Effect of the FIF rules on immigration: proposals for amendments

An officials' issues paper

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CONTENTS

CHAPTER 1

Introduction

1.1 The Government wants to encourage investment in the IT and technology sectors, as well as attracting foreign direct investment generally. One way to achieve these goals is to attract people to New Zealand who are already working or investing in these sectors overseas.

1.2 New Zealand is regarded internationally as a good place to move to. Advantages include our climate, political stability, low level of corruption and ease of doing business. Our immigration policies have sought to leverage these qualities to contribute to, among other priorities, the development of a culture in New Zealand of enterprise and innovation. An example of this is the Active Investor Plus visa, which provides a pathway for experienced, high-value investors to move to New Zealand and help build globally successful Kiwi businesses.[1]

1.3 A feature of the New Zealand economy that will be relevant to many potential migrants is our tax system. New Zealand's tax system compares well internationally. Based on the principle of broad-base low-rate, our tax system generally tries to tax widely with few exceptions or incentives. This makes our tax system comparatively simple and less distortionary. Broad taxation also allows the tax to be levied at lower rates than what otherwise might be needed to meet the government's revenue needs.

1.4 An issue with our tax system that has been identified by migrants, potential migrants and those working with them, is New Zealand's rules for taxing investments of 10% or less in foreign companies.[2] These rules are referred to as the foreign investment fund (FIF) rules. The FIF rules aim to ensure there is no New Zealand tax advantage from investing offshore compared to investing domestically. They make sense in the context of the New Zealand tax system, which does not generally tax capital gains but which in this case is trying to tax investments where dividends may not be regularly paid. However, they are internationally unusual in (generally) taxing deemed income on an annual basis, rather than taxing on a realisation basis (dividends and proceeds of sale).

1.5 The issue is that the FIF rules may be discouraging non-residents who hold portfolio interests in foreign companies from coming to and staying in New Zealand. Migrants will generally have made their investments without awareness of the FIF rules and may not be organised so that they can fund the tax on deemed, rather than actual, income. This is particularly a problem for illiquid investments acquired pre-migration. Even for post-migration investments, migrants who remain subject to tax on a worldwide basis in another country may face double taxation arising from the unusual nature of New Zealand's FIF regime. Because the FIF tax is imposed in years before realisation and on deemed rather than actual income, FIF taxes paid may not be creditable against foreign taxes charged on the sale of the investment.

1.6 This consultation document discusses the impact of the FIF rules on migrants and explores some solutions to the rules being a discouraging factor. Importantly we note that while the Government is interested in a solution to these issues, it has not yet committed to make the changes described in this

[1] https://www.nzte.govt.nz/page/investor-migrants

[2] See for example the New Zealand Institute of Economic Research report *The place where talent does not want to live - The intersection of New Zealand immigration and tax policies in a globalising world*, April 2024, available at https://www.nzier.org.nz/publications/the-place-where-talent-does-not-want-to-live

paper. Whether the Government agrees to the changes will depend on factors like their fiscal cost and how their benefits compare with those of other agencies' proposals that are competing for the same limited pool of funds. We will use the feedback from this consultation to refine our policy proposals which we will then submit to the Government for its consideration.

1.7 The Government may also consider other FIF changes in the future, such as an increase to the current $50,000 FIF de minimis threshold.

Summary of options

1.8 In designing a solution, the initial choice to be made is whether the change should apply only to migrants or to all New Zealand tax residents. For various reasons discussed below, this paper focusses on a "migrants only" solution. Given that decision, officials have identified two main options for changing the FIF rules. These options would be additional to the existing FIF methods, so migrants would not be forced to use them. They would only apply to migrants who become subject to the FIF rules after a specified date. The Government could apply the changes retrospectively from 1 April 2025. This paper also canvasses a third option that officials do not currently favour but seek feedback on.

Revenue account method

1.9 The FIF interests could be taxed on revenue account. That is, only dividends received and any gain in value of those investments attributable to New Zealand on disposal or emigration would be taxed.

1.10 This method would generally only apply to a migrant's non-listed foreign equity investments at the time of migration to New Zealand. On this basis, the current FIF rules would apply to all other FIF interests held by the person.

1.11 However, if the migrant is likely to face double taxation on their FIF interests, even after they become a New Zealand tax resident, then there is a case for the revenue account method to apply to all FIF interests. This includes listed foreign investments as well as any further FIF interests acquired after they become a New Zealand tax resident.

Deferral method

1.12 The FIF rules could be modified so that they apply on a realisation basis. This could be achieved in a way that is similar to how withdrawals from foreign superannuation schemes are taxed.[3]

1.13 A similar method could be implemented where a migrant's FIF interests are taxed upon realisation, based on a deemed 5% per annum income from the date of their migration, with an interest charge for deferral.

1.14 The advantages of this method are that it taxes on realisation, and the tax liability is determined solely based on the amount those interests are sold for (meaning the actual gain would not be relevant). This resolves the valuation and cashflow issues which are common criticisms of the FIF rules. We think this method could also resolve the double taxation issue because the tax would be applied on a realisation basis, which should give rise to a foreign income tax credit in other jurisdictions. However, this method deems an annual return so

[3] See section CF 3 of the Income Tax Act 2007 and Inland Revenue's public guidance *IR1024 Tax rules for foreign superannuation lump sums* for more information.

it would not resolve the issue of taxable income being misaligned with the taxpayer's true economic gain.

Exit tax

1.15 We suggest for whichever option chosen, consistent with the approach taken in other countries, an "exit tax" (a tax on unrealised gains where a New Zealand resident ceases to be resident) be used to buttress the integrity of either method. We note that the Income Tax Act 2007 currently already deems a disposal at market value on emigration and the methods proposed above would use this existing provision.[4] Strictly speaking, the "exit tax" would not be a separate tax – instead it would be a method to generate income on emigration which would then be taxed under the existing income tax rules.

