

**INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ
INC**

Submission
to the
Finance & Expenditure Select
Committee
on the
Taxation (Annual Rates,
Business Taxation, KiwiSaver,
and Remedial Matters) Bill

12 July 2007



I.S.I

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INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ INC

SUBMISSION TO THE FINANCE AND EXPENDITURE SELECT COMMITTEE ON THE TAXATION (ANNUAL RATES, BUSINESS TAXATION, KIWISAVER, AND REMEDIAL MATTERS) BILL

Introduction

The Investment Savings and Insurance Association (“ISI”) welcomes the opportunity to comment on the Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill (“the Bill”).

ISI represents the issuers and managers of life insurance, superannuation and managed funds that in total have responsibility in excess of \$50 billion of managed fund assets. A list of ISI members appears at the end of this document. The interests of ISI members lie predominantly in:

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

Our submission contains three distinct sections:

1. Industry support for policy direction.
2. Response to criticism from Gareth Morgan – contained in his submission to the Finance & Expenditure Select Committee.
3. Comment and suggestions to improve technical aspects of the Bill.

As well as providing this written submission ISI would appreciate and look forward to the opportunity to make an oral presentation to the Select Committee

1. Support for Policy Direction

ISI welcomes the provisions in the Bill that extend the benefits of the Portfolio Investment Entity (“PIE”) regime to unit-linked life insurance products. We believe that those New Zealanders who have chosen to save via a life insurance policy should not be disadvantaged in comparison with those who have invested in managed funds. The legislation will improve the situation for some, but not all, of those policyholders.

ISI also welcomes the provisions in the Bill that enhance the KiwiSaver scheme. We commend the Government for its recognition of the importance of encouraging the growth of personal saving in New Zealand and for its decision to ensure the success of KiwiSaver by the provision of tax credits and compulsory employer contributions.

As we have stated to the Select Committee, the new taxation regime enacted in the Taxation (Savings Investment and Miscellaneous Provisions) Act 2006 and the Taxation (KiwiSaver and Company Tax Rate Amendments) Act 2007, will address most of the issues that previously disadvantaged saving in collective investments compared with direct investment and are therefore supported by ISI members.

There are, however, a number of anomalies flowing from the Taxation (KiwiSaver and Company Tax Rate Amendments) Act, passed under urgency, that we recommend should be addressed in the current Bill. These changes are proposed to ensure that the Act when passed achieves its policy objectives in the most effective manner.

2. Response to Criticism by Gareth Morgan

We note that Dr Morgan has included his criticism of life insurers and fund management practices in his submission to the Finance and Expenditure Select Committee. A copy of Dr Morgan's submission has appeared on his website. It is as a result of this action that ISI finds it necessary to comment to this Committee.

ISI has been in contact with the Ministry of Economic Development and the Ministers of Finance and Commerce for a number of weeks as a consequence of Dr Morgan's constant media attempts over recent months to undermine public confidence in KiwiSaver and his lack of independence when criticising his competition (Gareth Morgan KiwiSaver is a competitor).

We attach a copy of our letter (Appendix A) dated 27 June 2007 to the Ministry of Economic Development commenting in respect of:

- Hidden fees and charges.
- Reserve funds.
- Unit pricing errors.
- Pooling of funds.
- Life insurers.
- Independence of financial advisers.

We also attach a copy of our letter (Appendix B) to the Ministry of Economic Development dated 11 July 2007, rejecting Dr Morgan's comments contained in the submission to the Finance and Expenditure Select Committee.

Dr Morgan's inference that 'unit pricing' concerns and 'systemic risk' does not stand scrutiny. These issues were the subject of reviews conducted in 2004 by the Securities Commission in NZ and the Australian Securities and Investments Commission (ASIC) in Australia. In both reviews the Regulators found no evidence of systemic risk or unit pricing concerns.

