

INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ INC

Submission
to the
Finance & Expenditure Select
Committee
on the
Taxation (International Taxation,
Life Insurance, and Remedial
Matters) Bill

3 December 2008



I·S·I

<u>Contents</u>	<u>Page</u>
1.0 Introduction	3
2.0 Recommendations	4
3.0 Detailed Comments	
3.1 Currency hedging and the FDR method	7
3.2 PIE Eligibility	
3.2.1 Association	8
3.2.2 Investor interest adjustment	9
3.2.3 Public unit trusts	10
3.2.4 Community Trusts	11
3.2.5 Portfolio investment proxy	11
3.3 Other PIE Issues	
3.3.1 Land loss restriction	12
3.3.2 Consolidated tax group including PTREs	13
3.3.3 Transferring member scheme expenses	13
3.3.4 Partial withdrawals and subsequent tax rate changes	14
3.3.5 Corporate investors in PIEs	16
3.3.6 Notification requirements for Multi-rate PIEs	16
3.3.7 Terminology in rewrite of PIE Rules	17
3.4 FDR Issues	
3.4.1 Quick sale adjustment in FDR calculations	18
3.5 Other PIE and FDR issues	
3.5.1 FWT rules and PTREs	18
3.5.2 Management fee rebate and FDR	19
3.5.3 Tax credits for supplementary dividends	20
3.6 Tax deductibility of interest under IFRS	20
3.7 Stapled securities	23
Appendix One: Table: Impact of currency hedging	26
Appendix Two: List of Members	27

INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ INC

SUBMISSION TO THE FINANCE AND EXPENDITURE SELECT COMMITTEE ON THE TAXATION (INTERNATIONAL TAXATION, LIFE INSURANCE, AND REMEDIAL MATTERS) BILL

1.0 Introduction

The Investment Savings and Insurance Association (“ISI”) welcomes the opportunity to comment on the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill (“the Bill”).

ISI represents the issuers and managers of life insurance, superannuation and managed funds that in total have responsibility for approximately \$60 billion of assets. A list of ISI members appears at the end of this document. The interests of ISI members lie predominantly in:

- Life insurance
- New Zealand-based collective investment vehicles,
- New Zealand-based custodial/wrap account services,
- Commission income generated from selling offshore-based product.

ISI has made a separate submission to the Committee specifically commenting on the revised taxation regime for life insurance.

This submission refers only to the changes proposed for the Portfolio Investment Entity (“PIE”) rules. We generally support the provisions in the Bill and have appreciated the opportunity for discussion with officials during the development of the proposals. Our submission sets out a number of suggestions for technical amendments that we believe will improve the practical application of the legislation.

The list of recommendations is followed by detailed comments on each of the technical issues.

2.0 Recommendations

- That the NZ dollar hedging arrangements entered into by PIEs in relation to their offshore equities should be excluded from the financial arrangement rules.
- That section YB 11 and YB 12 relating to association for trusts and limited partnerships should be amended to ensure that a manager of a fund does not become associated with the fund even though the manager has no beneficial interest in the fund.
- That section HM 48 should be amended to require a PIE to adjust an investor's interest or a distribution to reflect the investor's prescribed investor rate within a reasonable time period i.e. that no specific date be prescribed in the legislation.
- That IRD support material should advise that a 'reasonable time period' would include payment made by the later of 30 June or 60 days of receipt of a PIE rebate for a PIE in a net-rebate position.
- That Section HM 27 should be removed.
- That the current section HL 9 should be retrospectively amended so that there is no investor interest size requirement for a portfolio investor class that, if treated as a unit trust, would meet the requirements of one or more of paragraphs (a) and (c) to (e) of the definition of a public unit trust. This should be in addition to the current provision which applies for an investor who would meet those requirements.
- That section HM 22 should be amended to provide that sections HM 14 and HM 15 also do not apply to an investor who, if treated as a unit trust, would meet the requirements of 1 or more of paragraphs (a) and (c) to (e) of the definition of public unit trust.
- That in new section HL 9(4) (hc) and section HM 21(1) (g) of the rewrite, "Community Trusts" should be added to the list of investors to which exceptions apply, after Auckland Regional Holdings.
- That the use of "investor" in section HL 9 should be amended to ensure that where a PIP is concerned, the underlying investor is the person who is limited to holding 20% or less of the class, rather than the PIP; and
- That further consideration should be given to allowing a PIP to be an excluded investor subject to a notification requirement at certain levels of holdings.
- That the definition of "land investment company" in cl.408 (72) should be amended to exclude foreign PIE equivalents (referred to as foreign investment vehicles in the 2007 Act).

- That the proposed section HM64 (currently section HL32) should be restricted to losses arising from the investments in land or shares in the land investment companies referred to.
- That section IC 4 should be amended to clarify that a wholly owned group of companies can include PTREs and that this can apply to a PTRE that owns 66% of the voting interests in portfolio land companies.
- That section HM 36 (e) (ii) should be amended to allow a member scheme to transfer deductible expenses eligible for transfer under subpart DV to any multi-rate PIE that the member scheme was invested in at the time that the expenses were incurred; and
- That section DV 6 should be amended so that it does not apply when the master fund is a PTRE.
- That the current definition of “portfolio investor rate” (in section YA 1) should be aligned with the proposed definition of “notified rate” (in section HM 59(3) of the rewrite) and the policy intention.
- That excluded PIE income should retain its excluded character on subsequent distribution and upon windup of zero-rated investors that meet the definition of public unit trust.
- That the requirement for multi- rate PIE to provide tax statements for zero-rated investors should be changed to ‘by 30 June after the end of the tax year’, consistent with the requirement for other investors. This change to apply for the 2008-09 and later income years.
- That the original terminology for PIEs should be reinstated to alleviate administration costs and confusion.
- That the proposed section EX 53(8) should be amended to reinstate:
 - The 1 day exclusion.
 - That the period that is used to determine whether quick sales adjustments are required is limited to the valuation period not the income year.
- That FWT of an investor should not be allowed to affect the PIE taxable income calculations relating to other investors in the PTRE. The amount of FWT deducted from an investor should be payable as a separate tax payment (outside of the PIE tax rules).
- That management fee rebates received from an offshore manager in relation to the FIF interest should not be taxable. Section EX 59(2) of the Act should be extended to include income derived from and in relation to the FIF interest held.
- That tax credits from supplementary dividends should be grossed up at the company tax rate on the date of entry into the PIE regime and treated as formation losses. This change to apply retrospectively from 1 October 2007.