Document outline

1.16 Chapter 2 provides some important background and context to the problem.

1.17 Chapter 3 defines the scope of the issue and the boundaries of any solution.

1.18 Chapter 4 provides a brief outline of the methods that have been considered.

1.19 Chapter 5 discusses the revenue account method.

1.20 Chapter 6 discusses the deferral method.

Making a submission

1.21 We invite submissions on the proposals in this document, including the specific questions asked and any other issues raised.

1.22 Include in your submission a brief summary of the major points and recommendations you have made. Please indicate if officials from Inland Revenue can contact you to discuss the points raised, if required.

1.23 The closing date for submissions is **27 January 2025**.

1.24 Submissions can be made:

- by email to policy.webmaster@ird.govt.nz with "Amending the FIF rules for migrants" in the subject line, or
- by post to:
  Amending the FIF rules for migrants
  C/- Deputy Commissioner, Policy
  Inland Revenue Department
  PO Box 2198
  Wellington 6140

1.25 Your submission will be proactively released on Inland Revenue's tax policy website. Submissions may be the subject of a request under the Official Information Act 1982. Please clearly indicate in your submission if you consider that any information should be withheld on the grounds of privacy, or for any other reason (contact information such as an address, email, and phone number for submissions from individuals will be withheld). Whether any information is withheld will be determined using the Official Information Act 1982.

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[4] Section EX 64.

CHAPTER 2

Background

Foreign investment fund rules

2.1 The FIF rules aim to protect the integrity of the New Zealand tax base by ensuring that when a New Zealand resident invests in a non-resident company rather than a New Zealand company, that choice does not mean that New Zealand income taxation is unduly deferred or eliminated.

2.2 If a New Zealand resident owns shares in a domestic company, that company pays New Zealand tax on its income as it is earned. Shareholders are taxed on dividends but with an allowance for company tax paid via the dividend imputation system.

2.3 However, New Zealand cannot tax a company that is resident in another country on its non-New Zealand sourced income. New Zealand can tax a New Zealand shareholder on dividends received from such a company, but there are many companies, including some of the largest in the world, that pay no or minimal dividends. Because New Zealand does not tax capital gains, without the FIF rules, no New Zealand tax would ever be paid on an investment in a foreign company that paid no dividends and was sold for a capital gain.

2.4 The result is that without the FIF rules, New Zealand residents have a tax-driven incentive to invest in foreign companies that enjoy low effective tax rates and do not pay significant dividends. Even if they invest in companies with foreign tax rates comparable to New Zealand, payment of foreign tax is of no benefit to New Zealand.

2.5 The FIF rules address the potential loss of New Zealand tax revenue from investment in foreign (rather than domestic) companies by imposing tax on a basis that approximates the tax effect of investing in a domestic company.

2.6 The FIF rules generally apply to investments by a New Zealand resident (other than a transitional resident) in foreign companies and other similar entities. However, there are several exceptions to the FIF rules. The FIF rules do not apply to interests of greater than 10% in a New Zealand controlled foreign company. Holders of these interests are taxed under an attribution method, which essentially:

- Exempts active income from a non-New Zealand business;
- Taxes passive income earned by the foreign business and certain other income that could as easily been earned by a New Zealand company as the foreign company; and
- For a non-corporate shareholder, taxes dividends with a credit for any New Zealand tax already paid under the attributable FIF income method.

This method can also be applied on an elective basis by a person who owns an interest of 10% or more in a non-NZ controlled foreign company.

2.7 This alternative reflects the policy intent that the rigour of the other FIF methods should not apply to income from an “active” as opposed to a “passive” investment. This is on the basis that the location of an active investment is much more heavily influenced by commercial and business considerations particular to the investment than by a simple desire to maximise after-tax income from passive investment. The Government is prepared to defer New

Zealand tax on active investments until income is received (as a dividend) and to miss out on tax altogether when income is derived through sale of shares held on capital account. This differentiation between "active" and "passive" income is a common feature of cross-border tax regimes globally. The use of a 10% interest threshold to discriminate between the two is also common, though at the margin it can seem arbitrary.

2.8 The FIF rules also do not apply to a natural person or family trust whose FIF interests cost less than $50,000, or to shares in an Australian resident company which maintains a franking account and is listed on the ASX. There are also certain exemptions for early-stage companies which have a business in New Zealand.

2.9 There are four different methods for calculating income from foreign portfolio investment under the FIF rules. The most commonly applicable methods for an individual or family trust are the fair dividend rate (FDR) method and the comparative value (CV) method (in a year when the taxpayer's FIF portfolio makes a return of less than 5%).

FDR and CV methods

2.10 The FDR and CV methods apply on a portfolio basis (rather than on a company-by-company basis). In practice, a natural person's income from all their FIF interests subject to the FDR method is the greater of zero and the **lesser** of:

- 5% of the value of the shares at the beginning of the year; and
- the change in value of the shares during the year plus any dividends received, ie income calculated under the CV method.[5]

Cost method

2.11 An individual may use the cost method if the use of the FDR method is allowed but is not practical because the market value of the shares at the time is not readily available. This method, like the FDR method, deems an income equal to 5% of the opening value of the shares at the beginning of each year, although this method differs in how the opening value is calculated. Rather than being based on market value it is based on the cost of the shares plus a 5% per annum uplift. This method will generally be used for unlisted shares, the value of which is not always readily available.

Impact on migrants

Effect of the FIF rules

2.12 The FIF rules, including the FDR method can give rise to tax outcomes that migrants and potential migrants see as undesirable.

2.13 Most importantly, because the FIF rules deem income independent of any cash receipt, the resulting tax liability can be difficult to finance. This is particularly an issue for shares in unlisted companies (such as shares in a start-up), which the individual may have acquired through their overseas employment,[6] or investment activities. Such shares often do not pay dividends and cannot easily

[5] This method ensures that if the individual's return from the shares during the year is less than 5%, taxable income does not exceed this return. Although a loss is not recognised for tax purposes.

[6] There is an exception from the FIF rules for shares acquired under an employee share scheme (section EX 38), but it expires once there is no legal restriction on sale of the shares.

be sold. This is more of an issue for migrants, who have had no reason to take the New Zealand FIF rules into account when acquiring their FIF interests prior to becoming New Zealand residents.

