



14 February 2011

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Dear David,

Introduction

1. Thank you for your letter dated 28 January 2011 giving the Investment Savings and Insurance Association (“ISI”) the opportunity to comment on the design of the proposal to remove the over-taxation of non-resident investment into PIEs.
2. We would like to record our appreciation for the very open and constructive process that you have followed in consultation with the industry on this issue.
3. ISI is supportive of the proposal, with the proviso we are concerned regarding the complexity of the Foreign Investor Variable Rate option. We support the proposals to simplify the design and consider that further changes are required to reduce the compliance costs and implementation costs of this option.. The proposal is likely to be taken up by relatively few (specialised) funds in the early stages and care should be taken to ensure that the design does not incur excessive costs for the wider industry.
4. We have limited our comments to those areas where we recommend an amendment to the design, or where the intention of the proposal is not clear.
5. If appropriate we are keen to meet to discuss these comments in more detail.

Comments

Definition of investment in land

6. It is not clear from the proposal what the test for 'land' would be and whether 'investment in New Zealand land' would include a listed property trust. First glance would indicate that an investment in a listed property trusts would be allowed in a Variable Rate PIE, as it results in NZ dividend flow, whereas an investment resulting in attributed PIE rental income from a direct property investment would not be allowed. Such a distortion does not appear appropriate.

Diversified/Balanced funds currently usually have a property exposure and the exclusion of 'land' may mean that these funds could not elect to become Variable Rate PIEs. In the interest of ensuring that the legislation can be adopted in the time frame anticipated, we will accept this distortion if 'land' is defined to exclude an investment in a listed property trust but to include an unlisted property PIE. However, if there are wide scale elections to become Variable Rate PIEs, we would appreciate acknowledgment that the exclusion of 'land' from Variable Rate PIEs may need to be revisited.

7. *Categories of Foreign Investor PIE*

- 7.1 We recommend that the legislation is drafted to allow different classes of a PIE to opt into different categories and in particular the Foreign Investor Zero Rate category. The investor information requirements would be required to be retained as proposed for all the investors in a PIE where a class has elected for a Foreign Investor option.

Foreign Investor Zero Rate PIE

- 7.2 It is not clear how the 5% cash de minimis will be tested. These details are important to ensure that the 5% cash de minimis is appropriate. We recommend a quarterly test in line with the existing PIE eligibility test. The existing eligibility tests for PIEs should be modified to ensure that Foreign Investor eligibility is not immediately lost at the end of the first quarter because a failure is within the control of the entity.

Foreign Investor Variable Rate PIE

- 7.3 We recommend simplifying the tax rates for the different income sources to:

- Remove the 15% and 30% (no DTA) rate
- Reduce the 1.44% AIL rate to 0%.

- 7.4 The AIL rate should be zero percent as we anticipate the proposed legislation to exempt AIL from certain widely held bonds will be enacted. Through the function of the existing PIE eligibility criteria it is anticipated that most funds would meet the widely held bond criteria for the exemption of AIL. As such, any lost revenue would be minimal and would be unlikely to exceed the compliance cost of maintaining both another PIR rate as well as tracking another type of taxable income.

- 7.5 A 0% rate would be applied to the imputed dividend income where this income is subject to RWT and PIE elects that this withholding tax is a final tax for a non resident.

7.6 For the PIE where 0% rate is applicable to all interest and dividend NZ sourced income the PIE should not need to provide to the Inland Revenue separate details of interest and imputed dividend income.

7.7 We understand that it is intended that the income sources listed in paragraph 15 encompass all income from NZ financial arrangements. It is not clear whether any losses will be able to be deducted or whether a tax rebate will be paid if a PIE has a loss on financial arrangements at the end of the year. In the event that a loss in one period is recovered by a gain in the next, investors are likely to be surprised if they are taxed on that recovery. If our recommendation in paragraph 7.3 above is not accepted we consider that both realised and unrealised gains on financial arrangements should be treated as foreign sourced income and taxed at the nil rate.

8. ***Unimputed Dividends***

8.1 The proposals regarding NRWT have the potential to create significant systems development issues that may be justified only for specialist funds with large non-resident investors.

8.2 We will reserve further comment until we see the detail of the drafting but recommend care to ensure that this provision does not compromise existing funds.

9. ***Wholesale Funds – reporting requirements***

9.1 Our understanding is that due to the possible compliance costs this regime is optional. We consider it is important that no additional compliance costs should be imposed on Funds that do not elect to be a 'Foreign Investor PIE' or wholesale Funds that elect not to provide the required information. Therefore no additional information / compliance costs should be imposed on those funds that do not elect into the regime.

9.2 It is a commercial decision whether a Fund opts into the regime and as such they must negotiate with their own suppliers how any additional IRD information will be supplied to the Fund. The proposed legislative changes should not impose an obligation on the wholesale funds which do not opt into the regime.

9.3 If a wholesale fund is required to undertake system development in order to supply the required additional information, then the retail funds will also be obliged to undertake system development in order to receive this.

If a wholesale fund has agreement from its retail fund investors that it will not elect into the regime, both funds should be able to continue to operate under the current reporting requirements. Otherwise, funds will be forced to make IT changes for no benefit.

10. ***Investors Changing Residency Status***

On consultation with the industry the proposals are that the "notified foreign investor" can only change their PIR from the beginning of the next tax year.

However on further reflection such an approach is inconsistent with current processes for investors changing their PIR (which is applied to future redemptions). We note that the proposed approach will be inconsistent with changes for residents and will require system changes to accommodate such a change.

Hedging

We look forward to continuing discussions on the FDR hedging issue as you consider options.

We would be happy to discuss these comments in more detail.

Yours sincerely,

Deborah Keating
EXECUTIVE OFFICER