- That interest paid under a New Zealand denominated loan should be allowed to be deducted as paid (ie, timing of deductions determined outside the financial arrangement provisions at subpart EW).
- That the yield to maturity method or the Determination G26 method (or materially similar alternative), should be allowed to be applied to New Zealand denominated loans under section EW 15B (4) of the Income Tax Act 2004 and EW 15I of the Income Tax Act 2007.
- That the expected value methodology at section EW 15E (2) of the 2004 Act, and EW 15F (2) of the 2007 Act, should be allowed to be applied to borrowing costs capitalised under IAS 23.
- That an interest deduction for stapled debt instruments should be allowed where certain conditions are met; and
- That for outbound investment the combined debt and equity returns should be subject to the FDR regime, but limited to widely held investment vehicles.

3.0 DETAILED COMMENTS

3.1 Impact of Currency Hedging and the Fair Dividend Rate (“FDR”) Method

Issue

When an investor invests into offshore equities, the tax treatment of currency hedging distorts the hedging of foreign investments subject to FDR for NZ based fund managers. As a result, hedging before tax does not provide the same level of hedging after tax. Under the PIE regime it is impossible to obtain the perfect after tax hedge. This issue also applies to Group Investment Funds.

Background

- Foreign assets are taxed under FDR and, therefore, the tax obligation is unaffected by changes in the asset value.
- However, the currency hedging contracts are taxed using the financial arrangement rules if arranged in New Zealand. Therefore, the tax obligation under the currency hedge is affected by changes in the currency value.
- This results in hedging before tax not providing the same level of hedging after tax. For example, 100% hedging before tax does not provide 100% hedging after tax.
- The hedge can be scaled to provide effective 100% hedging after tax for a particular tax rate. However, the hedging will not be effective for all marginal tax rates within a PIE vehicle.
- Grossing up the hedge also results in additional cost to the fund both in terms of the actual cost of the hedge and the tax cost. There is greater cash-flow volatility entailing more transactions in the underlying asset to fund those cash flows

This is demonstrated in the example contained in Appendix One of this submission.

Recommendation

There are sound policy reasons for excluding from the financial arrangement rules, the NZ dollar hedging arrangements entered into by PIEs in relation to their offshore equities.

Fully hedged foreign assets which are subject to FDR within a PIE should be fully subject to FDR. The hedging should also be taxed under FDR. This would ensure that 100% hedging before tax would also be 100% hedging after tax for all investors in the PIE.

The tax treatment will be aligned with the tax treatment of an offshore fund investing in international equities where the NZ dollar hedge is held within the offshore vehicle. NZ resident fund managers will not be forced to move their international share funds and administration functions offshore to better meet their investment management functions.

We also recommend that this treatment be extended to Group Investment Funds as they face similar issues in relation to hedged foreign assets which are subject to FDR.

From a fiscal cost perspective, carving out the hedging arrangements for PIEs is not expected to result in a significant cost to the Crown. It will provide a steady revenue stream under the FDR rules which will be unaffected by the tax effect of currency volatility.

3.2 PIE Eligibility

3.2.1 Association

Issue

The Bill has widened the definition of associated persons, with some unintended implications for managers of funds. For example, the widened definition of associated person creates a risk that the PIE investor membership requirement contained in section HL 6(1) could be inadvertently breached. Also, as discussed further below, the manager of a fund could be associated with the fund even though the manager has no beneficial interest in the fund.

Under new section YB 11, a trustee and a person with the power of appointment or removal of the trustee are associated persons. This may result in a manager who sets up a new trust being associated with the trust even though the manager has no interest under the trust.

Under new section YB 12, it appears that the general partner of a limited partnership and the limited partnership will be associated persons. Therefore, where a limited partnership is used for the management of funds, the manager (who will be the general partner) will be associated with the limited partnership even if it has no partnership share in the limited partnership.

Background

New section YB 11 provides that a trustee of a trust and a person with a power of appointment or removal of the trustee will be associated persons. This is because it is considered there is sufficient connection between these persons to justify treating them as associated persons. However, when a manager sets up a new trust for investors the manager usually appoints the trustee to the trust. The manager will not have any power to remove the trustee. Under proposed section YB 11, the manager and the trust will now be associated persons. The manager should not be associated with the trust because the manager has no beneficial interest in the trust.

Limited partners will not be associated with the limited partnership unless the limited partner has a partnership share of 25 percent or more in the limited partnership. There is no corresponding rule requiring that the general partner has a partnership share before it is associated with the limited partnership. Where the general partner is the manager of the limited partnership and does not have a partnership interest in the limited partnership then the general partner should not be associated with the limited partnership.

Recommendation

That section YB 11 is amended to require that the person must have both the power of appointment and removal or just the power of removal before the trust and the person are associated.

That there is a requirement that the general partner has a partnership share of 25 percent or more before it is associated with the limited partnership (as required for limited partners).

3.2.2 Investor Interest Adjustment

Issue:

Section HM 27 provides that a multi-rate PIE loses PIE status immediately if it fails per HM 48 to adjust an investor's interest or distribution to reflect the investor's prescribed investor rate within 2 months of the end of the tax year i.e. by 31 May for a tax year ending 31 March. Losing PIE eligibility has a critical impact on fund investors and therefore on a fund's viability as well as the fund manager's reputation. We believe that dictating a date by which payment must be made is unnecessary as fund managers have other imperatives to pay an amount due to an investor within a reasonable period, including requirements under securities legislation to comply with trust deeds and their own compensation policies. We also believe that the immediate loss of PIE status under HM 27 is out of proportion with a failure to comply with what is essentially an administrative deadline.