2.14 Second, the FIF rules require valuation of a migrant's FIF interests at the beginning of the year the FIF rules first apply. Valuations can be expensive and difficult, particularly for start-up companies. Valuation is often not required for non-migrant residents.[7]

2.15 Third, double taxation can occur as a result of the FIF rules taxing unrealised income. If a person is subject to tax in another country on gain from the sale of their shares, it is possible that neither the foreign tax on sale nor the tax calculated under the FIF rules are creditable against each other. This is particularly an issue for United States (US) citizens who remain subject to US tax on worldwide income even when they are tax resident elsewhere.

2.16 Another common objection to the FDR method is that over the life of an investment or portfolio, taxpayers may pay tax on an amount more than their economic gain. However:

- this is also a feature of any tax system that excludes capital gains and losses; and
- taxpayers can also pay tax under the FDR method on an amount that is less than their economic gain.

Unfamiliarity issues for migrants

2.17 Migrants may also find the FIF rules unattractive because they are unfamiliar. While they may be accustomed to the idea of paying tax on gains on sale (unlike New Zealand taxpayers) they are less likely to be accustomed to paying tax on deemed income that arises in the absence of cashflow. The negative perceptions caused by the issues outlined above may be exacerbated by the novel nature of the applicable FIF income calculation methods internationally.

2.18 The Government is concerned that all of the issues raised above are discouraging migrants and returning Kiwis from moving to or staying in New Zealand. Hence, the Government is interested in a solution to these issues.

[7] This is because they can often use the cost method, which (as described above)is essentially the same as the FDR method except that it determines the opening value of shares each year by starting with their original cost and adding a 5% per annum uplift.

CHAPTER 3

Scope

3.1 In response to the problem definition set out in the previous chapter, we consider the most appropriate solution would be to allow certain FIF interests held by migrants to be taxed on a realisation basis. This chapter considers a number of parameters which could help frame the solution.

Who would be in scope?

Migrants

3.2 The FIF rules are an integrity measure that protects the New Zealand tax base as well as the domestic capital market. While the FIF rules create a disincentive for migrants, particularly those who already hold FIF interests, to come to New Zealand, any relaxation of the rules needs to be balanced against the continued need for the rules. Targeting the right demographic is therefore critically important. As a starting point, it is useful to consider the definition of a "migrant" that would be in scope for the purpose of this paper.

3.3 The FIF rules may disincentivise expatriates from returning to New Zealand if they have accumulated significant FIF interests while living and working overseas. The issue does not impact only immigrants, hence we consider that defining a "migrant" based on visa or immigration status would not adequately cover everyone. Instead, the tax residency rules may be a more appropriate basis for determining who would constitute a migrant.

3.4 For a New Zealand tax resident to become a non-resident, the person must:

- not have a permanent place of abode in New Zealand; and
- be physically absent from New Zealand for 325 days or more in a 12-month period.

3.5 This is generally a good basis for determining whether a person is a migrant for our purpose as a non-resident has weak ties to New Zealand and has been physically absent from New Zealand for at least a significant part of the year. However, this by itself could raise integrity concerns as those who are internationally mobile could access realisation-based taxation of their FIF interests by simply leaving New Zealand for 325 days. This concern is exacerbated by the growing trend of remote work. The transitional resident regime might be a better basis as it addresses this integrity concern.

3.6 A non-resident person becomes a transitional resident for four years when they become a New Zealand tax resident. To qualify for this treatment, they must have been a non-resident for a continuous period of at least ten years immediately before becoming a New Zealand tax resident and must not have been a transitional resident before. This test is harder to exploit than the simple non-residence test as it is a one-time status granted to people who have been physically absent from New Zealand for at least ten years. Officials are not aware of any issues with those particular policy settings. If existing policy settings for transitional resident status are unproblematic, then those settings are likely also appropriate for taxation of FIF interests on a realisation basis.

Whether any change should apply to everyone or only migrants

3.7 Another issue is whether any changes to the FIF regime should apply only to migrants or also to existing New Zealand residents. The types of people this proposal would be aimed at are often internationally mobile, both inwards and outwards. If New Zealand's tax rules are a disincentive to people who would otherwise take up New Zealand residence, they may also be an incentive to leave New Zealand for New Zealand tax residents we would like to retain. They may also be distortionary when New Zealand tax residents make investment decisions. Further, the FIF rules may also be discouraging New Zealand entrepreneurs from expanding their business overseas or obtaining capital from foreign investors in cases where additional capital might dilute their interests below 10% (making them unable to continue applying the attributable FIF income method).

3.8 However, any measure applied to non-migrant residents would need to be aligned with the existing policy setting of imposing tax on portfolio interests in foreign companies. To achieve this alignment, the measure may need to be significantly limited in its coverage. For example, it may be necessary to limit it to companies the investor had a more substantial connection with than a mere passive investment. Possible limits would be that the person:

- Is or has been a director or senior employee of the company; and
- Held a 10% or greater interest in the company for some time before falling below that threshold.

3.9 A response that applies to everyone might also require a more generous alternative to FDR. New Zealand residents may not be particularly enthusiastic about, for example, a regime that would impose a realised capital gains tax (even though non-residents would in general be better accustomed to such a tax). This is because the marginal income tax rates in New Zealand would be higher than the rates that capital gains tend to be taxed at overseas.[8] It is more likely that New Zealand residents would be looking for some extension to the attributable FIF income method.

3.10 In favour of any proposal applying only to migrants, there is already precedent for applying different rules to migrant residents than to those who have always been residents. Examples are:

- The treatment of employment-related superannuation, where the tax treatment of a migrant to New Zealand on investment made while non-resident is different from the treatment of New Zealand residents on similar investments.
- The treatment of income earned by the foreign trustee of a trust which a person settles while non-resident. Even once the settlor becomes a New Zealand resident, there is no requirement for the settlor or the foreign trustee to pay tax on such income. However, if a New Zealand resident settles assets on a foreign trustee, the settlor is liable for tax on the income from those assets.

