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# **Fair dividend rate foreign currency hedges**

Issued: 28 April 2022

**Public Act 2022 No 10**

This special report provides early information on the changes to the fair dividend rate foreign currency hedges rules made in the Taxation (Annual Rates for 2021-22, GST and Remedial Matters) Act 2022 ahead of an upcoming edition of the *Tax Information Bulletin*.

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## Fair dividend rate foreign currency hedges

*Sections EM1, EM 2, EM 3, EM 4, EM 5, EM 5B, EM 6, EM 7, EM 8 of the Income Tax Act 2007*

Technical amendments have been made to the rules for hedging of foreign currency movement in Australian non-attributing shares and attributing FDR method interests (the FDR FX hedges rules) in subpart EM of the Income Tax Act 2007 to improve their functionality from a practical perspective and to reduce compliance costs for investors with large numbers of hedges.

### Background

When a person invests into an offshore asset, changes in the exchange rate can affect the value of the person's investment when it is converted back to New Zealand dollars (NZD). Therefore, many people who invest offshore enter arrangements to protect themselves from exchange rate changes. These arrangements are referred to as foreign currency hedges. Changes in the hedge's value due to movements in the exchange rate are intended to offset changes in the value of the hedged foreign assets due to those same exchange rate movements. This allows an investor to gain exposure to the economic performance of the hedged asset only, without a corresponding exposure to the currency that asset is denominated in.

A tax mismatch arises when a person hedges an investment taxed under the fair dividend rate (FDR) method. This is because, under the FDR method, changes in an asset's value are not taxed. Instead, FDR assets are deemed to return income equal to five percent of the asset's market value at the start of the period. Conversely, changes in a hedge's value are fully taxed under the financial arrangements rules. This mismatch in tax treatment means that a hedge that is effective in removing the impact of unexpected currency fluctuations before tax ceases to be effective after tax.

While taxpayers can attempt to hedge effectively on an after-tax basis, this is often not practical, especially when the taxpayer is taxed based on its investors' marginal rates (for example, portfolio investment entities (PIEs), which are prevalent in the managed funds industry). It also increases the hedging transaction costs for an investor.

The FDR FX hedges rules in subpart EM of the Income Tax Act 2007 were introduced in 2013 with the policy intent of eliminating this mismatch in the tax treatment of foreign currency hedges and hedged offshore assets. The rules are optional and allow a taxpayer to calculate tax on a foreign currency hedge on the same basis as the hedged offshore asset – by imputing taxable income of five percent of a hedge's opening market value.

The FDR FX hedges rules were designed both to ensure that FDR treatment is not available for currency speculation or hedges of non-eligible assets and to prevent manipulation. These risks were addressed by including appropriate restrictions in the rules. However, these restrictions imposed burdensome compliance costs on taxpayers with large numbers of hedges, and this resulted in the rules being unfeasible to apply. Further, some practical issues had been identified that needed to be addressed.

Amendments have therefore been made to the FDR FX hedges rules to reduce compliance costs for investors with large numbers of hedges and to improve their functionality.

Note, this special report only discusses the amendments made to the rules by the Taxation (Annual Rates for 2021-22, GST and Remedial Matters) Act 2022. Please refer to *Tax Information Bulletin* Vol 25, No 9, October 2013, pp 47-51 for a full discussion of the rules.

## Key features

The amendments to the FDR FX hedges rules:

- modify the second hedge-by-hedge method for determining the extent to which foreign currency hedges can be subject to FDR treatment (FDR hedge portions) in section EM 5
- specify how the hedge-by-hedge methods for determining FDR hedge portions apply to a hedge of a hedge<sup>1</sup>
- update the quarterly testing timing requirements for the hedge-by-hedge methods
- introduce an optional new method (the portfolio method) for determining FDR hedge portions to allow taxpayers with significant hedging activity to apply the rules from a practical perspective
- allow eligible hedges to continue to be subject to FDR treatment when there is a transfer of ownership of the assets of a fund or investor class
- allow eligible hedges to have no NZD leg, subject to certain requirements
- introduce an optional look-through rule to allow taxpayers who hedge indirectly owned eligible assets to apply the rules

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<sup>1</sup> A hedge of a hedge is a hedge that effectively cancels out another hedge of a foreign currency to NZD. A hedge of a hedge can also be referred to as a negative hedge.

- specify how the formula for calculating FDR income from eligible hedges is applied to hedges entered and settled within a valuation period, and
- update the definition of “non-eligible assets” by excluding from the definition eligible hedges, certain foreign cash assets, and New Zealand securities listed on foreign exchanges and denominated in foreign currencies to the extent that no foreign currency hedges have been entered to hedge these assets.

## Application date

The amendments apply from 1 April 2022.

## Detailed analysis

Amendments have been made to the FDR FX hedges rules to reduce compliance costs for taxpayers that enter large numbers of hedges and to improve the functionality of the rules from a practical perspective. The specific changes are detailed below.

### **Modification to second hedge-by-hedge method (sections EM 5(9)–(10D))**

Section EM 5 includes two alternative methods that a taxpayer can choose from to determine the maximum<sup>2</sup> FDR hedge portion on a hedge-by-hedge basis. The FDR hedge portion is the amount of an eligible foreign currency hedge that is subject to FDR treatment. Both these methods ensure the amount of a taxpayer’s eligible hedges that can be subject to FDR treatment does not exceed the value of their hedged eligible assets.