We agree that the requirement to pay PIE rebates or adjust distributions is necessary to deliver the benefits of prescribed investor rates to investors. Indeed, the requirement to pay PIE rebates to investors is now widely incorporated into fund trust deeds, prospectuses and investment statements with associated legal requirements. Based on industry experience at the end of the first PIE tax year, the period ending 31 March 2008, the following circumstances are examples of difficulties a fund manager may face in meeting a prescribed 31 May deadline:

- PIE funds may need to receive a rebate from the Inland Revenue Department before paying investors. While the PIE fund is required to file its tax return for the year ending 31 March by 30 April, extenuating circumstances may delay filing. In addition, there is no due date by which the Inland Revenue Department must pay a PIE rebate to a fund.
- A problem may occur with an administration information system, leading to an inability to make all rebate payments prior to the deadline.

We believe that an immediate loss of PIE status is out of proportion to these issues. We also believe that there are sufficient commercial imperatives to ensure fund managers make investor interest adjustments within reasonable time-frames and to ensure fund managers compensate investors if rebate payments are delayed by factors within the fund managers' control.

Recommendation:

We recommend that section HM 48 be amended to require a PIE to adjust an investor's interest or a distribution to reflect the investor's prescribed investor rate within a reasonable time period, i.e. that no specific date be prescribed in the legislation.

We also recommend that IRD support material should advise that a 'reasonable time period' would include payment made by the later of 30 June or 60 days of receipt of a PIE rebate for a PIE in a net-rebate position.

We recommend that Section HM 27 be removed.

3.2.3 Public Unit Trusts

Issue

Both a portfolio investor class and an investor in a PIE class should be able to use the 'public unit trust' definition' as a means to meet the requirement of the investor interest size in section HL 9.

Background

Currently, section HL 9(2) allows an investor in a portfolio investor class to breach the 20% interest size threshold if the investor satisfies one of the specified definitions of a "public unit trust". Prior to the legislation being amended so that it applied to a class rather than the whole entity, the entity could apply this option.

We agree that the public unit trust definition should apply to an investor in a class when considering whether they satisfy the investor interest size requirement. However, we consider that this test should also apply to the class as a whole.

We also note that the current drafting of the proposed section HM 22(1) is written so that the public unit trust exception is applied to the portfolio investor class for the purposes of sections HM 14 and HM 15 (replacing HL 6 and HL 9 respectively). This drafting seems to confirm that the intention is that the test should be applied to a class rather than just an investor.

In line with the above, therefore, we also consider that the ability for an investor to apply the public unit trust definition should be added to the proposed section HM 22(1) so that it is consistent with the legislation as it currently stands.

Recommendation

We recommend that the current section HL 9 should be retrospectively amended so that there is no investor interest size requirement for a portfolio investor class that, if treated as a unit trust, would meet the requirements of one or more of paragraphs (a) and (c) to (e) of the definition of a public unit trust. We propose that this should be in addition to the current provision which applies for an investor who would meet those requirements.

We also recommend that section HM 22 should be amended to provide that sections HM 14 and HM 15 also do not apply to an investor who, if treated as a unit trust, would meet the requirements of 1 or more of paragraphs (a) and (c) to (e) of the definition of public unit trust.

3.2.4 Community Trusts

Issue

Community trusts regularly look to invest in PIEs given the ability to zero rate. Although large trusts like ASB can invest on a direct basis those with lesser but still significant investments can easily breach the 20% PIE investor holding threshold of 20% yet are of insufficient size to invest directly as a means of avoiding this problem.

Recommendation

That in new section HL 9(4) (hc) and section HM 21(1) (g) of the rewrite “Community Trusts” is added to the list of investors to which exceptions apply, after Auckland Regional Holdings.

3.2.5 Portfolio Investor Proxy (“PIP”) - definition of ‘investor’

Issue

Where a PIP invests into a PIE the PIE should be able to look through the PIP to its underlying investors when assessing its eligibility. However, when assessing the investor interest size requirement under section HL 9, the Act specifies that an "investor" is not allowed to have an interest in the PIE of more than 20%. Section HL 5B(1)(d) defines "investor", in the case of a share held through a PIP, as the PIP, therefore, a PIP cannot hold more than 20% of a class according to section HL 9. This seems inconsistent with the policy intention.

Background

Our understanding is that from a policy point of view, a PIE should be able to look through a PIP to the underlying investors when assessing its PIE eligibility. This seems to be supported by the legislation in section HL 33(3) (f), which states that a PIP must provide the PIE with details about its investors so that the PIE can assess its eligibility. It also seems consistent with the general rule in section YB 21 which states that if a person holds a share/unit etc as a nominee for another person, the other person is treated as holding that share/unit.

Section HL 9, referring as it does to “investors”, which is specifically defined in section HL 5B, seems to be contrary to this policy, and renders section HL 33(3) (f) rather incongruous. A PIP should be able to hold more than 20% of a PIE as long as none of the underlying investors in the PIP will hold more than 20% of the PIE class.

An alternative is to allow a PIE proxy to be an excluded investor which is able to hold more than 20% of a PIE. We appreciate that this could, if uncontrolled, be used to allow a breach of the 20% holding rule. To minimise this risk, HL 33 (3) (f) could be modified to require a PIE proxy to advise a PIE of any investor who holds more than, say, 50% of the PIE proxy’s holding in the PIE if the PIE proxy holds more than 20% of the PIE.

Recommendation

We propose that the use of “investor” in section HL 9 be amended to ensure that where a PIP is concerned, the underlying investor is the person who is limited to holding 20% or less of the class, rather than the PIP.

A more compliance-efficient approach would be to allow a PIP to be an excluded investor subject to a notification requirement at certain levels of holdings. We recommend this is considered further.

3.3 Other PIE Issues

3.3.1 Portfolio Land Class Loss Restriction on Non-land Losses

Issue

The land loss restriction in proposed section HM 64 (currently a portfolio land class loss in section HL 32 of the 2007 Act) applies to all losses of an investor class not just to losses from investments in land or shares in a land investment company (currently a portfolio land company in the 2007 Act) where the required investment threshold is satisfied for the land loss restriction to apply.