3.11 These examples demonstrate that New Zealand's existing rules already recognise that it may not be appropriate to tax migrants in the same way as residents, in respect of income from property they owned before migration. With respect to that property, they are in a different position to New Zealand residents, and this may justify taxing them differently.

3.12 Finally, the revenue cost from a more general rule would be more difficult to quantify. This is because Inland Revenue holds no data that would enable an

[8] For instance, the highest capital gains tax rate in the United States is 20% depending on the taxable income and filing status of the taxpayer.

estimate of who would be affected by the change or by how much. A higher revenue cost may also make the policy harder to justify.

Questions for submitters

- Do you agree the proposal should only apply to migrants?
- What do you think would be a good test for determining whether someone is eligible for having their FIF interests taxed on a realisation basis?
- If you think some test based on the number of years spent as a non-resident is more appropriate, how many years do you think would be appropriate?

What would be in scope?

3.13 This paper is only concerned with direct income interest in a foreign company – that is, foreign shares. As discussed in Chapter 2, the issue is that the FIF rules may be creating a disincentive for migrants from coming to or staying in New Zealand. For foreign shares that are difficult to sell and do not provide a stream of income in the form of dividends, the FIF rules create cashflow problems. Further, some shares can be expensive and difficult to value; usually this is because those shares are not listed on a stock exchange. This difficulty with valuation can be a further disincentive for migrants looking to come to New Zealand.

3.14 The FIF rules tax an individual on deemed income. The tax cost of this deemed income for a person on a 39% tax rate is 1.85% of the value of the investment. If cash income from the investment (generally dividends) is less than the tax, the person will need to:

- use cash on hand or borrowings; or
- sell a small portion of their foreign investments.

3.15 In order to create a self-funding scenario, the person could sell a portion of their investment and reinvest the proceeds in another investment which provides sufficient cash flow to pay the tax on both its own income and the FIF income from the original investment.

3.16 Partial sale should not be problematic for shares that can easily be sold, so there is less of a case for taxing liquid shares on a realisation basis as they are readily disposable and informed investment decisions can be made.

3.17 The issues with the current FIF rules are much more significant for illiquid shares. Illiquid shares are, by definition, difficult to sell. In addition, unlisted shares may come with contractual restrictions on whether and when the individual can sell them. This is often the case for family businesses, companies with venture capital investors, or for senior employees and founders of start-ups. On this basis, it may be more appropriate to make an exception for illiquid shares only and tax those on a realisation basis. A simple way to do this could be to assume all unlisted shares are illiquid, although this might not always be true.

Questions for submitters

- Do you think the proposal should be limited to illiquid shares?
- Do you agree that being unlisted is a good proxy for being illiquid? If not, what is a better way to target illiquid shares?

Investments made after migration

3.18 Another element to consider if any amendment is limited to migrants is whether the amendment should only apply to foreign shares acquired before migration, or whether foreign shares acquired after a migrant becomes a New Zealand resident should be included in scope.

3.19 A person is unlikely to make investment decisions with the FIF rules in mind before migrating to New Zealand. However, once a migrant becomes a New Zealand tax resident, they can be expected to become informed of New Zealand tax laws and make decisions accordingly, just like people who have always been a New Zealand tax resident. It is also the norm that a jurisdiction is able to tax its residents on their worldwide income. Therefore, if a migrant becomes a New Zealand tax resident and then chooses to make further equity investments outside New Zealand, it seems reasonable that New Zealand taxes those investments in the same way it taxes such investments made by residents who are not former non-residents in line with existing rules. Accordingly, any departure from the existing FIF regime should prima facie only apply to pre-migration foreign investments.

3.20 There may be an argument that there should be an exception for illiquid shares as some migrants may be required to make further investments in foreign illiquid shares even after migration. However, we think this could be difficult to justify given people who have always been a New Zealand tax resident could be in similar situations but realisation-basis taxation is not available to them.

3.21 This limitation of the proposal may discourage desirable immigration, but it seems a reasonable compromise between the aim of the proposal and the horizontal equity objective of taxing residents on the same basis where their circumstances are the same.

Setting the scope

3.22 Amendments that are available to migrants only and apply to illiquid shares acquired before migration only would most directly target the FIF interests that are most impacted by the issues identified without inadvertently eroding the integrity of the FIF regime. These settings would serve as our starting point when considering possible amendments. However, we have not come to any firm conclusions and we are interested in feedback on this.

3.23 Further, there is an inter-relationship between the type of solution chosen and its application to non-migrants – some of the solutions discussed later in this paper lend themselves to a wider application than others. Accordingly, which solution is preferred may affect views on whether it should apply to non-migrants.

3.24 If the solution is only available to migrants, making sure the other settings do not adversely impact horizontal equity is important. For instance, there may be a case for a migrant being allowed to tax all pre-migration FIF interests on a realisation basis. Indeed, the New Zealand Institute of Economic Research (NZIER) published a report on this issue and argued for all pre-existing investments in FIFs to be ring-fenced and taxed on a realisation basis.[9] Their rationale for this is that New Zealand should not tax investment decisions that were made before the person becomes a tax resident, but taxing the income from those investments repatriated to New Zealand is appropriate. Although there are existing cases where migrants are taxed differently to people who have always been a New Zealand tax resident, any divergence from the existing FIF rules must be principled.

People facing double taxation

3.25 The above discussion has focussed on migrants facing cashflow and valuation issues. A different issue arises if a New Zealand resident is subject in another country to tax on the income from investments. Unless either:

- the other country's tax is creditable against the New Zealand tax under the FIF regime; or
- the New Zealand tax under the FIF regime is creditable against the foreign tax,

the person will be subject to double taxation.

3.26 So far as officials are aware, if the other country is taxing the income on the basis of source (e.g., by way of a dividend withholding tax) there is no significant difficulty in obtaining a tax credit against the New Zealand tax (of course if the foreign tax exceeds the New Zealand tax, then there will be no credit to the extent of the excess). This is very much the standard pattern where residence base taxation defers to properly imposed source base taxation.