Key Concerns

- 1.** A number of Remedial Matters in relation to clarification of the Portfolio Investor Entity rules.
- 2.** A number of remedial matters in relation to clarification of the KiwiSaver rules.
- 3.** Ensuring life companies are treated equitably with other corporates.
- 4.** Ensuring policyholders are treated equitably with other investors.
- 5.** Clarification of research and development rules
- 6.** Other matters

Detailed Comments

Remedial Matters

1. Employer Reserve Accounts - Unvested and Unallocated amounts

Background

We note with reference to Dr Morgan's recent statement as described in our introduction that these Reserve Accounts are unable to be accessed by the manager and are for the sole benefit of the fund.

Issue

Where an employer has made a contribution to a PIE with a vesting period and the employee has left before the contribution has vested, the employer may or may not get access to the money, or it might remain in the reserve account, depending on the particular Trust deed. In this situation, if the contribution becomes unallocated and non-vested, i.e. it sits in the PIE, how should the liability on income earned on the reserve account be taxed and reported to the IRD?

Understanding

Per HL 16(1) and HL 20(9) of the recently enacted legislation we understand the money will be taxed and reported for PIE tax return filing purposes as follows:

1. The income on such monies will be taxed at 33%.
2. The IRD number used will be that of the PIE.

Recommendation

It would be useful in administering these monies if the investor certificates could be filed under the employer plans/reserve accounts name rather than the PIE's name. This would provide the fund manager and trustees of any employer plan with greater

clarity and transparency of this income. It would be important that this income was treated as a final tax and not brought into account in the employer's tax return.

2. Section DV 2 Transfers

Issue

Where a superannuation fund does not elect to become a PIE but invests into a Portfolio Tax Rate Entity (“PTRE”), the mechanism to pass expenditure to the PTRE under section DV 2 needs to be changed so that the expenditure can be treated as a deductible investor fee under section HL 20.

Background

Currently under section DV 2 a member superannuation fund that invested into a master superannuation fund can transfer expenditure incurred to the master superannuation fund in return for units in the master superannuation fund. This allows the member superannuation fund to receive a deduction for the expenditure incurred which would otherwise not be deductible.

Under PIE, if a superannuation fund elects to not become a PIE, it can invest into PTRE. The non-PIE superannuation fund can also elect to have the PTRE deduct tax on its behalf by electing a prescribed investor rate (“PIR”) of greater than 0%. Where this election is made, the non-PIE superannuation fund will have no income from the PTRE to offset against expenditure incurred. With the portfolio investor allocation rules requiring allocation of income and fund expenses between all investors in proportion to the investor fraction held, providing value to the non-PIE superannuation fund may be difficult as the value of this expenditure will be dependant on the tax position for each investor. This may not reflect the value of the expenditure to the non-PIE superannuation fund if it had been zero rated by the PTRE and paid tax in its own tax return.

Recommendation

We propose that where a non-PIE superannuation fund elects to apply a PIR of greater than 0%, section HL 20(11) be amended to allow a deduction for the expenditure that would have qualified to be transferred between the two entities under section DV

2(2). The value of the expenditure would be received only by the investor that incurred the cost and not by any other investors within the fund. The PTRE should also have the ability to not accept these expenditure transfers.

As the amount of the expenditure may not be known until after the end of the allocation period, we propose that the non-PIE superannuation fund would have up to the time within which it would have otherwise had to file a tax return to advise the PTRE of the expenditure. The deduction would then be made in the next portfolio calculation period once it was accepted by the PTRE.

Where the application is made after the end of the year in which the expenditure is incurred and the PTRE does not accept the expenditure claim, the non-PIE superannuation fund should be entitled to claim the expenditure in the next tax return.

3. Changes to HL 7

Issue

We are concerned that the changes made to HL 7 by the Taxation (KiwiSaver and Company Tax Rate Amendments) Act 2007 are not adequate to deal with the need for express power to cancel units on a same day basis.

Background

The special report of 17 May 2007 on the technical amendments to the Tax Amendment Act above provides the only source of comfort that units can be cancelled to pay for PIE tax at an investors PIR earlier than periods identified in HL 7 (3). Legally this report can be used as a guide to the meaning of HL 7 under the Interpretation Act only if the wording in HL 7(3) is unclear having regard to the scheme and purpose of the Tax Act . There is ambiguity for a daily valuer paying tax annually and on exit as "within 2 months of the end of the tax year" can mean 2 months before or 2 months after. Without that ambiguity the plain meaning of the words would not appear to permit adjustment at an earlier time when this is required as a matter of necessity.