The second of these two hedge-by-hedge methods for calculating FDR hedge portions is now contained in sections EM 5(9) to EM 5(10D). The amended method now ensures that its application does not always result in an FDR hedge portion of less than 100% when a taxpayer’s non-eligible assets are already fully hedged.

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<sup>2</sup> When the methods are applied to a hedge of a hedge, an amendment has been made so that they now calculate the minimum FDR hedge portion. This amendment is discussed below in this special report.

The second hedge-by-hedge method uses the following formula in section EM 5(9) to calculate the maximum FDR hedge portion for a person's eligible hedge (the calculation hedge):

$$\text{FDR gross amount} \times \left( \frac{\text{apportioned current hedge amount}}{\text{calculation hedge amount}} \right)$$

The result of this calculation, expressed as a percentage, is the maximum (or minimum for a hedge of a hedge) FDR hedge portion for the person's eligible hedge.

All calculations for this method must be performed in NZD. It can be broken down into three steps.

### **Step 1 – calculate the apportioned current hedge amount**

The first step is to calculate the "apportioned current hedge amount". If the apportioned current hedge amount is zero, the FDR hedge portion will be zero and no further action is required.

The purpose of this step is to allocate a hedge to non-eligible assets first.

Under section EM 5(10D), the "apportioned current hedge amount" is one of the following amounts:

- If the calculation hedge is not a hedge of a hedge, or is a hedge of a hedge and the second bullet point below does not apply, then the apportioned current hedge amount is the lesser of the following amounts:
  - the amount of foreign currency hedged by the calculation hedge, and
  - the amount of foreign currency that is hedged by a person's hedges including the calculation hedge *less* the amount of foreign currency that is hedged by a person's FDR hedge portions excluding the calculation hedge *less* the total market value of a person's non-eligible assets, treating a negative result as zero.
- If the calculation hedge is a hedge of a hedge and the amount of foreign currency that is hedged by a person's FDR hedge portions excluding the calculation hedge *plus* the calculation hedge (treating a hedge of a hedge as a negative amount) *equals less than zero*, then the apportioned current hedge amount is the negative of the amount of foreign currency that is hedged by a person's FDR hedge portions excluding the calculation hedge.

### **Example 1: Apportioned current hedge amount of zero because hedge is allocated to non-eligible assets**

At the beginning of 1 April 2023, Sterling Cooper Fund (Sterling Cooper) has a portfolio of:

- US\$35,000 of shares in US-based companies (eligible assets, worth NZ\$70,000)
- US\$15,000 of share options (non-eligible assets, worth NZ\$30,000)
- A hedge of USD to NZD, with a foreign amount hedged of US\$36,000 (equivalent to NZ\$72,000). This hedge has an FDR hedge portion of 100%.

On 1 April 2023, Sterling Cooper enters into an eligible hedge for US dollars, with a foreign amount hedged of US\$15,000 (equivalent to NZ\$30,000).

The second hedge-by-hedge method is applied to the hedge entered on 1 April 2023 by Sterling Cooper below.

#### *First step*

The apportioned current hedge amount is NZ\$0 as it equals the lesser of:

- the amount of foreign currency hedged by the calculation hedge (NZ\$30,000), and
- the amount of foreign currency that is hedged (including by the calculation hedge) *less* the amount of foreign currency that is hedged by Sterling Cooper's FDR hedge portions excluding the calculation hedge *less* the total market value of Sterling Cooper's non-eligible assets (NZ\$102,000 – NZ\$72,000 – NZ\$30,000 = NZ\$0).

The apportioned current hedge amount is zero, so the FDR hedge portion will be zero and no further action is required.

### **Step 2 – calculate the FDR gross amount**

The second step is to calculate the "FDR gross amount". This is the portion of the apportioned current hedge amount that hedges eligible assets and is therefore eligible for FDR treatment.

Under sections EM 5(10B) and (10C), the “FDR gross amount” is the lesser of 1 and the amount resulting from the following formula:

$$\frac{(1.05 \times \text{eligible currency assets} - \text{FDR hedges amount})}{\text{apportioned current hedge amount}}$$

Where:

**Eligible currency assets** is the total market value of a person’s eligible assets owned directly and, if the person chooses and is an investor in a multi-rate PIE (either directly or indirectly through one or more multi-rate PIEs), their interest in the eligible assets that are owned by the multi-rate PIE.

**FDR hedges amount** is the amount of foreign currency hedged by a person’s FDR hedge portions but excluding the portion for the calculation hedge.

**Apportioned current hedge amount** is the amount calculated under the first step.

If the denominator is zero (that is, the apportioned current hedge amount), the formula result is to be treated as zero.

### Step 3 – convert the FDR gross amount into a portion of the calculation hedge

The third step is to convert the FDR gross amount into a portion of the calculation hedge by applying the formula in section EM 5(9):

$$\text{FDR gross amount} \times \left( \frac{\text{apportioned current hedge amount}}{\text{calculation hedge amount}} \right)$$

Where:

**FDR gross amount** is the amount calculated for the second step.

**Apportioned current hedge amount** is the amount calculated for the first step.

**Calculation hedge amount** is the amount of foreign currency that is hedged by the current hedge.

The result of this step, expressed as a percentage, is the maximum (or minimum for a hedge of a hedge) FDR hedge portion for a person’s hedge. A negative percentage must be treated as zero.

