



10 October 2008

Imputation Review
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
P O Box 2198
Wellington

Streaming and Refundability of Imputation Credits

The Investment Savings and Insurance Association of NZ Inc. (“ISI”) appreciates the opportunity to comment on the Government tax policy discussion document *Streaming and refundability of imputation credits*.

Our comments on the discussion document are set out below.

Issue

The current imputation rules do not provide refunds for imputation credits that cannot be used. Chapter 4 of the discussion document requests submissions on providing refunds for imputation credits for tax-exempt organisations such as charities and, in particular, seeks comment on the following matters:

- Does the absence of a rule allowing a refund for imputation credits affect the type of investments a tax-exempt organisation makes;
- If rules were introduced to allow imputation credits to be refunded what checks and balances would a responsible refund mechanism have to ensure they did not undermine the objectives of the imputation system?

Background

Does the absence of a rule allowing a refund for imputation credits affect the type of investments a tax-exempt organisation makes?

ISI members administer over 400 charitable trusts. Submissions from ISI members indicate that the absence of a rule allowing a refund for imputation credits does influence the investment behaviour of trustees. The net of tax return from investing in managed funds and shares means these investments are less attractive to trustees. Within appropriate levels of risk trustees may seek higher gross returns from other assets such as directly held commercial property.

This also results in trustees favouring fixed interest instruments because charitable trusts holding an exemption certificate have no withholding tax deducted. This is despite the fact charitable trusts set up for long term or perpetual benefits would not usually invest in fixed interest securities as a substitute for share investment. Investment only in fixed interest securities assists the short term income objectives but denies the opportunity for capital preservation.

Members also noted that some overseas jurisdictions (notably Australia) will recognise the tax exempt status of New Zealand charities and accordingly refund non-resident withholding tax. Other jurisdictions refund tax credits to non-residents. This means trustees will sometimes favour foreign rather than domestic investments, other than for reasons of portfolio diversification.

Checks and balances to ensure any refund mechanism did not undermine the objectives of the imputation system?

Tax Planning

Members support adopting similar scoping rules as Australia to qualify for a refund and would, in principle, support adopting similar avoidance mechanisms.

In relation New Zealand charities it is noted that tax exemptions are only available to trusts registered with the Charities Commission. All registered trusts are required to file financial statements with the Charities Commission. They are required to fill out a survey detailing sources of income. All trusts filing accounts with the Charities Commission are also required to supply their IRD number. We understand financial information supplied to the Charities Commission is provided to Inland Revenue.

Therefore revenue authorities should be able to receive and consider applications for refunds with only limited work. A trust believing it is entitled to a refund would make an application that relates to the financial statements that must be filed with the Charities Commission. Detail as to amounts must cross reference to numbers in the filed financial statements.

Although the trusts under management do not actively trade their assets they will make adjustments to portfolios to meet changing conditions. The attraction to acquire shares at less than usual market price because of tax benefits being part of the price, as in example 8 from the discussion document, has been considered. It is suggested that, similar to Australia, this could be controlled by a double mechanism of an anti-avoidance rule and a minimum holding period eg refunds could apply only to investments held for a minimum period of 3 months. It is also suggested the rebate

would only apply to imputation credits received from shareholdings in or held through widely held entities such as:

1. Widely held companies (as defined in the Income Tax Act 2007);
2. Portfolio Investment Entities (“PIE”);
3. Group Investment Funds; or
4. Unit Trusts.

Finally, Inland Revenue also has discretion as to whether it will grant charities tax exempt status. It is submitted any charity abusing this regime could face losing its tax exempt status.

Fiscal cost

As noted, trusts that are tax exempt file financial information with the Charities Commission so the amount of revenue at stake should be able to be accurately estimated by Officials. It would also be a fairly simple matter of getting charities to disclose the amount of their imputation credits either in their financial statements or in the Charities Commission Survey.

It is estimated by Members that currently the amount of imputation credits that are lost to the charitable trusts they administer are approximately \$2,000,000 per annum.

Members do not consider this to be a significant cost to the revenue base. They also refute that this is a cost to New Zealand as all rebates received would be put back into the community, directly targeting those in need and being used to educate young New Zealanders.

Fairness

It is noted that currently individual taxpayers may receive refunds of imputation credits for investments in PIEs. Therefore, there is an existing element of unfairness in that charities have been excluded from receiving refunds on imputation credits for their investment in a PIE while a 39% taxpayer may receive a refund on their imputation credits.

While members would welcome Officials extending the refund of imputation credits to other tax exempt entities they note that charities are particularly affected by this. Local authorities, friendly societies and amateur sports clubs may all levy subscriptions, rates and receive other forms of income from their members which are tax exempt. While a minority of charitable trusts actively seek donations the majority of them rely on investment income earned on the capital from the original bequest by the settlor. This investment income when invested in a company is subject to tax at 30%.

Preferred Solution

Tax exempt entities pursuing their objectives principally in New Zealand would receive a rebate on imputation credits received from shareholdings in or held through widely held entities such as:

- Widely held companies (as defined in the Income Tax Act 2007);
- Portfolio Investment Entities (“PIE”);
- Group Investment Funds; or
- Unit Trusts.

These shares would need to have been held for a minimum holding period to qualify. This rebate could also be subject to avoidance measures discussed above.

Please contact this office if any clarification of these points is required.

Yours sincerely,

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CHIEF EXECUTIVE