3.27 Matters become more complex if the foreign tax is imposed on the basis not of source but of residence or citizenship. Most migrants do not face this issue, because the vast majority of countries only tax on the basis of residence or source. At more or less the same time as becoming New Zealand tax resident, the migrant will cease to be tax resident anywhere else, either because they cease to satisfy any other country's domestic tests or because a treaty tiebreaker applies.

3.28 Income tax imposed by the US can be an exception to this general pattern, as the US taxes US citizens and green card holders on their worldwide income, wherever they are tax resident. The New Zealand-US Tax Treaty provides that income tax imposed by New Zealand in accordance with the Treaty on a person who is both New Zealand tax resident and a US citizen is creditable against the person's US income tax (Articles 22(1)(a), (3), and (4)(c)). However, this credit is "subject to the law of the United States as it may be amended from time to time without changing the general principle hereof."

3.29 Notwithstanding the wording of the Treaty, officials understand that there may be some difference of approach between taxpayers and advisors as to whether or not tax imposed under the FIF regime can be credited against US income tax. The uncertainty is likely because the two taxes are imposed on different amounts, and possibly will be imposed in different years. For example, if the relevant shares are in unlisted companies paying no or minimal dividends, New Zealand tax under the FIF regime may be imposed well in advance of US tax, and on amounts which are different not only in each year but also in aggregate.

3.30 Officials further understand that the risk that the New Zealand tax will not be creditable, and the different timing of the liability, are significant issues for US citizens considering coming to or staying in New Zealand. These issues could

[9] https://www.nzier.org.nz/publications/the-place-where-talent-does-not-want-to-live

be materially reduced if the New Zealand tax treatment were closer to the US treatment. The double tax issue arising under the FIF regime and the benefit of moving to a system more aligned with realisation, applies both to liquid and illiquid investment, and also to pre- and post-migration investments.

3.31 Officials are not aware of other countries where this is an issue. However, as a general proposition, there would be much less to be concerned about if the rate of tax in the other country is relatively low. Accordingly, if the proposal to allow a realisation method to be added to the FIF rules were extended to all FIF interests held by persons subject to tax on a citizenship basis, it might be appropriate to limit this to where the foreign tax rate exceeds some minimum rate, e.g., 15%. We note that the current rates of long-term capital gains for individuals in the US are 15% and 20%.

Questions for submitters

- Do you agree the proposal should only apply to investments acquired before migration (unless the migrant would otherwise suffer double taxation on any gain from sale)?
- Do you have any views or experience on whether US citizens are entitled to a credit against their US taxes for New Zealand tax imposed under the FIF regime?
- Do you agree that people who would otherwise suffer double taxation on their foreign investments even after becoming a New Zealand resident should be able to have all their foreign share investments taxed on a realisation basis?
- Do you agree that any rule targeted at avoiding double taxation should be subject to the existence of a minimum foreign tax rate? If so, do you agree that 15% is a reasonable minimum rate? If not, what rate would you suggest?

CHAPTER 4

Methods

4.1 We identified in Chapter 3 three questions regarding the eligibility parameters of any given amendment:

- Available for migrants only or for everyone;
- Applicable to illiquid foreign shares only or to liquid foreign shares as well; and
- Applicable to foreign shares acquired before migration only or to foreign shares acquired after the migrant becomes a New Zealand tax resident as well.

4.2 While any solution may be applied to any combination of the three questions, they need to form a coherent package, having regard to horizontal equity and the integrity and purpose of the FIF regime. In producing this consultation document, we considered three different methods:

- Adjusting the attributable FIF income method
- Revenue account method
- Deferral method

Adjusting the attributable FIF income method

4.3 The attributable FIF income method is an existing method for calculating a person's FIF income. Currently, this method can only be chosen by a person with an income interest of 10% or more in a FIF which is a foreign company if sufficient information can be provided to Inland Revenue to check the relevant calculations. The calculations can be complex and are based on the CFC rules with certain modifications – no FIF income arises if the company is an active FIF[10] but a person may have to report dividends in their tax return and pay tax on capital gains if the interest is held on revenue account (which we expect it generally would not be).

4.4 A potential relaxation of the FIF rules would be to remove the 10% threshold required to access this method. This would allow an individual to access the attributable FIF income method for any interest in an active FIF. The 10% threshold acts as a brightline for distinguishing between active and passive investment, so removing this threshold would require another metric for distinguishing between active and passive investments. It might be reasonably argued that having access to the information required to make the relevant calculations under this method would suggest the investor has a more active role within the company. However, this may not be considered sufficient by itself, and another test may be necessary to adequately draw the line between active and passive investments. For example it could be limited to companies the investor had a more substantial connection with. Some possibilities for are considered in the previous chapter in the discussion on whether the proposal could apply to non-migrants.

4.5 This method would resolve the cashflow and double taxation issues. Given this is an existing method and we are just adjusting the eligibility criteria, there is

[10] Generally, this is a FIF of which passive income is less than 5% of gross income.

a stronger case for this method to be available to everyone. Under the current rules, the method is available to liquid or illiquid shares but requires the taxpayer to be able to provide the requisite information for their calculation to be checked. However, we would need to consider whether the method should be restricted to illiquid investments for less than 10% shareholdings.

4.6 We do not consider this method on its own to adequately resolve the issues identified. While this method resolves most, if not all, of the issues identified in Chapter 2, it only does so for individuals with access to the requisite information. This would likely exclude a significant portion of migrant and non-migrant tax residents. For those who are able to access this method, the calculations can be complex.

4.7 For these reasons officials do not currently favour this method, but we are interested in any feedback on its desirability and potential design parameters.

Questions for submitters

- Do you think that removing the 10% threshold for accessing the attributable FIF income method is a viable solution? If so, should it apply to everyone or just migrants and to liquid investments as well as illiquid ones?

Revenue account method

4.8 Another method would be to tax in-scope shares on revenue account. This means only dividends and any capital gain on disposal are taxed. Because this method is concessionary, our starting point is that this method should be available to migrants only, and applicable to illiquid shares acquired before migration. This method is discussed further in Chapter 5.