Background

The following is an example of this outcome. A New Zealand PIE invests in units in an Australian unit trust (“AUT”). The AUT holds A\$ units in listed property trusts (“LPTs”) (deemed company unit trusts for New Zealand tax purposes) in Australia. The NZ PIE hedges the A\$ exposure back into NZ\$. The NZ PIE has a loss on this currency hedge that exceeds the fair dividend rate (“FDR”) income from holding the AUT units. Proposed section HM 64 (section HL 32 of the 2007 Act) and the definition of “land investment company” (“portfolio land company” in the 2007 Act) mean the NZ PIE loss is a land loss (portfolio land class loss in the 2007 Act). The AUT and LPTs are land investment companies (portfolio land companies in the 2007 Act). Section HL 32(3) (b) of the 2007 Act does not just apply to the loss from the investments in land or shares.

Recommendation

The above scenario could be corrected by amending the definition of “land investment company” to exclude foreign PIE equivalents (referred to as foreign investment vehicles in the 2007 Act).

More broadly, the issue could be corrected by the proposed section HM 64 (currently section HL 32) being restricted to losses arising from the investments in land or shares in the land investment companies referred to.

3.3.2 Consolidated Tax Group including Portfolio Tax Rate Entities (“PTREs”)

Issue

Can a consolidated tax group include PTREs?

Background

Inland Revenue have clarified in Tax Information Bulletin Vol 20, No 3 page 119 that the grouping provisions can apply to a group of companies if the only entities in the group are PTREs and portfolio land companies. As a result, the entities receive the same economic outcome, but can achieve significant compliance cost savings depending on the number of entities within the group.

However, the provisions of the Income Tax Act 2007 (“2007 Act”) are not so clear. Section IC 3(2B) applies to a group of companies with common voting interests of 66% and states that such a group can include a PTRE where the PTRE owns 100% of the voting interest in the other portfolio land companies.

Section IC 4 deals with wholly owned groups of companies but does not refer to section IC 3 or to PTREs being able to be included in wholly owned groups of companies.

Section IG 1 of the Income Tax Act 2004 (“2004 Act”) has been correctly amended to reflect that PTREs can be included in a wholly owned group of companies. This has been achieved by referencing the subsection relating to the wholly owned group of companies to the subsection dealing with 66% common ownership. This reference was removed in the 2007 Act.

In addition, portfolio land companies sometimes wish to issue some shares to managers as a performance incentive. This can not happen with the requirement for 100% voting interests being held by the PTRE

Recommendation

That section IC 4 is amended to clarify that a wholly owned group of companies can include PTREs and that this can apply to a PTRE that owns 66% of the voting interests in portfolio land companies.

3.3.3 Inclusion of Member Scheme Expenses in Multi-rate PIE Calculation

Issue:

Section HM 36 (e) (ii) limits the expenses (eligible for transfer under subpart DV) that can be transferred by a member scheme to a multi-rate PIE and included in that investor’s PIE calculation, to those incurred specifically in relation to an investor class.

Member schemes may invest in multiple investor classes or multiple multi-rate PIEs and the legislation as drafted limits the ability of a member scheme to transfer expenses incurred in relation to investment in more than one investor class or PIE. Such expenses include audit and trustee fees. The effect of this limitation is that member schemes with such expenses and

more than one investment will incur additional compliance costs by being required to file an income tax return to claim a deduction for the expenses. In practical terms the member scheme will be forced to use a 0% prescribed investor rate (rather than a 30% rate), include PIE allocated taxable income and deductible expenses in a tax return and pay tax on the income through the provisional tax system. If the recommendation below is accepted, member schemes will be able to invest in PIEs with PIE tax paid as a final tax and no further tax return required.

It is noted that subpart DV was, and continues to be, used by funds operating under non-PIE rules to obtain value for the deductibility of expenses where the member scheme derives exempt income from a master superannuation scheme or fully imputed income from a master unit trust and is therefore unable to take or benefit from the deduction at the member scheme level. Section HM 36 (e) (ii), as drafted, has the effect of denying member schemes, now invested in multi-rate PIE master schemes, a deduction for expenses of a nature that could previously be transferred.

Also, subpart DV contains a limitation on the maximum deduction allowed to be transferred to the master fund which is calculated by reference to the fund's taxable income (this is specifically contained in section DV 6). This is no longer relevant when the master fund is a PIE. In addition, investors should be able to obtain rebates where the level of expenses transferred to the fund exceeds the taxable income allocated to the investor.

Recommendation:

We recommend that section HM 36 (e) (ii) should be amended to allow a member scheme to transfer deductible expenses eligible for transfer under subpart DV to any multi-rate PIE that the member scheme was invested in at the time that the expenses were incurred.

We recommend that section DV 6 should be amended so that it does not apply when the master fund is a PTRE.

3.3.4 Partial Withdrawals and Subsequent Tax Rate Changes

Issue

Currently, paragraph (b) of the “portfolio investor rate” definition requires a tax rate to be notified prior to the start of the “period” to which it relates (i.e. “before the time”). It is unclear how “period” is meant to be interpreted.

If “period” is meant to refer to a portfolio calculation period, as the portfolio calculation period is a day for a PTRE that chooses the annual option, this interpretation would preclude a new rate being applied from the start of a tax year if the rate is provided part-way through a year. The alternative interpretation is that “period” is the period relating to a tax event (i.e. the period for which a PTRE calculates its tax liability for payment to Inland Revenue). This would be a quarter for a quarterly PTRE, an income year for a provisional tax PTRE, or the tax year or relevant exit/withdrawal period for an annual PTRE. This latter interpretation is more consistent with our understanding of the policy intention.

ISI believes that the policy intention is for the last notified portfolio investor rate to apply from:

- The start of the tax year for a PTRE that is subject to section HL 24 (i.e. an annual PTRE). However, this new rate should not be applicable to optional payments of tax (under section HL 25), which the PIE intends to be a final payment in respect of the income allocated to a partial withdrawal.
- The start of the tax year for a PTRE subject to section HL 23 (i.e. a provisional tax PTRE).
- The start of the quarter in which the rate is notified, for a PTRE subject to section HL 22 (a quarterly PTRE). However, if a quarterly PIE has made a deduction from a partial withdrawal (that would be a voluntary payment of tax under HL 25) at a different rate to that subsequently notified and that is intended to be a final payment in respect of the income allocated to the partial withdrawal, the tax deducted should be allowed to stand.