There is the argument suggested by the technical report that the time frame is the maximum for making the return adjustment. However HL 7 (2) demands that the adjustment to be made is that in HL 7 (3). HL 7 (3) is then prescriptive in fixing periods such as within 2 months of year end. So the question is where lies the power to make adjustments earlier than this? The answer is that there is none.

Practically adjustments (cancellation of units) need to be made every day by a daily valuer. This is to permit same day withdrawal which most funds offer. Software and systems have been built not to do this from distributions but by way of cancellation of units prior to/in lieu of distribution. Consequently HL 7(3)(b) permitting deduction from distributions does not provide the panacea.

The previous wording of HL 7(3) (a)(i) (as inserted into the Act by the Taxation (Kiwisaver and Company Tax Rate Amendments) Act 2006) permitted cancellation any time within two months of the end of the portfolio calculation period (which may occur daily). ISI requested it be changed to a period commencing with any calculation period (not after the end of it) to permit same day withdrawals and officials agreed. The changes do not deliver this. Instead they specify a time by which tax must be extracted from investors but fail to provide the power to adjust their interests to do this as required on up to a daily basis.

Deed changes permitting the managers of super funds and unit trusts to adjust the interests of investors as and when they deem appropriate to pay for PIE tax and PIR have been proposed to overcome the legislation short comings. However these clauses are proving to be regarded as introducing an adverse effect on the interests of super fund members if they extend the legislation and the view is that if they do extend the legislative power they are prohibited under the Super Schemes Act and most deeds. Trustees are also reluctant to allow such a change to be made to a unit trust without a meeting of unit holders for similar reasons.

It seems clear that because HL 7 is so central to the changes made to the Trustee, Unit Trusts and Super Schemes Acts expressly to permit tax to be deducted from investors as practically required, it needs to be amended to expressly make it clear that the adjustment can occur any time from (and including during) a portfolio allocation period, but must be made no later than the periods set out in HL 7(3).

Officials have indicated they would support this clarification.

Recommendation

HL 7(2) should be amended by inserting the following after “adjustment” at the end of the first line “at any time from and including a portfolio calculation period but no later than the periods”;

HL 7(3)(b) should be made optional to reflect HL 7(4) but is currently prefaced with must. Insert “or” prior to it to cover this off.

4. Application of FIF Rules to Funds Electing to Become PIEs on 1 October 2007

Issue

The application date of the FIF rules when a non-balance date fund elects to become a PIE.

Background

The interaction between the FIF rules and the PIE rules does not work well. A non-standard balance date fund (say 30 June 2007) who has not elected to defer the application of the new FIF rules, would under the FIF legislation apply the FDR from 1 July 2007. However, if the Fund elects to become a PIE on 1 October 2007, then HL 12 deems the Fund to have a new balance date ending 30 September 2007 and the FDR will apply from 1 October 2007. It would appear a Fund that intends to elect into the PIE rules on 1 October has no choice but to apply the new rules from 1 October irrespective of whether a deferral election was made or not.

This issue has been raised with IRD Policy who confirmed that FDR can apply from 1 July 2007.

Recommendation

We request that the IRD's interpretation of this issue is outlined in a Standard Practice Statement or Tax Information Bulletin.

5. Investors under De-minimus whose Status Changes to FDR during an Income Year

Issue

Investors initially under the \$50,000 de minimus whose status changes to FDR during an income year should be allowed a credit, in their tax return, for any RWT deducted from distributions by a RWT proxy (or a bare trustee).

Background

Under sections CQ 5(1) and DN 6(1), investors holding shares costing \$50,000 or less, at all times during an income year, are not subject to the FIF rules. For these investors, funds may offer an RWT proxy to reduce compliance costs from having to return distributions as gross income. Similarly, a bare trustee may deduct RWT from offshore dividends.