Deferral method

4.9 A third method is to account for and tax FIF income on a realisation basis. This method is similar to how lump sum withdrawals from and transfers of foreign superannuation schemes are taxed now. Because this method preserves the integrity of the FIF regime, there is a stronger case for this method to be available to non-migrant New Zealand tax residents as well. However, we note that there would still be a fiscal cost in the short-term as tax would not crystalise until the shares have been disposed. This method is discussed further in Chapter 6.

CHAPTER 5

Revenue account method

5.1 The "revenue account method" would be a new FIF calculation method under which only dividends and gain on sale of foreign shares (to the extent attributable to the period of the owner's New Zealand tax residence) are taxed.

Eligibility

5.2 As noted in Chapter 3, our starting position is that this method should be available to migrants only and only apply to illiquid shares acquired before migration.

5.3 For migrant tax residents who continue to be subject to an effective tax of 15% or more in another jurisdiction on their worldwide income, they would be allowed to apply this method on all foreign shares.

Questions for submitters

- Do you agree the revenue account method should be available in relation to all investments owned by migrants facing double taxation at an effective tax rate of 15% or higher?

Optionality

5.4 Treating foreign investments as held on revenue account and taxing them on a realisation basis would address the cash, non-creditability, and "taxation in the absence of economic gain" issues referred to in Chapter 2. However, it is a proposal that might be less attractive for some migrants than the existing FIF regime. For instance, this might be the case if the taxpayer believes that they may make a significant capital gain from sale of the shares within a short period of time. It may therefore be desirable for taxpayers to be able to opt into this method, rather than making it mandatory.

5.5 For ease of administration and to prevent cherry-picking, officials propose that the revenue account method be applied to a taxpayer's entire portfolio, rather than on a company-by-company basis. That is:

- Under the general rule, a migrant who elects to apply this method would elect it for all their pre-migration illiquid shares
- Under the rule applying to migrants still subject to tax on a citizenship basis, a migrant would have to apply this method to all their foreign shares.

5.6 It would not seem to make sense to allow taxpayers to switch between the realisation and other methods. Accordingly, the election to use the realisation method should be a once-only election, that is made the first year a person is eligible to make it or not at all.

Questions for submitters

- Do you agree that this method should be elective?
- Do you agree that the method should apply on a portfolio basis?
- Do you think that electing into this method should be irreversible?

Change of circumstances

5.7 If a migrant's circumstances change and they are no longer subject to double taxation over 15% (for instance, if they gave up their US citizenship), it might be appropriate to shift from the migrant applying the revenue account method on all foreign shares to just their illiquid shares acquired before migration. Our starting position is that, once a taxpayer no longer faces double taxation, the rationale for them to be able to apply the revenue account method on all foreign shares no longer exists. We think it would be more principled for the taxpayer to apply the current FIF rules on all their post-migration foreign shares, as well as any liquid pre-migration foreign shares.

5.8 To make this transition, the taxpayer would be deemed to have disposed all liquid pre-migration foreign shares and all post-migration foreign shares. They would pay tax on any gains attributable to the period after they became a New Zealand tax resident. The taxpayer would then apply the current FIF rules on those shares from the start of the next tax year.

5.9 We do not think this transition method would be inappropriate. Many capital gains tax regimes include an exit tax as an integrity measure. Most exit taxes deem emigration to be a disposal event and tax the capital gains accordingly. A person who no longer faces the possibility of double taxation may well have triggered the exit tax of another jurisdiction. It makes sense for a deemed disposal event to be triggered under the revenue account method as well in such a scenario.

5.10 The alternative would be for the taxpayer to continue to use revenue account method for all shares acquired while they were still subject to double taxation and use the existing methods for all shares acquired afterwards. This would be simpler, as it would remove the need for a transitional tax calculation.

Questions for submitters

- Do you agree that a migrant who would no longer suffer double taxation should align how they treat their foreign shares with migrants who were not subject to double taxation?
- Do you agree with the suggested approach to deem a disposal for market value in this case?

Rate

5.11 Our starting point is that the tax rate on gains from the disposal of the in-scope foreign shares should be the taxpayer's marginal tax rate. This is intuitive because the tax rate on FIF income under the current rules is also the taxpayer's marginal tax rate. However, a marginal tax rate up to 39% on capital gains may be too high to make taxation on realisation an attractive option. This is because foreign jurisdictions tend to tax capital gains at a lower rate, or they allow a discount on those gains to account for the effects of inflation. Most relevantly, the rate for long term capital gains in the US is either 15% or 20%, depending on a person's level of income. The rate in Australia is a person's marginal rate but only half of the gain is taxed, so the effective tax rate varies from 8% to 22.5%. In the UK the rates are generally 18% or 24%.

5.12 We note that the 2019 Tax Working Group considered what the appropriate tax rate would be if New Zealand ever introduced a comprehensive capital gains tax regime. In their final report, they did not recommend any discount, nor did they recommend that income derived from realising included assets should be adjusted for inflation. In their deliberation, they concluded that reduced rates would increase complexity and compliance costs and would limit the extent to which a comprehensive capital gains tax would improve the horizontal and vertical equity of the tax system. In addition, a realisation-based tax would already provide significant deferral advantage to the taxpayer, which would offset the impact of inflation.

5.13 However, we recognise that for many migrants, a tax on their capital gains at 33% or 39% could mean the FIF rules would continue to be a deterrent to settling in New Zealand.

Questions for submitters

- Do you think a lower tax rate or discount would be appropriate under the revenue account method?
- Can you explain what tax rate or rate of discount would be appropriate and why?

