

POLICY AND STRATEGY

**Tax policy report: Setting the deemed rate of return for the 2018–19
income year: Order in Council for the Cabinet
Legislation Committee**

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| Date: | 15 July 2019 | Priority: | Medium |
| Security level: | In Confidence | Report number: | IR2019/350 |

Action sought

| | Action sought | Deadline |
|---------------------|---|--------------------------------|
| Minister of Revenue | Agree to recommendations. Approve and lodge the attached Cabinet paper and advice sheet to Cabinet Legislation Committee with the Cabinet Office. | 10am, Thursday, 15 August 2019 |

Contact for telephone discussion (if required)

| Name | Position | Telephone |
|-------------|--------------------------|------------------|
| s 9(2)(a) | Team Leader | s 9(2)(a) |
| s 9(2)(a) | Assistant Policy Analyst | |

15 July 2019

Minister of Revenue

Setting the deemed rate of return for the 2018–19 income year: Order in Council for the Cabinet Legislation Committee

Background

1. The Income Tax Act 2007 requires the deemed rate of return under the foreign investment fund (FIF) rules for each income year be set by Order in Council.
2. New Zealand's FIF rules tax New Zealand residents on attributed income from non-controlling investments in foreign companies, life insurance policies, and certain superannuation schemes. Since 1 April 2014, most interests in foreign superannuation schemes are taxed on transfer, rather than under the FIF rules.
3. The Income Tax Act 2007 provides a number of different methods to calculate FIF income (or loss) for tax purposes, one of which is the deemed rate of return method. An investor must use the deemed rate of return method where:
 - the interest consists of certain non-ordinary shares that have debt characteristics; and
 - the comparative value method cannot be used because the end-of-year market value of the interest cannot be determined.
4. Under the deemed rate of return method, income from a FIF is calculated each year by multiplying the opening book value of the investment by the rate set annually by Order in Council.
5. An Order in Council is now required to set the deemed rate of return for the 2018–19 income year.

Calculation

6. The method for calculating the annual deemed rate of return was established and approved in 1994 (*CAB (94) M 35/3 C(vi)* refers) and published in Inland Revenue's October 1994 *Tax Information Bulletin*. The calculation involves taking an average of the five-year "risk-free" Government bond rates at the end of each quarter of the income year and adding a risk premium margin of four percentage points. If the last day of the quarter falls on a weekend or statutory holiday, the rate on the next business day is used.
7. Officials recommend that the current method for calculating the deemed rate of return be used again for the 2018–19 income year. It is a simple way of approximating the expected return on foreign equities, incorporating a four percentage-point risk premium over the return on "risk-free" debt, such as Government stock. The method has been used for every income year since 1994.
8. The average of the quarterly five-year Government bond interest rates for the 2018–19 income year is 1.86%. This means that the deemed rate of return for the 2018–19 income year will be 5.86% (1.86% plus four percentage points). This is a decrease from last year's deemed rate of return, which was 6.44%.

Regulatory Impact Analysis

9. A Regulatory Impact Analysis is not required because no policy decision is being sought. The deemed rate of return has been calculated in accordance with a formula that was approved by Cabinet in 1994 (*CAB (94) M 35/3 C(vi)* refers).

Timing

10. The Order in Council will enable taxpayers using the deemed rate of return method to calculate their FIF income for the 2018–19 income year and will therefore effectively apply from 1 April 2018. However, because the deemed rate calculation is based on the 2018–19 five-year Government bond rates, the Order in Council will have retrospective effect.
11. A waiver of the 28-day rule for this regulation coming into force will not be sought this year. This departs from the approach taken in previous years.

Cabinet paper and associated materials

12. The Cabinet paper and the advice sheet for the Order in Council have been prepared and are attached to this report. These two documents should be signed and referred to the Cabinet Office by 10am, Thursday, 15 August 2019, for consideration at the Cabinet Legislation Committee's meeting on Tuesday, 20 August 2019.
13. The Parliamentary Counsel Office will provide copies of the finalised Order in Council directly to the Cabinet Office.
14. A media statement will be issued once the Order in Council has been made.

Proactive Release

15. I propose to proactively release this Cabinet paper, associated minutes, and key advice papers within 30 working days of Cabinet making final decisions, subject to minor redactions under the Official Information Act 1982.

Recommended action

We recommend that you:

16. **Agree** to the release of the attached Cabinet paper and associated minutes, within 30 working days of Cabinet making final decisions.

Agreed/Disagreed

17. **Approve and lodge** the attached Cabinet paper and advice sheet to the Cabinet Office by 10am, Thursday, 15 August 2019, for consideration at the Cabinet Legislation Committee meeting on Tuesday, 20 August 2019.

Approved and lodged

s 9(2)(a)

Team Leader
Policy and Strategy

Hon Stuart Nash
Minister of Revenue
/ / 2019