**Example 2: Hedging on hand not subject to FDR treatment equals non-eligible assets, new hedging equals eligible assets<sup>3</sup>**

At the beginning of 1 June 2023, Sterling Cooper Fund (Sterling Cooper) has a portfolio of:

- US\$35,000 of shares in US-based companies (eligible assets, worth NZ\$70,000)
- US\$15,000 of share options (non-eligible assets, worth NZ\$30,000)
- A hedge of USD to NZD, with a foreign amount hedged of US\$15,000 (equivalent to NZ\$30,000). This hedge has an FDR hedge portion of zero.

On 1 June 2023, Sterling Cooper enters into an eligible hedge for US dollars, with a foreign amount hedged of US\$35,000 (equivalent to NZ\$70,000). The second hedge-by-hedge method is applied to this hedge below.

*First step*

The apportioned current hedge amount is NZ\$70,000 as it equals the lesser of:

- the amount of foreign currency hedged by the calculation hedge (NZ\$70,000), and
- the amount of foreign currency that is hedged (including by the calculation hedge) *less* the amount of foreign currency that is hedged by Sterling Cooper’s FDR hedge portions excluding the calculation hedge *less* the total market value of Sterling Cooper’s non-eligible assets (NZ\$100,000 – NZ\$0 – NZ\$30,000 = \$70,000).

*Second step*

The FDR gross amount is 1 as it equals the lesser of 1 and the amount under the formula:

$$\frac{(1.05 \times \text{eligible currency assets} - \text{FDR hedges amount})}{\text{apportioned current hedge amount}}$$

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<sup>3</sup> In examples 2 to 5, the fund only holds foreign assets denominated in the same foreign currency. This has been done for simplicity purposes and to highlight the modifications to the second hedge-by-hedge method. When applying this method in practice, the formulae in the second hedge-by-hedge method are not applied on a currency-by-currency basis – that is, they are applied taking into account the values of all foreign currency assets and hedges, converted to New Zealand dollars.

$$\frac{(1.05 \times \text{NZ\$}70,000 - 0)}{\text{NZ\$}70,000} = 1.05$$

*Third step*

Applying the formula in section EM 5(9):

$$\text{FDR gross amount} \times \frac{\text{apportioned current hedge amount}}{\text{calculation hedge amount}}$$

$$1 \times \frac{\text{NZ\$}70,000}{\text{NZ\$}70,000} = 100\%$$

This means that the maximum FDR hedge portion that can be applied to the hedge of US\$35,000 is 100%.

**Example 3: Hedging on hand not subject to FDR treatment is less than non-eligible assets**

At the beginning of 1 August 2023, Sterling Cooper Fund (Sterling Cooper) has a portfolio of:

- US\$35,000 of shares in US-based companies (eligible assets, worth NZ\$70,000)
- US\$15,000 of share options (non-eligible assets, worth NZ\$30,000)
- A hedge of USD to NZD, with a foreign amount hedged of US\$10,000 (equivalent to NZ\$20,000). This hedge has an FDR hedge portion of zero.

On 1 August 2023, Sterling Cooper enters into an eligible hedge for US dollars, with a foreign amount hedged of US\$40,000 (equivalent to NZ\$80,000). The second hedge-by-hedge method is applied to this hedge below.

*First step*

The apportioned current hedge amount is NZ\$70,000 as it equals the lesser of:

- the amount of foreign currency hedged by the calculation hedge (NZ\$80,000), and
- the amount of foreign currency that is hedged (including by the calculation hedge) *less* the amount of foreign currency that is hedged by Sterling Cooper's FDR hedge portions excluding the calculation hedge *less* the total market value

of Sterling Cooper’s non-eligible assets (NZ\$100,000 – NZ\$0 – NZ\$30,000 = \$70,000).

*Second step*

The FDR gross amount is 1 as it equals the lesser of 1 and the amount under the formula:

$$\frac{(1.05 \times \text{eligible currency assets} - \text{FDR hedges amount})}{\text{apportioned current hedge amount}}$$

$$\frac{(1.05 \times \text{NZ\$70,000} - 0)}{\text{NZ\$70,000}} = 1.05$$

*Third step*

Applying the formula in section EM 5(9):

$$\text{FDR gross amount} \times \frac{\text{apportioned current hedge amount}}{\text{calculation hedge amount}}$$

$$1 \times \frac{\text{NZ\$70,000}}{\text{NZ\$80,000}} = 87.5\%$$

This means that the maximum FDR hedge portion that can be applied to the hedge of US\$40,000 is 87.5%.

**Example 4: Hedging on hand not subject to FDR treatment is less than non-eligible assets, FDR hedge portions on hand**

At the beginning of 1 October 2023, Sterling Cooper Fund (Sterling Cooper) has a portfolio of:

- US\$35,000 of shares in US-based companies (eligible assets, worth NZ\$70,000)
- US\$15,000 of share options (non-eligible assets, worth NZ\$30,000)
- A hedge of USD to NZD, with a foreign amount hedged of US\$20,000 (equivalent to NZ\$40,000). This hedge has an FDR hedge portion of 50%.