ISI also considers that there should be flexibility in the PIE rules to apply a new portfolio investor rate from the date the new rate is notified (i.e. prospectively). Some fund providers' systems may not allow a tax rate to be applied retrospectively, from the start of a tax year or quarter (e.g. if a "final" tax calculation is occurring daily rather than at quarter or year-end, on a look-back basis). ISI accepts that it may be appropriate to have a rule requiring the PIE to be consistent in the way it applies the changes in notified PIR across members of the PIE and over time.

Given the current uncertainty, the definition of "portfolio investor rate" needs to be amended consistent with the policy intention and the proposed definition of a "notified rate" in proposed section HM 59(3) of the rewrite.

In the new rewrite section HM 59(3), a multi-rate PIE must apply the last "notified rate" to every day of a period. Again, period is undefined and the rate must be provided before the end of this period. We understand that the period is the "calculation period" of the PIE (a newly defined term in section YA 1).

"Calculation period" is proposed to be defined in section YA 1 as an income year for a multi-rate PIE electing the exit calculation option (or an exit period, as applicable), which would mean that the updated rate applies from the start of the income year or the exit period. There is an exclusion from this requirement for voluntary tax payments already made under section HM 45. This new definition of "notified rate" therefore appears to be consistent with the above policy intention.

However, the reference to "unless the rate last notified applies to the voluntary payment" creates some uncertainty. It is unclear whether it is the PIE or the investor that has the power to "apply" the last notified rate to re-calculate a voluntary tax payment under HM 45. This discretion should rest with the PIE, and not the investor, as fund IT systems will drive whether a PIE is able to recalculate a tax deduction. We recommend the following clarification: "unless the entity applies the rate last notified to the voluntary payment".

Recommendation:

We recommend that the current definition of "portfolio investor rate" (in section YA 1) should be aligned with the proposed definition of "notified rate" (in section HM 59(3) of the rewrite) and the policy intention.

3.3.5 Corporate Investors in PIEs - No Relief on Subsequent Distribution of Excluded Income

Issue

Distributions and redemptions from PIEs are excluded income where they are not listed. However, where the investor is a corporate (including widely held funds that are not PIEs) they are not able to distribute the excluded income to their shareholders or unit holders without incurring further tax except to the extent they have imputation credits from tax paid on PIE income allocated to them.

Widely held funds such as public unit trusts that are not PIEs can not ameliorate this result by using manager buy back as assets are typically on revenue account and most PIEs do not offer buyback in any event.

Superannuation funds that are not PIEs do not suffer this result so the policy is inconsistent and unfair.

In discussion with Policy Advice officials during implementation there was a suggestion that attaching imputation credits could be a solution. However, that would not shelter capital gains made by the PIE which also emerge as excluded income.

There are numerous non-PIE widely held funds taxed as corporates investing in PIEs that wish to wind up (often for the same reason they did not become PIEs eg not enough funds under management to sustain operating costs) and this has been identified as a major structural impediment.

Recommendation:

We recommend that excluded PIE income (over and above that allocated to a zero rated investor if necessary) should retain its excluded character on subsequent distribution and upon wind up of zero rated investors that meet the definition of public unit trust.

This change requires retrospective amendment to the commencement of the PIE regime.

3.3.6 Notification Requirements for Multi-rate PIEs [section 31C of Tax Administration Act 1994]

Issue:

A multi-rate PIE using the exit calculation option under HM 42 is required to provide tax statements to zero-rated portfolio investors within 1 month of tax year end (i.e. 30 April). Statements for other investors can be provided by 30 June.

One month after the tax year end is insufficient time to provide tax statements to zero-rated investors. For the tax year ended 31 March 2008, some members of the industry had difficulty meeting the requirement to provide tax statements for zero-rated portfolio investors by 30 April. These members requested an extension of time to provide this information and also requested that the due date be changed to 30 June (same as for other investors). IRD

officials indicated that they would change the requirement to provide notification for zero-rated portfolio investors by 30 June.

Section 31C (2) of the Tax Administration Act already covers notification for those PIE entities using the quarterly calculation option under HM 43. Subsections (3) and (4) of HL 31C should therefore be deleted and subsection (5) amended to refer to subsection (2) only.

Recommendation:

We recommend that the requirement for multi-rate PIEs to provide tax statements for zero-rated investors should be changed to ‘by 30 June after the end of the tax year’, consistent with the requirement for other investors. This change should apply for the 2008-09 and later income years.

3.3.7 Use of Existing Terminology for Rewrite of PIE Rules

Issue:

The rewrite of the PIE tax rules in subpart HM includes a change in the terminology used for PIEs. Given that the PIE regime only came into effect in October 2007, we question the necessity of changing all of the terminology, with the confusion and administrative expense that this creates.

Background:

Subpart HM – PIEs has been rewritten as part of the rewrite process. While we are generally supportive of the rewrite of the PIE rules, there have been a number of changes in terminology that we consider are unnecessary.

Examples of the changes in terminology are as follows:

From:	To:
Portfolio Tax Rate Entity	Multi-Rate PIE
Portfolio Land Company	Land Investment Company
Foreign Investment Vehicle	Foreign PIE Equivalent
Portfolio Listed Company	Listed PIE
Portfolio Defined Benefit Fund	A Benefit Fund PIE
Portfolio Investment Linked Life Fund	A Life Fund PIE

This change in terminology does not seem to add a great benefit but does create confusion, given that the PIE regime is relatively new and people are still coming to grips with the initial terminology. The change in terminology also results in administrative costs as members will be required to amend documentation including the prospectus, investment statement and investor correspondence. This will also involve being required to retrain advisors.

Recommendation

We recommend that the original terminology for PIEs is reinstated to alleviate administration costs and confusion.

3.4 FDR Issues

3.4.1 Application of Quick Sale Adjustment to FDR Calculations for Unit Valuers

Issue:

The proposed change to section EX 53(8) would no longer limit the requirement to undertake the quick sale adjustment to transactions that involve a purchase and sale of FDR interests to the valuation period. Also, it requires all unit valuers to undertake this calculation.