Cost basis

5.14 Using the cost base of shares acquired before a person becomes New Zealand resident would mean bringing accrued gains and losses from the pre-migration period into the New Zealand tax base. This is not necessarily appropriate given those gains or losses accrued before New Zealand had a taxing right over them. Alternative methods are:

- To value the shares on the date the person becomes a New Zealand resident (or possibly the date the FIF rules begin to apply to the person);
- To apportion the taxable gain or loss that arises when the shares are sold or otherwise deemed to be disposed of over the period of the person's ownership into a pre-New Zealand residence portion and the remainder. Only the remainder would be brought into the New Zealand tax base. The apportionment would be based purely on the time the shares were held pre-migration versus post migration. So, for example, if the shares were acquired 6 years before the person migrated to New Zealand, and the person held them for a further 6 years post-migration before selling them, only half of the gain on sale would be attributed to New Zealand and subject to tax.

5.15 The second approach assumes that the eventual gain or loss on the shares accrues evenly over the person's ownership. It requires knowledge of the cost and acquisition date of the shares, but avoids the need for a valuation on the date they enter the New Zealand tax base.

5.16 Another issue that will need to be considered is the cost-flow assumption where shares are both acquired and disposed of in more than one tranche. The two cost-flow methods currently allowed for the purpose of valuing excepted financial arrangements are first-in first-out (FIFO) and weighted average cost

(WAC). However, the WAC method may not be appropriate as it does not allow tracking of which shares have been disposed of, which is critical for the application of different methods to shares acquired before and after migration. As a general proposition, officials believe that a FIFO assumption will be preferable.

Questions for submitters

- Do you think it would be better to establish the opening value of shares for New Zealand tax purposes with a valuation requirement, or to use a pro rata time-based apportionment?
- Do you think we should allow other cost methods in addition to, or in place of, FIFO? If so, what other methods would you suggest and why?

Disclosure

5.17 The current law requires that a person discloses their FIF interests on a dedicated form, although individuals are exempt from this requirement if they use the FDR or comparative value methods to value their interest and the FIF is resident in one of the 41 countries with which New Zealand has a tax treaty.[11] These disclosures typically include:

- Name of the FIF
- Stock exchange code (if known)
- Country of incorporation, organisation or registration
- Opening market value in New Zealand dollars

5.18 We think that migrants electing to use the revenue account method should be required to disclose their pre-migration interests to which they are applying this method. Primarily, this is to provide information necessary to determine the amount of income attributable to New Zealand when the pre-migration interest is eventually sold. This is also necessary to give Inland Revenue visibility of the extent to which this method is being used and would improve Inland Revenue's ability to audit its use.

5.19 We would require the following information in relation to the shares to which the individual is applying the revenue account method. This is in addition to what we already require for existing FIF disclosures.

- Number of shares owned
- Cost of further shares acquired throughout the year
- Cost of shares disposed of throughout the year
- Amount shares were disposed for throughout the year
- Gain from the disposal of shares throughout the year

[11] "International tax disclosure exemption ITR35", issued 31 March 2024.

Questions for submitters

- What information do you think taxpayers who elect to apply the revenue account method should disclose?

Migration and other non-market value disposals

5.20 The tax on gains should not be able to be circumvented by the taxpayer emigrating from New Zealand. That would create an incentive for a migrant who has become New Zealand resident and who has appreciated shares, to emigrate before selling them. That is the opposite of what this proposal is trying to achieve.

5.21 With increasing tax residence mobility, exit taxes are becoming a more common integrity measure in countries that have capital gains tax. There are numerous questions in the design of such a tax. Imposing it when the shares are sold, which may be many years after the person has left New Zealand, seems challenging from a compliance perspective. Imposing it when the person leaves would require valuation of the shares and the imposition of a tax although the individual may not have the cashflow to meet it. Unless significant resources are devoted to setting up appropriate systems, there is a real issue as to the level of compliance we can expect with an exit tax.

5.22 We propose that an exit tax be imposed if a person who has elected to use the revenue account method subsequently ceases to be resident in New Zealand. Section EX 64 of the Income Tax Act 2007 already deems a disposal of FIF interests at market value when a person leaves New Zealand. The revenue account method would simply tax the value of this deemed disposal. The migrating person would return this income in their tax return for the year of migration.

5.23 There are other situations when investments subject to this regime may be disposed of for less than market value. The most common are by gift, on death, or under relationship property procedures. In general, the Income Tax Act 2007 taxes such disposals as sales for market value, but there is an exception for most transfers on death and transfers of relationship property. In these cases, the transferor generally recognises no gain or loss. Instead, the transferee "steps into the shoes" of the transferor, being treated as having acquired the property at the same time, for the same purpose and for the same price, as the transferor. We suggest that these provisions also apply to shares subject to the revenue account method. However, if the transferee is a non-resident, the market value sale rule would continue to apply since those interests would be leaving the New Zealand tax base and subsequent disposals could not be taxed.

Questions for submitters

- Do you agree that an exit tax should be implemented alongside the revenue account method to shore up the integrity of the regime?
- Do you agree that transfers on death or under relationship property procedures generally should not constitute a disposal event?
- Do you agree that transfers on death or under relationship property procedures should constitute a disposal event if the transferee is a non-resident?

Losses

5.24 Most of the methods for calculating income from FIFs cannot produce a loss. Of the two that can:

- Losses under the comparative value method from a particular FIF can reduce other FIF income calculated under the comparative value method in the same year but are otherwise lost.
- Losses under the attributable FIF income method can only be used against attributable FIF income from the same country, either in the current or a future year.

5.25 Based on the above, we propose that any loss on sale from investments subject to the revenue account method be able to be used only against other FIF income arising under this method in a same or a future year.

Questions for submitters

- Do you agree that loss on sale from investments taxed under the revenue account method should only be allowed to be used against other FIF income arising under this method?
- Do you agree that loss on sale from investments taxed under the revenue account method should be able to be carried forward into future years?