On 1 October 2023, Sterling Cooper enters into an eligible hedge for US dollars, with a foreign amount hedged of US\$30,000 (equivalent to NZ\$60,000). The second hedge-by-hedge method is applied to this hedge below.

### First step

The apportioned current hedge amount is NZ\$50,000 as it equals the lesser of:

- the amount of foreign currency hedged by the calculation hedge (NZ\$60,000), and
- the amount of foreign currency that is hedged (including by the calculation hedge) less the amount of foreign currency that is hedged by Sterling Cooper’s FDR hedge portions excluding the calculation hedge less the total market value of Sterling Cooper’s non-eligible assets (NZ\$100,000 – NZ\$20,000 – NZ\$30,000 = \$50,000).

### Second step

The FDR gross amount is 1 as it equals the lesser of 1 and the amount under the formula:

$$\frac{(1.05 \times \text{eligible currency assets} - \text{FDR hedges amount})}{\text{apportioned current hedge amount}}$$

$$\frac{(1.05 \times \text{NZ\$70,000} - \text{NZ\$20,000})}{\text{NZ\$50,000}} = 1.07$$

### Third step

Applying the formula in section EM 5(9):

$$\text{FDR gross amount} \times \frac{\text{apportioned current hedge amount}}{\text{calculation hedge amount}}$$

$$1 \times \frac{\text{NZ\$50,000}}{\text{NZ\$60,000}} = 83.33\%$$

This means that the maximum FDR hedge portion that can be applied to the hedge of US\$30,000 is 83.33%.

### Example 5: Hedging on hand not subject to FDR treatment equals non-eligible assets, new hedging exceeds 105% of eligible assets

At the beginning of 1 December 2023, Sterling Cooper Fund (Sterling Cooper) has a portfolio of:

- US\$35,000 of shares in US-based companies (eligible assets, worth NZ\$70,000)
- US\$15,000 of share options (non-eligible assets, worth NZ\$30,000)

- A hedge of USD to NZD, with a foreign amount hedged of US\$15,000 (equivalent to NZ\$30,000). This hedge has an FDR hedge portion of zero.

On 1 December 2023, Sterling Cooper enters into an eligible hedge for US dollars, with a foreign amount hedged of US\$37,500 (equivalent to NZ\$75,000). The second hedge-by-hedge method is applied to this hedge below.

*First step*

The apportioned current hedge amount is NZ\$75,000 as it equals the lesser of:

- the amount of foreign currency hedged by the calculation hedge (NZ\$75,000), and
- the amount of foreign currency that is hedged (including by the calculation hedge) less the amount of foreign currency that is hedged by Sterling Cooper’s FDR hedge portions excluding the calculation hedge less the total market value of Sterling Cooper’s non-eligible assets (NZ\$105,000 – 0 – NZ\$30,000 = NZ\$75,000).

*Second step*

The FDR gross amount is 0.98 as it equals the lesser of 1 and the amount under the formula:

$$\frac{(1.05 \times \text{eligible currency assets} - \text{FDR hedges amount})}{\text{apportioned current hedge amount}}$$

$$\frac{(1.05 \times \text{NZ\$70,000} - 0)}{\text{NZ\$75,000}} = 0.98$$

*Third step*

Applying the formula in section EM 5(9):

$$\text{FDR gross amount} \times \frac{\text{apportioned current hedge amount}}{\text{calculation hedge amount}}$$

$$0.98 \times \frac{\text{NZ\$75,000}}{\text{NZ\$75,000}} = 98\%$$

This means that the maximum FDR hedge portion that can be applied to the hedge of US\$37,500 is 98%.

## Hedge of a hedge (sections EM 5(1), (4) and (9))

The two hedge-by-hedge methods for calculating FDR hedge portions in section EM 5 have been amended so that they work as intended when applied to a hedge of a hedge. These two methods now identify the minimum, rather than the maximum, FDR hedge portion when applied to a hedge of a hedge.

A taxpayer can choose an FDR hedge portion for a hedge of a hedge between the minimum identified by the method applied and 100%. The purpose of identifying the minimum FDR hedge portion is to require a taxpayer's total FDR hedge portions to be reduced by a new hedge of a hedge where the existing FDR hedge portions on hand (not counting the new hedge of a hedge) exceed 105% of eligible assets.

When applying these methods to a hedge of a hedge, the hedge of a hedge should be treated as a negative amount in the formulae.

If the FDR hedge portion calculated is less than zero, this must be treated as a minimum FDR hedge portion of 0%.

### **Example 6: Minimum FDR hedge portion results in combined FDR hedge portions equal to 105% of eligible assets**

At the beginning of 1 June 2023, Dunder Mifflin Fund (Dunder Mifflin) has a portfolio of:

- US\$45,000 of shares in US-based companies (eligible assets, worth NZ\$90,000)
- US\$5,000 of share options (non-eligible assets, worth NZ\$10,000)
- A hedge of USD to NZD, with a foreign amount hedged of US\$50,000 (equivalent to NZ\$100,000). This hedge has an FDR hedge portion of 90% (calculated under the second hedge-by-hedge method). Therefore, the total FDR hedge portions coverage of eligible assets is 100%.