Background:

Section EX 53(8) currently does not require the quick sale adjustment to be undertaken when the valuation period is 1 day. Where the valuation period is greater than 1 day, the quick sale adjustment is only required when there has been a sale of FDR interest which had been acquired within the same valuation period.

The proposed amendment removes the 1 day exclusion and changes the period required to track transactions to the income year. This would add significant compliance costs in tracking this information to undertake the calculations, and potentially additional tax liability.

As a consequence of discussion with Inland Revenue Policy, it is understood that there was no intention to change when quick sales calculations are required to be undertaken and what transactions would be considered for quick sales calculations.

Recommendation:

We recommend that the proposed section EX 53(8) should be amended to reinstate:

- The 1 day exclusion, and
- That the period that is used to determine whether quick sales adjustments are required is limited to the valuation period, not the income year.

3.5 Other PIE and FDR Tax Issues (not in the Bill)

3.5.1 Application of fund withdrawal tax (FWT) rules to superannuation funds that have elected to be portfolio tax rate entities (PTRE)

Issue

This issue affects those superannuation funds that are electing into PIE rules and have not chosen the provisional tax method.

The FWT rule continues to apply to a superannuation fund (non-KiwiSaver) electing to be a PTRE. However, under the PIE environment, it is problematic for PTREs to include the grossed up amount of FWT as taxable income of the PTRE in the tax year following that of an investor's exit. Further, notwithstanding that any FWT deducted is held by the PTRE, there is no mechanism in the PIE rules to credit the FWT against other investors' deemed tax liabilities arising on this notional income.

Recommendation:

From a policy perspective, we consider that FWT of an investor should not be allowed to impact the PIE taxable income calculations relating to other investors in the PTRE. The amount of FWT deducted from an investor should be payable as a separate tax payment (outside of the PIE tax rules). This can be by way of a new FWT payment form. The PTRE will make the payment annually, no later than 30 June, which will represent deductions made from withdrawals for the tax year to 31 March. As an example, for a PTRE with a 31 March balance date, the initial year payment due on 30 June 2009 would include deductions made from withdrawals from the commencement date as a PTRE to 31 March 2009.

3.5.2 Management Fee Rebate received from an offshore fund which is subject to fair dividend rate ('FDR') method.

Issue

Under section EX 59(2) of the Income Tax Act 2007 ("No income other than FIF income"), the person is treated as not having any income from the interest for the period other than FIF income. In particular, any dividends derived in the period from the interest, and any income gained from disposing of the interest in the period, are disregarded.

Take the situation of a PIE which invests in an unlisted offshore unit trust. The PIE calculates taxable income in respect of the units held in the offshore unit trust under the FDR method (accept that it qualifies for FDR). The offshore fund currently reports the unit price net of management fees charged, and this is the price used for FDR income calculation purposes. The PIE receives a rebate of management fees in cash from the investment manager of the offshore unit trust.

Questions:

- Should the management fee rebates be separately taxable (under ordinary concepts) or can the amounts be treated as excluded income under EX 59(2) of the Act?
- Do the management fee rebates affect the unit price valuation for FDR purposes? Should 5% of the rebate amount be taxed, on the basis that if the rebates were re-invested, FDR would apply to 5% of the increase in the offshore fund's unit price?

Section EX 59(2) of the Act is not helpful as the provision applies to "not having any income from the interest for the period other than FIF income". Although the payment of the rebate is not directly from the FIF interest itself, the rebate is specifically in relation to the FIF interest held. The management fee rebate would not be payable had the FIF interest not been held.

Our view is that, given the rebate is not a stand alone income stream, it should not be separately taxable.

Most PIEs and managed funds will be unit-valuing funds, calculating their FIF income using the FDR method, under EX 53 of the Act. The FIF income is based on 5% of the opening market value of the offshore fund. Market value is a defined term and does not require the management fee rebate to be included under this calculation. Accordingly, the management

rebate is not taxable to the extent of 5% or required to be included in the offshore fund's market value.

Recommendation:

We recommend that management fee rebates received from the offshore manager in relation to the FIF interest should not be taxable. Section EX 59(2) of the Act should be extended to include income derived from and in relation to the FIF interest held.

3.5.3 Tax credits for supplementary dividends carried forward upon transition into PIE

Issue

A fund that has tax credits from supplementary dividends that are not able to be utilised during the pre-PIE period (i.e. no tax liability in the current or previous 4 tax years) can carry forward the tax credits to the next tax year (LP 3(4) of the Act). Where such a fund has elected to become a PTRE, it is still able to carry forward these tax credits. However, a PTRE that is not a provisional taxpayer has no mechanism to utilise these tax credits. These credits are not incurred post PIE and are not the type to qualify under HL 29. The PTRE is able to carry forward formation losses and offset the losses against portfolio investor class taxable income. It would be practical to convert the tax credits to formation losses, by grossing them up at the company tax rate.

Recommendation:

The tax credits from supplementary dividends should be grossed up at the company tax rate on the date of entry into the PIE regime and treated as formation losses. This change should apply retrospectively from 1 October 2007.

3.6 Tax Deductibility of Interest Capitalised for Accounting Purposes under International Financial Reporting Standards (“IFRS”)

Issue

As a consequence of the IFRS changes, interest that is capitalised for accounting purposes is no longer deductible as incurred for tax purposes with pre-IFRS interest deductions claimed for tax purposes being adjusted, where applicable.

Background

Accounting treatment

Under IFRS, and under previous New Zealand accounting standards, interest incurred by a taxpayer in acquiring, constructing, producing or developing an asset that necessarily takes a substantial time before it is ready for its intended use, is able to be capitalised to the cost of that asset for accounting purposes. Ultimately, this interest cost would be depreciated with the asset created. Under IFRS this treatment will continue at the option of the entity under New Zealand International Accounting Standard 23 (Borrowing Costs).

While this treatment is currently optional, the International Accounting Standards Board (“IASB”) has released an exposure draft suggesting it should be compulsory. It is unclear whether the New Zealand Financial Reporting Standards Board (governing the issue of

reporting standards in New Zealand) would adopt this measure if it was incorporated by the IASB.