CHAPTER 6

Deferral method

6.1 An alternative method for taxing FIF interests on a realisation basis is to apply the FDR method retrospectively upon a disposal event. This method involves taking the sale price of the shares and calculating the gain based on a deemed 5% per annum return over the period the taxpayer has been in New Zealand. This method is similar to the schedule method used to calculate the tax on foreign superannuation lump sums under section CF 3 of the Income Tax Act 2007.[12] Under the schedule method, individuals pay tax on a percentage of the lump sum from their foreign superannuation. The percentage varies according to how long they have been a New Zealand tax resident:

Table 1: Schedule method

Year	Percentage %	Year	Percentage %
1	4.76	14	60.27
2	9.45	15	64.08
3	14.06	16	67.84
4	18.60	17	71.53
5	23.07	18	75.17
6	27.47	19	78.75
7	31.80	20	82.28
8	36.06	21	85.74
9	40.26	22	89.16
10	44.39	23	92.58
11	48.45	24	95.83
12	52.45	25	99.08
13	56.39	26+	100.00

6.2 When a tax resident disposes of their foreign investments, they would include a percentage of the proceeds of sale in their return as FIF income. The amount of the sale proceeds included would be based on the number of years they have been a New Zealand tax resident (using the same inclusion rates as for the schedule method set out in Table 1). To align with the transitional resident exemption, we suggest excluding the years when they have transitional resident status. For migrants facing double taxation who dispose of shares acquired *after* migration to New Zealand, they would determine the inclusion rate by using the number of years since their transitional resident status ended or the acquisition of those shares, whichever is later.

6.3 This method seeks to address the issues identified in Chapter 2 without departing in principle from the existing FIF rules. By delaying the payment of tax until the FIF interest is sold, this method resolves the cashflow issue. As the deemed gain is calculated based on the number of years the taxpayer has been a resident of New Zealand and the amount those FIF interests have been sold for, this method should also resolve the valuation issue as no cost basis is

[12] Foreign superannuation

required. As a tax liability arises on realisation, we think this would resolve the double taxation issue as well. Further, the schedule is administratively simple to apply.

6.4 This method is not without its disadvantages. Firstly, it deems an annual 5% return on investment. This means that the taxpayer may still have a tax liability even if they dispose of their foreign shares for a loss. There may be the possibility of using the formula method that is an alternative to the schedule method for foreign superannuation schemes under section CF 3 (see below), but the formula is complex and may not be viable for most people.

6.5 Second, although this tax has the merit of being imposed on a dividend or sale, the relatively unusual calculation of the liability might raise an issue of creditability against (for instance) US capital gains tax.

6.6 Third, the schedule recognises that a benefit is conferred by deferring the payment of taxes on FIF income and has some interest baked in to compensate. This means that the entire amount the shares were sold for could be taxable. Some would argue that a 100% inclusion rate would result in the cost of those investments being taxed as well as the profit. While this is due to the inclusion of interest to compensate the government for the deferral of payment, this is not intuitive – particularly if the shares were sold at a loss.

Questions for submitters

- Do you think the deferral method is a viable solution to the problems identified in Chapter 2?
- Do you agree that the deferral method could resolve the double taxation issue faced by some migrants?
- If you do not favour the deferral method, can you explain why and what would be a better solution?

Formula

6.7 When the schedule method was implemented in 2016 for foreign superannuation schemes, the formula method was implemented alongside it as a way for taxpayers to be taxed on the actual gains of their foreign superannuation scheme interest. However, the prescribed formula with which the taxpayer works out their actual gains is complex,[13] as the formula also includes an interest charge to recognise that payment of the tax had been deferred until money was withdrawn from the scheme.

6.8 We think the formula method, although complex, could provide a way for taxpayers to be taxed on their actual gain (if lower than the deemed 5% per annum) or loss on disposal. However, we are uncertain how useful a complex formula method would be.

Questions for submitters

- Do you think a formula for calculating actual gains would be a viable alternative to using a schedule?

[13] Foreign super and the formula method

Dividends

6.9 The FDR method deems an annual income equal to 5% of the opening value of an individual's foreign shares. This substitutes for any dividend income received during the year as well as any gain in the value of those shares. However, if the deemed income does not arise until the disposal of those shares, a question arises as to what happens to the dividends paid throughout the holding period.

6.10 Officials' view is that any dividends received throughout the holding period should be taxable as they are received. This is because the value of those dividends would reduce the share price on disposal.

6.11 However, not all of the dividend should be taxed. Instead, the amount taxable should be determined in accordance with the inclusion schedule that would apply to a complete sale. For example, if a dividend of $100 were paid in the 10th year after a person ceased to be a transitional resident, 44.39% of the dividend would be subject to tax. This effectively treats the dividends as if they were consideration for a partial disposal of the shares.

Questions for submitters

- If the deferral method was adopted, do you agree with the proposed treatment of dividends set out above? If not, what treatment would you suggest and why?

Eligibility

6.12 The deferral method provides a way to defer the payment of FIF income until realisation while preserving the integrity of the FIF rules as it includes an interest charge for the deferral. For this reason, there is a stronger argument for this method to be used by New Zealand residents for their illiquid investments. However, extending this method to all investments would increase the fiscal cost of the proposal and would be a broader approach than required to solve the relevant policy problem.

6.13 The deferral method should be elective. We consider it would be too complex to allow this decision to be reversible as opting out of this method would require a wash-up calculation to be performed to maintain the integrity of this method. We therefore propose the deferral method be available only in the first year the interest is subject to the FIF regime and that this decision would not be reversible.

Questions for submitters

- Do you agree that the deferral method should be elective?
- Do you think that the deferral method should be available to everyone?
- Do you think the decision to elect into the deferral method should be reversible?

Disclosure

6.14 In order to assist Inland Revenue with the efficient administration and audit of the deferral method, additional disclosures should include the taxpayer's election to apply the deferral method, the date from which the assessable period starts and whether this is the date the individual's transitional resident status ends or the date the shares were acquired if after the end of the transitional resident status.

Questions for submitters

- What information do you think individuals who elect to apply the deferral method should have to disclose?

Migration and other non-market value disposals

6.15 We consider the discussion in Chapter 5 on emigration and other non-market value disposals to also be relevant to the deferral method (please refer to the "Migration and other non-market value disposals" section in Chapter 5). Accordingly, the same exit tax would also be required for taxpayers whose New Zealand tax residence ceases when they use the deferral method.