By the beginning of 10 June 2023, the value of Dunder Mifflin's US shares has dropped to US\$35,000 (NZ\$70,000). To adjust the foreign currency hedge exposure as result of this drop, Dunder Mifflin enters into a hedge of a hedge for US\$10,000 (NZ\$20,000) on 10 June 2023. Applying the second hedge-by-hedge method in sections EM 5(9)–(10D), the minimum FDR hedge portion for this hedge of a hedge is calculated as follows:

### *First step*

The apportioned current hedge amount is –NZ\$20,000 as it equals the lesser of:

- the amount of foreign currency hedged by the calculation hedge (–NZ\$20,000), and
- the amount of foreign currency that is hedged (including by the calculation hedge) less the amount of foreign currency that is hedged by Dunder Mifflin’s FDR hedge portions excluding the calculation hedge less the total market value of Dunder Mifflin’s non-eligible assets, treating a negative result as zero (NZ\$80,000 – NZ\$90,000 – NZ\$10,000 = –NZ\$20,000, which is treated as NZ\$0).

(Section EM 10D(b) does not apply because the amount of foreign currency that is hedged by Dunder Mifflin’s FDR hedge portions excluding the calculation hedge plus the calculation hedge (treating a hedge of a hedge as a negative amount) does not equal less than zero.)

### *Second step*

The FDR gross amount is 0.825 as it equals the lesser of 1 and the amount under the formula:

$$\frac{(1.05 \times \text{NZ\$}70,000 - \text{NZ\$}90,000)}{-\text{NZ\$}20,000} = 0.825$$

### *Third step*

Applying the formula in section EM 5(9):

$$0.825 \times \frac{-\text{NZ\$}20,000}{-\text{NZ\$}20,000} = 82.5\%$$

This means that the minimum FDR hedge portion that can be applied to the hedge of a hedge of –US\$10,000 is 82.5%. Dunder Mifflin can choose an FDR hedge portion for the hedge of a hedge from 82.5% to 100%.

A minimum FDR hedge portion of 82.5% for the hedge of a hedge (–NZ\$20,000 x 82.5% = –NZ\$16,500) would result in the total FDR hedge portions equalling 105% of eligible assets ((NZ\$90,000 existing FDR hedge portion on hand – NZ\$16,500 FDR hedge portion for the new hedge of a hedge) / NZ\$70,000 of eligible assets = 1.05) which is the maximum allowed.

### Example 7: Minimum FDR hedge portion of 0%

At the beginning of 1 October 2023, Ark Investment Fund (Ark) has a portfolio of:

- US\$45,000 of shares in US-based companies (eligible assets, worth NZ\$90,000)
- US\$5,000 of share options (non-eligible assets, worth NZ\$10,000)
- A hedge of USD to NZD, with a foreign amount hedged of US\$30,000 (equivalent to NZ\$60,000). This hedge has an FDR hedge portion of 100% (calculated under the second hedge-by-hedge method).

On 10 October 2023, Ark enters into a hedge of a hedge for US\$10,000 (NZ\$20,000). Applying the second hedge-by-hedge method in sections EM 5(9)–(10D), the minimum FDR hedge portion for this hedge of a hedge is calculated as follows:

#### *First step*

The apportioned current hedge amount is –NZ\$20,000 as it equals the lesser of:

- the amount of foreign currency hedged by the calculation hedge (–NZ\$20,000), and
- the amount of foreign currency that is hedged (including by the calculation hedge) *less* the amount of foreign currency that is hedged by Ark’s FDR hedge portions excluding the calculation hedge *less* the total market value of Ark’s non-eligible assets, treating a negative result as zero (NZ\$40,000 – NZ\$60,000 – NZ\$10,000 = –NZ\$30,000, which is treated as NZ\$0).

#### *Second step*

The FDR gross amount is –1.725 as it equals the lesser of 1 and the amount under the formula:

$$\frac{(1.05 \times \text{NZ\$90,000} - \text{NZ\$60,000})}{-\text{NZ\$20,000}} = -1.725$$

#### *Third step*

Applying the formula in section EM 5(9):

$$-1.725 \times \frac{-\text{NZ\$20,000}}{-\text{NZ\$20,000}} = -172.5\%, \text{ treated as } 0\%$$

This means that the minimum FDR hedge portion that can be applied to the hedge of a hedge of –US\$10,000 is 0%. Ark can choose an FDR hedge portion for the hedge of a hedge from 0% to 100%.

### **Quarterly testing (section EM 7)**

Under section EM 7, a taxpayer that uses one of the hedge-by-hedge methods must calculate a quarterly FDR hedging ratio to ensure that their FDR hedge portions for eligible hedges remain appropriate. This requirement has been amended to allow taxpayers to choose the day in a quarter on which the testing is performed, provided the testing is done on the same day of each quarter in an income year.

If a taxpayer chooses to change the calculation day for an income year, this may increase or decrease the number of days between the quarterly testing for the last quarter of the income year before the change and the quarterly testing for the first quarter in the income year of the change.

### **The portfolio method (section EM 5B)**

Where taxpayers hold a significant number of hedges at any point in time, and they turnover hedges regularly, the requirement to apply the rules on a hedge-by-hedge basis can impose burdensome compliance costs that result in the rules being impractical to apply.