Tax treatment

Under the new IFRS spreading methodologies [included in the Taxation (Business Taxation and Remedial Matters) Act 2007 and inserting additional provisions within subpart EW of the Income Tax Act 2004 and 2007 (the “ITA”)], where this capitalised interest relates to a New Zealand dollar denominated loan, the majority of the IFRS methodologies are not available to the taxpayer. In effect, the taxpayer must follow the accounting treatments set out in section EW 15C.

This results in the deferral of interest deductions in line with the accounting treatment under section EW 15C. In addition, interest deductions already taken for tax but capitalised for accounting would be reversed under a spreading method adjustment as required under section EW 26

The tax effect of the change in spreading methodologies does reverse over the life of the arrangement. However, as highlighted above, the term of these arrangements is often a number of years or may relate to a credit facility that does not ‘mature’ in a fixed period, resulting in a considerable deferral of tax deductions. There are also a number of immediate consequences for the taxpayer, such as:

- Tax payable in the year of IFRS adoption is increased as deductions are denied for tax purposes. This is particularly the case where the arrangements have been in place for a number of financial periods and tax deductions have previously been taken as interest is incurred.
- Compliance costs are increased year on year as a result of the following factors:
 - The depreciation claimed for accounting and attributable to the interest capitalised to the fixed asset register must be separately identified for tax deduction.
 - On maturity of a particular arrangement a base price adjustment (“BPA”) will be available. At this time, where a number of such arrangements have been treated in the same way for accounting (i.e., interest capitalised), the interest accruing to that particular arrangement must be isolated in the fixed asset register such that the BPA can be correctly calculated. In future accounting periods the depreciation relating to capitalised interest on matured arrangements must be identified and reversed out of profit for tax purposes.

Given many such arrangements have been in place for some time, it may be difficult to identify where particular interest expenses have been capitalised to for accounting purposes as fixed asset registers would not necessarily have been set up with this information separately delineated. The potential difficulty in correctly identifying the amounts capitalised and / or depreciated for accounting, as well as tracking those amounts deducted for tax purposes, is likely to increase the incidence of errors arising in the returned position.

- The Income Tax Act provides that unacceptable interpretation shortfall penalties will not arise where early adopters followed IFRS methodologies before the

relevant legislation was finalised. No such concession has been enacted with regard to interest or penalties payable on additional tax arising unexpectedly due to an unintended change in the methodologies for spreading income under the financial arrangement rules.

Consequently, significant amounts of use of money interest arise due to the increased provisional tax liability for the period of adoption, these increases being directly attributable to the reversal of prior period tax deductions and denial of current period interest deductions as a result of the unintended change.

Discussions with Inland Revenue Policy

As a consequence of discussions one of our members has had with Inland Revenue Policy, the following position has been agreed.

- The impact of the revised IFRS methodologies on capitalised interest is an unintended change in the application of the accrual rule spreading methodologies as applied to the interest incurred on New Zealand dollar denominated financial arrangements.
- The stated tax policy of 2001 on introduction of the company interest deduction rules at section DB 7 “that interest on business borrowings should be deductible, in a manner similar to other business-related expenditure”¹ remains in line with current tax policy intentions.

The position should be corrected in the Bill to prevent further confusion and assist taxpayers in filing their 31 March 2008 income year returns.

Recommendation

We suggest some alternative amendments below to correct this position:

- Allowing interest paid under a New Zealand denominated loan to be deducted as paid (i.e., timing of deductions determined outside the financial arrangement provisions at subpart EW). For example, the following wording is suggested as an addition to EW 5 of the legislation:

“EW 5(10B) LOAN IN NEW ZEALAND CURRENCY A loan to which all the following apply is an excepted financial arrangement for the borrower:

(a) the loan is in New Zealand currency; and

(b) the loan is advanced by a non-associated party; and

(c) the borrower has adopted IFRS; and

(d) interest paid is capitalised for accounting purposes under IFRS.”
- Allowing the yield to maturity method or the Determination G26 method, (or materially similar alternative) to be applied to New Zealand denominated loans under

¹ Tax Information Bulletin Volume 13, No.11 – November 2001

section EW 15B(4) of the Income Tax Act 2004 (“the 2004 Act”), and EW 15I of the Income Tax Act 2007 (“the 2007 Act”).

For example, the following wording is suggested as an addition to EW 15B (4)(b) of the 2004 Act and EW 15I(1)(b) of the 2007 Act:

“(iic) is a New Zealand dollar denominated loan from a non-associated party where the interest expense is capitalised for IFRS purposes:”

As this would not assist those arrangements where the date of repayment of principal is not known we would also suggest the following:

- Allowing the expected value methodology at section EW 15E(2) of the 2004 Act, and EW 15F(2) of the 2007 Act, to be applied to borrowing costs capitalised under IAS 23 (currently referenced to derivatives under IAS 39 or foreign currency arrangements only);

For example, the following wording is suggested as an addition to EW 15E(1)(b) of the 2004 Act and EW 15F(1)(b) of the 2007 Act:

“(b) the financial arrangement is ... a derivative instrument or is a New Zealand denominated loan from a non-associated party where the interest expense is capitalised for IFRS purposes;”

As an interim measure, we would ask that you consider an adjustment to the change in methodology adjustment provisions at sections EW 26 and 27 of the legislation, allowing interest deductions capitalised for accounting but deducted for tax in periods prior to IFRS adoption to be exempted from the change in spreading adjustment at EW 26 and 27.

For example, the following wording is suggested as an addition to EW 27(8):

“(8) [EXPENDITURE (OLD METHOD) **Expenditure (old method)** is expenditure incurred by the person under the financial arrangement in previous income years] less interest deducted for tax that has been capitalised for accounting purposes where the change in spreading methodology occurs due to the adoption of IFRS.”

Timing

As the issue arises on adoption of IFRS, we suggest any amendment should be timed to apply from that adoption by the taxpayer. The wording suggested above covers this timing.

3.7 Stapled Securities

Issue

There is significant concern within our members regarding the potential impact of the legislation on investment into New Zealand funds, as well as concern over some uncertainty in interpretation and specific technical difficulties which are covered in more detail below.

