



## POLICY AND REGULATORY STEWARDSHIP

**Tax policy report:** Cabinet paper: Income Tax (Deemed Rate of Return on Attributing Interests in Foreign Investment Funds, 2020–21 Income Year) Order 2021

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<b>Date:</b>	12 May 2021	<b>Priority:</b>	Medium
<b>Security level:</b>	In Confidence	<b>Report number:</b>	IR2021/176

### Action sought

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	<b>Action sought</b>	<b>Deadline</b>
Minister of Revenue	<b>Agree</b> to recommendations <b>Approve</b> the attached Cabinet paper and advice sheet	2 June 2021

### Contact for telephone discussion (if required)

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<b>Name</b>	<b>Position</b>	<b>Telephone</b>
Sam Rowe	Policy Lead (acting)	s 9(2)(a)
Eugene Parker	Policy Advisor	

12 May 2021

Minister of Revenue

## **Cabinet paper: Income Tax (Deemed Rate of Return on Attributing Interests in Foreign Investment Funds, 2020–21 Income Year) Order 2021**

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### **Summary**

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#### **Purpose**

1. This report informs you about the required annual change to the deemed rate of return on attributing interests in foreign investment funds. A Cabinet paper is attached that recommends an Order in Council be made to set the deemed rate of return for the 2020–21 income year.

#### **Background**

2. The Income Tax Act 2007 (the Act) requires the deemed rate of return under the foreign investment fund (FIF) rules for each income year to be set by Order in Council.
3. 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.
4. The Act 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 where:
  - 4.1 The interest consists of certain non-ordinary shares that have debt characteristics; and
  - 4.2 The comparative value method cannot be used because the end-of-year market value of the interest cannot be determined.
5. 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.
6. An Order in Council is now required to set the deemed rate of return for the 2020–21 income year.

#### **Calculation**

7. 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 a quarter falls on a weekend or statutory holiday, the rate on the next business day is used.

8. Officials recommend that the current method for calculating the deemed rate of return be used again for the 2020–21 income year. It is a simple way of approximating the expected return on foreign equities, incorporating a risk premium of four percentage points above the return on “risk-free” debt such as Government bonds. The method has been used for every income year since 1994.
9. The average of the quarterly five-year Government bond interest rates for the 2020–21 income year is 0.43%. This means that the deemed rate of return for the 2020–21 income year will be 4.43% (0.43% plus four percentage points). This is a decrease from last year’s deemed rate of return, which was 5.05%.

### **Regulatory Impact Analysis**

10. A Regulatory Impact Analysis is not required for this Cabinet paper 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**

11. Because the deemed rate of return is based on five-year Government bond rates from across the year for which the rate applies, it must always be calculated after the end of the income year but apply retrospectively from the beginning of that year.
12. This Order in Council will enable taxpayers using the deemed rate of return method to calculate their FIF income for the 2020–21 income year and therefore needs to apply retrospectively from 1 April 2020.
13. Officials recommend that a waiver of the 28-day rule for regulations is sought for this Order in Council. Taxpayers that use the deemed rate of return are not able to use the old rate to file a return for the 2020–21 year; they must wait for the new rate to come into force. A waiver would be taxpayer-friendly and beneficial to the Government, as (without a waiver) some taxpayers would have to wait an extra 28 days to be able to file a return solely because they are waiting on the rate to come into force.
14. The attached Cabinet paper is drafted on the basis that a waiver is sought for the Order in Council. This will mean the Order comes into force on 20 June 2021. If you do not agree to recommend a waiver, we will supply you with an updated Cabinet paper.

### **Cabinet paper and associated materials**

15. The Cabinet paper and the advice sheet for the Order in Council are attached to this report. These should be signed and referred to the Cabinet Office by 10am, Wednesday 2 June 2021, for consideration at the Cabinet Legislation Committee’s meeting on Thursday 10 June 2021.
16. The Parliamentary Counsel Office will provide copies of the finalised Order in Council directly to the Cabinet Office.
17. A media statement will be issued once the Order in Council has been made.

### **Consultation**

18. The Treasury was consulted on the Cabinet paper and agrees with its recommendations.

**Proactive release**

19. This Cabinet paper, associated minutes, and key advice papers should be proactively released within 30 working days of Cabinet making final decisions, subject to minor redactions under the Official Information Act 1982.

**Recommended action**

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20. **agree** for the Income Tax (Deemed Rate of Return on Attributing Interests in Foreign Investment Funds, 2020–21 Income Year) Order 2021 to set the deemed rate of return for the 2020–21 income year at 4.43%;

Agreed/Not agreed

Agreed/Not agreed

21. **agree** for the Order to have a commencement date of 20 June 2021, requiring a waiver of the 28-day rule to be agreed to by Cabinet;

Agreed/Not agreed

Agreed/Not agreed

22. **approve** the attached Cabinet paper and advice sheet for consideration at the Cabinet Legislation Committee meeting on Thursday 10 June 2021;

Approved/Not approved

Approved/Not approved

23. **agree** to the release of the Cabinet paper, associated minutes, and key advice papers within 30 working days of Cabinet making final decisions.

Agreed/Not agreed

Agreed/Not agreed

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**Sam Rowe**

Policy Lead (acting)

Policy and Regulatory Stewardship

**Hon David Parker**

Minister of Revenue

/ /2021