To address this issue, section EM 5B introduces a new method for calculating FDR hedge portions for eligible hedges on a portfolio basis. This method sits alongside the two hedge-by-hedge methods, and taxpayers have the option of selecting their preferred method (subject to eligibility criteria detailed below).

The quarterly testing requirements in section EM 7 do not apply to taxpayers using the portfolio method. This is because FDR hedge portions for all eligible hedges are reset periodically under this method.

### **Eligibility criteria and elections (sections EM 4(6) and (7))**

Only taxpayers with a unit valuation period of one month or less for section EX 53 can elect to use the portfolio method. This election can be made at any time. The exception to this is a re-election, which may only be made after 12 months have passed since a previous election to use the portfolio method was revoked.

Once an election to use the portfolio method has been made, taxpayers are required to apply the method for a minimum of 24 months to all existing eligible hedges on hand (regardless of whether they are subject to an existing hedge-by-hedge method) and any hedges entered into post-election.

The Commissioner may agree to reduce the election and re-election time periods prospectively when there are genuine commercial reasons that require a change in method for calculating FDR hedge portions. Where the Commissioner agrees, taxpayers can revoke an election to apply the portfolio method within 24 months or re-elect within 12 months. Genuine commercial reasons that warrant a change in method include where a taxpayer changes service provider and the new service provider only supports one of the methods for calculating FDR hedge portions.

### **Periodic basis for calculating FDR hedge portions (section EM 5B(3))**

Taxpayers can elect their own periodic basis for calculating FDR hedge portions, up to a maximum period of one month. The periodic basis chosen must be applied for an income year.

### **Portfolio FDR hedge portion (sections EM 5B(1) and EM 5B(3))**

The FDR hedge portion must be calculated at the start of each period and applied to the entire portfolio of eligible hedges for that period.

Where a taxpayer enters into a new eligible hedge within a period, the FDR hedge portion calculated for the portfolio at the start of the period applies to that hedge until the end of the period, at which point the FDR hedge portion calculated for the portfolio for the next period applies.

### **Formulae (sections EM 5B(2) and EM 5B(4)–(7))**

The approach for calculating FDR hedge portions under this method involves two formulae, with the portfolio FDR hedge portion being set at the lower of the two results. This is different to the hedge-by-hedge methods, which calculate the maximum (or minimum for a hedge of a hedge). Setting FDR hedge portions based on the results of the formulae under the portfolio method is intended to address concerns that taxpayers could otherwise gain a tax advantage by choosing the tax treatment of hedges on a periodic basis.

The purpose of the first formula is to allocate hedges to non-eligible assets first, while the second formula is intended to ensure that the amount of hedging subject to FDR treatment does not exceed 105% of eligible assets.

All amounts must be calculated in NZD.

The first formula is:

$$1 - \left( \frac{\text{non – eligible assets}}{\text{portfolio hedges amount}} \right)$$

Where:

**Non-eligible assets** is the total market value of a person’s foreign currency assets excluding eligible assets, certain cash assets, eligible hedges and certain New Zealand securities denominated in a foreign currency.

**Portfolio hedges amount** is the total amount of foreign currency that is hedged by a person’s hedges.

The second formula is:

$$\frac{(1.05 \times \text{eligible assets})}{\text{portfolio hedges amount}}$$

Where:

**Eligible assets** is the total market value of a person’s eligible assets owned directly and, if the person chooses and is an investor in a multi-rate PIE (either directly or indirectly through one or more multi-rate PIEs), their interest in the eligible assets that are owned by the multi-rate PIE.

**Portfolio hedges amount** is as above.

#### Example 8: The portfolio method

Gekko & Co Fund (Gekko) is a daily unit valuer who elects to use the portfolio method and chooses a periodic basis of one month.

At the beginning of 1 September 2023,<sup>4</sup> Gekko holds:

- UK£25,000 of shares in UK-based companies (eligible assets, worth NZ\$50,000)
- UK£10,000 of UK bonds (non-eligible assets, worth NZ\$20,000)
- Hedges of GBP to NZD with a foreign amount hedged of UK£30,000 (equivalent to NZ\$60,000).

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<sup>4</sup> Note, for practical purposes the opening values on 1 September 202X are the closing values on 31 August 202X

Gekko's FDR hedge portion for September 2023 is the lower of the amounts calculated under the following two formulae:

*First formula*  $1 - \frac{\text{NZ\$20,000}}{\text{NZ\$60,000}} = 67\%$

*Second formula*  $\frac{(1.05 \times \text{NZ\$50,000})}{\text{NZ\$60,000}} = 87.5\%$

The FDR hedge portion for Gekko's hedges for September 2023 is therefore 67%. This FDR hedge portion is applied to **all** hedges on hand at the start of the month. It also applies to any new hedges or hedges of hedges entered into within September 2023, regardless of any changes in the holdings of eligible or non-eligible assets.

At the beginning of 1 October 2023, Gekko holds:

- UK£15,000 of shares in UK-based companies (eligible assets, worth NZ\$30,000)
- UK£30,000 of UK bonds (non-eligible assets, worth NZ\$60,000)
- Hedges of GBP to NZD with a foreign amount hedged of UK£40,000 (equivalent to NZ\$80,000).

