foreign investor.

**Recommendation**

That the submission be declined.

---

## DRAFTING ISSUES

Submitters also made a number of useful drafting suggestions. These will be taken into account during the redrafting process.