We are very concerned at the manner of introduction of this change and its announcement by media release and also that only minor amendments were made after discussions between our members and officials.

Background

Inbound

The proposed changes will affect the way that international investors invest into New Zealand. The draft legislation sends the wrong message to those investors and it is likely to push them into 100% ownership of assets rather than co-investment with NZ investors via a simple stapled structure that would attract still attract tax in NZ to the extent that the investment is equity funded.

We are concerned that the proposed legislation will create uncertainty in interpretation, with a consequential increase in compliance costs and investors choosing to invest in Australia rather than NZ (especially with the recent Australian budget announcements reducing the tax rate for international investors to 7.5%). There is also uncertainty around what will be considered a new issue and what may be considered a stapled security that was issued before the announcement, e.g. the status of a unit trust that was established before the announcement but issues additional units after the announcement date.

Other points of uncertainty are:

- treatment of a stapled debt instrument which becomes unstapled after 25 February 2008;
- whether a part repayment of loan will be treated as a deemed dividend or return of capital;
- whether the definition of 'debt security', specifically the use of the words 'or ordinarily can', catches the situation where debt and equity are not formally traded together but, without a shareholder also holding debt, the value of the shares would lose their value. This has not been clarified in the Supplementary Order Paper.
- Inland Revenue audit activity will challenge debt arrangements not specifically stapled, but due to commercial reality debt would be repaid in equal portions or fully when an investor leaves.

The thin capitalisation rules currently provide a mechanism to ensure that returns from investment into New Zealand are taxed appropriately. Concern about the effectiveness of the rules should be addressed by attention to the rules surrounding when the thin capitalisation rules apply (for example, if there are stapled securities the company does not need to be controlled by a single non-resident for the thin capitalisation rules to apply) rather than by the proposed legislative change that targets a specific investment instrument. On the basis that the thin capitalisation rules apply to non-residents with stapled securities, the current thin capital ratio of 75% debt to 25% equity provides adequate protection to the New Zealand tax base while at the same time ensuring participation in New Zealand capital markets by both domestic and international investors.

Where New Zealand residents hold stapled securities there is no effect on the New Zealand tax base. Interest income will be taxable and interest expenses deductible.

Outbound

In addition, it is not clear whether the new rules will apply to stapled securities issued by offshore companies.

Recommendations

We recommend that:

- An interest deduction for stapled debt instruments should be allowed where certain conditions are met; and
- For outbound investment the combined debt and equity returns should be subject to the FDR regime, but limited to widely held investment vehicles.

Specific Recommendation - *Inbound*

We recommend that the thin capitalisation rules should determine whether interest deductions are excessive or not and deductions should be available where:

- thin capitalisation rules are met regardless of the size of any offshore ownership; and
- market rate of interest is used (at time rate is set); and
- debt is repaid at face value on maturity (i.e. fixed dollar amount, or converted to shares based on price at time of conversion). We do note that an amendment has been made so that the rules now exclude “fixed rate shares”.

Specific Recommendation - *Outbound*

If the new rules do apply to stapled securities issued by offshore companies, we recommend that the combined debt and equity returns of a stapled security should be covered by the FDR regime. That would provide a fair reflection of the economic position and also limit the significant compliance costs that would occur in having to identify, track and tax two separate instruments.

Appendix One

Example where there is a rise in the New Zealand dollar. The opposite will occur when there is a fall in the New Zealand dollar.

	No change in value of hedge (no “gross up”)	Hedge in Foreign Fund / Hedge not Taxed in NZ	With “Gross-Up”
Total portfolio value*	NZ\$1,000	NZ\$1,000	NZ\$1,000
Change in NZD	+20%	+20%	+20%
Hedge	NZ\$1,000	NZ\$1,000	NZ\$1,429**
Loss on offshore equities	(NZ\$200)	(NZ\$200)	(NZ\$200)
Gain on hedge	NZ\$200	NZ\$200	NZ\$286
Taxable income under FDR	NZ\$50	NZ\$50	NZ\$50
Taxable income under FA rules	NZ\$200	NZ\$0	NZ\$286
Tax effect under FDR	NZ\$15 tax to pay (assumes a tax rate of 30%)	NZ\$15 tax to pay	NZ\$15 tax to pay
Tax effect under FA rules	NZ\$60	NZ\$0	NZ\$85.80
Total tax	NZ\$75	NZ\$15	NZ\$100.80
After-tax portfolio value	NZ\$925	NZ\$985	NZ\$985***

* NZD value for portfolio of shares denominated in foreign currency

** Value of gross up = $(\$1,000 / (1 - 0.30))$

*** This is equal to the initial portfolio value plus the net gain in value of the equities less the total tax liability (i.e., $\$1,000 + (\$286 - \$200) - \100.80)

Appendix Two

List of ISI Members

ISI MEMBERS

AIG Life
AMP Financial Services
Asteron Life Ltd
AXA New Zealand
BNZ Investments and Insurance
CIGNA Life Insurance NZ Ltd
Dorchester Life
Equitable Group
Fidelity Life Assurance Co Ltd
Gen Re LifeHealth
Hannover Life Re of Australasia Ltd
ING New Zealand Ltd
Kiwibank Ltd
Medical Assurance Society NZ Ltd
Munich Reinsurance Co of Australasia Ltd
Public Trust
RGA Reinsurance Co. of Australia Ltd
Southsure
Sovereign Ltd
Swiss Re Life & Health Australia Ltd
TOWER New Zealand
Westpac/ BT Funds Management Ltd

Associate Members

Bell Gully Buddle Weir
BNP Paribas
Bravura Solutions
Burrowes & Co
Chapman Tripp Sheffield Young
Davies Financial & Actuarial Ltd
Deloitte Touche Tohmatsu
Ernst & Young
InvestmentLink (New Zealand) Ltd
KPMG
Kensington Swan
Melville Jessup Weaver
Mercer Human Resource Consulting Ltd
Morningstar Research Ltd
Phillips Fox
PricewaterhouseCoopers
Russell Investment Management
Russell McVeagh
Simpson Grierson