Gekko's FDR hedge portion at the start of October 2023 is calculated as the lower of the following two amounts:

*First formula*  $1 - \frac{\text{NZ\$60,000}}{\text{NZ\$80,000}} = 25\%$

*Second formula*  $\frac{(1.05 \times \text{NZ\$30,000})}{\text{NZ\$80,000}} = 39.375\%$

The portfolio hedge portion for Gekko for October 2023 is therefore 25%. This portfolio FDR hedge portion is applied to **all** hedges on hand at the start of the month. It also applies to any new hedges or hedges of hedges entered into within October 2023, regardless of any changes in the holdings of eligible or non-eligible assets.

### **Transfer of eligible hedges (sections EM 3(1)(d), EM 4(2), (3) and (5) and EM 5(3), (4) and (9))**

The FDR FX hedges rules have been amended so that they can be applied to eligible hedges that are acquired via a transfer between funds or sub funds. Before these amendments, it was not clear whether the rules could be applied in these circumstances because an eligible

hedge was required to have a fair value of zero when first entered into. An election to apply the rules also had to be made before a hedge was first entered into, and FDR hedge portion calculations had to be performed when a hedge was first entered into.

These issues have been addressed by amending the definition of an “eligible hedge” to include a hedge that is entered into *or acquired* at its fair value. In addition, elections for the rules to apply are now allowed to be made before a hedge is first entered into *or acquired*, and FDR hedge portion calculations can be performed when an eligible hedge is first entered into *or acquired*.

### **Certain eligible hedges may have no NZD leg (section EM 3(2))**

Taxpayers with large portfolios of hedges often rebalance their hedging of eligible assets denominated in two foreign currencies to NZD by hedging one foreign currency to the other – that is, by entering a hedge with no NZD leg. The rules have been amended to allow eligible hedges to have no NZD leg provided these hedges are entered into to adjust the hedging position of existing hedges on hand that have one leg in NZD.

This change to the eligible hedge requirements only applies to taxpayers that use the second hedge-by-hedge method or the new portfolio method for calculating FDR hedge portions. It does not apply when the first hedge-by-hedge method is used because amounts must be calculated in the calculation hedge’s foreign currency for that method, rather than converted to NZD, and this is not practical where a hedge has two legs in a foreign currency.

### **Optional look-through rule (sections EM 5(5) and (10C), EM 5B(7) and EM 8)**

An optional look-through rule has been introduced to allow taxpayers to include indirectly owned eligible assets in their calculation of eligible assets in certain circumstances.

This optional rule is available to “qualifying hedge funds”, as defined in section EM 8. These are taxpayers that invest in a multi-rate PIE, either directly or indirectly through one or more multi-rate PIEs, and have income from eligible assets held by the multi-rate PIE attributed to them.

In applying this new look-through rule, a taxpayer will need to determine the value of their interest in the eligible assets held by the multi-rate PIE by reference to the proportion of the units they hold in the PIE or investor class. A taxpayer will therefore need to have access to sufficient information from the multi-rate PIE to comply with the requirements if they wish to apply this optional rule.

## Hedges entered and settled within a valuation period (section EM 6)

Section EM 6 calculates the FDR income or expenditure from eligible hedges. The formula in section EM 6 has been amended to ensure that an amount of income or expenditure is calculated for hedges that are entered into and settled within a valuation period.

The amended formula has added the items 'period gain' and 'period loss' as follows:

$$\frac{(\text{FDR portions' value} + \textit{period gain} - \textit{period loss}) \times 0.05 \times \textit{valuation period}}{\textit{days in the year}}$$

Where:

**Period gain** is the net gain multiplied by the FDR hedge portion for relevant eligible hedges that are entered into and settled within the preceding valuation period.

**Period loss** is the net loss multiplied by the FDR hedge portion for relevant eligible hedges that are entered into and settled within the preceding valuation period.

As a result of this change, the net gain or loss on the FDR hedge portion of eligible hedges that are entered and settled within a preceding valuation period is now subject to FDR treatment.

### Example 9: Hedge entered and settled within valuation period

M. Burns Asset Management Fund (Burns) has a one-month valuation period. Its hedging activity during March 2023 is:

- On 4 March 2023, it enters into an eligible hedge for US\$100,000 (equivalent to NZ\$140,000 at acquisition). This hedge has an FDR hedge portion of 50%.
- On 15 March 2023, it enters into an eligible hedge for US\$50,000 (equivalent to NZ\$75,000 at acquisition). This hedge has an FDR hedge portion of 100%.
- On 27 March 2023, the hedge for US\$50,000 is settled. At settlement, US\$50,000 is equivalent to NZ\$70,000.
- At the end of 31 March 2023, the hedge entered into on 4 March 2023 is still on hand and US\$100,000 is equivalent to NZ\$125,000. There are no other hedges on hand.

Applying the updated formula in section EM 6, Burns' FDR income from its eligible hedges on 1 April 2023 is:

$$\frac{((\text{NZ\$125,000} \times 50\%) + 0 - \text{NZ\$5,000}) \times 0.05 \times 30}{365} = \$236$$

Period gain is zero on 1 April 2023 because there was no net gain on the hedge of US\$50,000 that was entered and settled within the preceding valuation period.

Period loss is NZ\$5,000 on 1 April 2023 (being (NZ\$70,000 – NZ\$75,000) × the 100% FDR hedge portion) because there was a net loss of \$5,000 on the hedge of US\$50,000 that was entered and settled within the preceding valuation period.