However, if the investor subsequently breaches the \$50,000 threshold during the year, they will become subject to FDR from the start of the income year. Currently, the legislation is unclear as to whether any RWT deducted and paid by the RWT proxy or bare trustee is able to be claimed for in an investor's tax return as a credit against the investor's FDR tax liability. We understand that investors may be required to write to Inland Revenue to obtain a refund for the tax deducted, separately. On the basis that an investor subject to FDR is required to file a tax return, this appears illogical and will increase compliance costs.

Recommendation

The legislation should clarify that any deductions of RWT, on behalf of an investor that is subject to the FDR method should be allowed as a credit against the investor's FDR liability.

6. PIE Processing Errors

Issue/Background

PIE processing errors may occur where the investor provides the correct PIR rate but the manager keys in an incorrect rate. The IRD position on this is that it would need to be corrected using the NOPA process or by filing a section 113 notice. Only amounts less than \$500 can be offset against the next return.

Recommendation

We would prefer a threshold of 1% of the net tangible assets (“NTA”) of the fund where, if an individual error does not breach this threshold, the error can be offset in the next monthly exit return.

At minimum we recommend that the threshold is aligned with the Australian Prudential Regulatory Authority (“APRA”) Unit Pricing – Guide to Good Practice. This would result in errors being offset in the next monthly exit return where the error is less than 0.3% (i.e., 30 basis points) of the NTA of the fund. APRA’s Guide to Good Practice suggests that compensation should be considered where a unit price is incorrect by 0.3% or more. Compensation may not actually be paid where the error exceeds 0.3% if it results from a normal processing procedure which is why we suggest 1% of NTA.

7. Fund Withdrawal Tax for Superannuation Funds (not KiwiSaver) becoming PIEs

Issue

The timing of the fund withdrawal tax (“FWT”) where employer contributed funds are withdrawn from a superannuation fund that is a Portfolio Investment Entity (“PIE”). The current timing for the payment of FWT is not appropriate for a PIE that has elected to make payments when an investor exits the scheme.

Background

Section CS 1 imposes FWT where a member withdraws an amount that was contributed by the member’s employer from a superannuation fund. Section CS 1(7) provides that the income arising from the withdrawal is allocated to the tax year following the tax year in which the withdrawal is made. This will not apply where the superannuation scheme is a Kiwisaver scheme.

Where the superannuation fund is a PIE that has elected to make payments when an investor exits the scheme pursuant to section HL 23 this timing is not appropriate as tax is payable within one month of the end of the month in which the portfolio investor exit period occurs (section HL 23(2)/ HL23B(3)).

Recommendation

Our initial recommendation is that FWT should be abolished as it has been in respect of any permitted Kiwisaver withdrawals or complying fund withdrawals.

If FWT is retained in respect of non-complying funds and non-Kiwisaver funds, we recommend that where the superannuation fund is a PIE, the superannuation fund can elect to pay any FWT to IRD within one month of the end of the month in which the withdrawal occurs. This would align the payment of FWT with the rules for payment of tax where a PIE elects to pay tax on partial or full withdrawals by portfolio investors.

8. PIE – Treatment of unvested amounts – superannuation schemes (section HL 16(2))

Issue

The transfer to a master scheme or a new provider is likely to be viewed as a new scheme for the purposes of section HL 16(2). Accordingly, where the vesting schedule of the pre-existing scheme is retained by the new scheme and is greater than five years, the new scheme will not meet the conditions of HL 16(2). Therefore, the member will effectively be taxed on all unvested amounts at the scheme's PIR rather than the member's PIR. This would clearly disadvantage members with a 19.5% PIR.

Background

Section HL 16(2) allows a superannuation scheme to treat unvested employer contributions to a superannuation scheme for an allocation period as being vested and therefore, enables the superannuation scheme to use the PIR rate of the member rather than the PIR of the superannuation scheme in calculating the tax liability of the scheme. However, in order to use the members PIR, certain qualifying criteria must be met, including:

1. The superannuation scheme must have existed before 17 May 2006 and the vesting period must not have been extended beyond the period in existence at 17 May 2006; or
2. Where the superannuation scheme was established after 17 May 2006, the vesting period is equal to or less than five years.