## Definition of “non-eligible assets” (section EM 8)

The definition of “non-eligible assets” in section EM 8 has been amended to improve the accuracy of FDR hedge portion calculations. Eligible foreign currency hedges are now excluded from the definition of “non-eligible assets”. Also excluded are New Zealand securities listed on a foreign exchange and denominated in a foreign currency to the extent that no foreign currency hedge has been entered into to hedge the shares.

Certain foreign currency cash assets are also excluded from non-eligible assets. There are two different approaches for taxpayers to calculate this exclusion — the *de minimis cash exclusion* and the *relational cash exclusion*. The *de minimis cash exclusion* approach is the default approach. However, either approach can be applied each time an FDR hedge portion is being calculated (but only one approach can be applied per FDR hedge portion calculation).

### De minimis cash exclusion approach

Under the *de minimis* approach, foreign currency cash assets totalling less than 5% of the market value of eligible assets are excluded from non-eligible assets. This means that if a taxpayer’s foreign currency cash assets equal less than 5% of eligible assets when calculating an FDR hedge portion, all the foreign currency cash assets will be excluded from non-eligible assets. If a taxpayer’s foreign currency cash assets equal 5% or more of eligible assets, then the maximum allowed (that is, 4.99%) will be excluded.

#### Example 10: Foreign currency cash assets equal less than 5% of eligible assets

At the beginning of 1 November 2023, Basil US Equity Fund (Basil) has a portfolio of:

- US\$50,000 of shares in US-based companies (eligible assets, worth NZ\$100,000)
- US\$2,000 of foreign currency cash assets (worth NZ\$4,000)

At the beginning of 1 November 2023, Basil’s foreign currency cash assets equal less than 5% of its eligible assets, so all NZ\$4,000 of the foreign currency cash assets are excluded from non-eligible assets under the de minimis approach.

#### **Example 11: Foreign currency cash assets equal more than 5% of eligible assets**

At the beginning of 1 November 2023, Thyme US Equity Fund (Thyme) has a portfolio of:

- US\$50,000 of shares in US-based companies (eligible assets, worth NZ\$100,000)
- US\$20,000 of foreign currency cash assets (worth NZ\$40,000)

At the beginning of 1 November 2023, Thyme’s foreign currency cash assets equal greater than 5% of its eligible assets, so NZ\$4,999.99 of the foreign currency cash assets (that is, the maximum allowed) are excluded from non-eligible assets under the de minimis cash exclusion approach. NZ\$35,000.01 of the foreign currency cash assets will be treated as non-eligible assets under this approach.

#### **Relational cash exclusion approach**

If a taxpayer does not wish to use the de minimis cash exclusion approach, they can elect to adopt the relational cash exclusion approach. Under this approach, foreign cash assets that relate directly to eligible assets or FDR hedge portions can be excluded from non-eligible assets. Examples of foreign cash assets that relate directly to eligible assets or FDR hedge portions include cash held:

- for investment or reinvestment in eligible assets
- for settling eligible hedges, to the extent of the FDR hedge portions, or
- to provide liquidity for redemption purposes, to the extent the fund invests in eligible assets.

**Example 12: Relational cash exclusion where fund invests in eligible assets**

Assume the same facts as in example 11.

NZ\$30,000 of Thyme's foreign currency cash is due to a subscription for units and is to be invested in US equities. NZ\$6,000 of the cash is due to a sale of shares and is to be reinvested in US equities. The remaining NZ\$4,000 is held to provide liquidity for redemption purposes.

All of Thyme's foreign cash assets relate directly to eligible assets, so the full NZ\$40,000 cash is excluded from non-eligible assets under the relational cash exclusion approach.

In some cases, foreign cash assets can relate to a mix of eligible assets and other assets. Taxpayers will need to determine the extent to which cash may be excluded from non-eligible assets on a reasonable basis in these circumstances. For example, this could be based on a proportional allocation of the cash (that is, based on the proportion of eligible assets to total assets, excluding cash balances) or on a direct attribution basis where foreign cash assets that relate solely to eligible assets are held in separate earmarked accounts.

**Example 13: Relational cash exclusion, on a proportional allocation basis, where fund invests in a mix of eligible assets and other assets**

At the beginning of 1 November 2023, Parsley US Investments Fund (Parsley) has a portfolio of:

- US\$40,000 of shares in US-based companies (eligible assets, worth NZ\$80,000)
- US\$10,000 of share options (non-eligible assets, worth NZ\$20,000)
- US\$15,000 of foreign currency cash assets (worth NZ\$30,000)

NZ\$20,000 of Parsley's foreign currency cash is due to a subscription for units and is to be invested in US equities and share options. NZ\$4,000 of the cash is due to rebalancing investment interests and is to be invested in US equities and share options. The remaining NZ\$6,000 is held for liquidity purposes.

NZ\$24,000 of cash is excluded from non-eligible assets on a proportional basis under the relational cash exclusion approach (NZ\$80,000 of eligible assets / NZ\$100,000 of assets excluding cash balances x NZ\$30,000 of foreign currency cash).

## About this document

Special reports are published shortly after new legislation is enacted or Orders in Council are made to help affected taxpayers and their advisors understand the consequences of the changes. These are published in advance of an article in the *Tax Information Bulletin*.