It is common in the superannuation fund industry for smaller superannuation schemes to transfer its members to master superannuation scheme. In addition a master superannuation scheme is essentially a service provider and over time a company could review its master scheme provider and choose to change. Both these instances are commonly known as a "transfer". In either instance the vesting periods of the existing scheme are generally retained by the new scheme. Accordingly, from the

members' perspective, in substance, there has been no change to their entitlements under their existing superannuation scheme.

Transfers, as described above, are governed by Section 9B of the Superannuation Schemes Act. The underlying principle of the 9B provisions is that members of a superannuation scheme must not be materially affected. The Government Actuary must sign-off on a 9B transfer. This means, that in substance a transfer will not occur if a member is worse off as a result of the transfer.

Other important provisions of the Superannuation Schemes Act are Sections 9A and 12 which set out that the provisions in respect of amending a superannuation scheme trust deed.

Furthermore, the reserve account (the account used to record unvested employer contributions after an employee exits) is subject to provisions of the Superannuation Schemes Act and cannot be returned to the company without the Government Actuary's consent.

The transfer to a master scheme or a new provider is likely to be viewed as a new scheme for the purposes of section HL 16(2). Accordingly, where the vesting schedule of the pre-existing scheme is retained by the new scheme and is greater than five years, the new scheme will not meet the conditions of HL 16(2). Therefore, the member will effectively be taxed on all unvested amounts at the scheme's PIR rather than the member's PIR. This would clearly disadvantage members with a 19.5% PIR.

We do not believe that this outcome is consistent with the intention of the Portfolio Investment Entity regime (which aims to tax income from investments at an appropriate rate being the investors/members PIR) where in-substance from the member's perspective, they are in exactly the same position before and after the transfer to the new scheme.

Further, there is an increased administrative burden of superannuation schemes having to separately identify existing schemes that are transferred that have a vesting

periods greater than 5 years which need to be flagged as being taxed at the scheme's PIR rather than the member's PIR.

Recommendation

We propose that where there is no change in-substance to the benefits a member will receive from unvested contributions upon the transfer of their existing interest in a superannuation scheme (where the existing vesting schedule is greater than 5 years and is retained) to a new master superannuation fund or to a scheme maintained by a new provider, then the new superannuation scheme should be able to apply the members PIR to unvested employer contributions regardless of the length of the vesting period. This change would ensure that members of existing schemes as at 17 May 2006 with vesting schedules of greater than five years are not disadvantaged where the trustees of a superannuation scheme elect to transfer a member to a new master scheme or new provider.

9. Imputation Credits where a Tax Liability Arises Prior to becoming a PIE but Tax is Payable after becoming a PIE

Issue

Once a fund becomes a PTRE it no longer maintains an imputation credit account. As a result, the pre PTRE fund will not obtain imputation credits in respect of:

- the payment of provisional tax on 7 November and 7 March for taxpayers who have a standard balance date and elect to become a PIE from 1 October 2007;
- the payment of tax in respect of a tax liability arising due to deemed disposal and acquisition on the application of the FIF rules; and
- the payment of tax in respect of a tax liability arising due to the deemed disposal and acquisition on entry into the PIE regime.

Within the unit trust regime, funds require imputation credits for all tax payments to avoid double taxation. Whilst the PTRE has no demand for imputation credits, investors may require imputation credits and redeem units prior to the fund's entry into the PIE regime. This may result in the fund having a debit imputation balance on entry into the PIE regime.

Background

Section ME 1 provides that a PTRE does not maintain an imputation credit account.

Section MB 4(1) provides that provisional tax is payable in three instalments in accordance with section MB 5(1) unless otherwise provided. It does not appear that these provisional tax rules have been amended where the entity elects to become a PIE from 1 October 2007 and ceases to become a provisional taxpayer. Therefore, entities with a standard balance date will still have two provisional tax payments due (7 November and 7 March) after electing to become a PIE.

Where an entity elects to become a PIE, section HL 12(3) treats the entity as disposing of and reacquiring at market value shares in New Zealand and certain

Australian resident listed companies (as defined under section CX 44C(1)(a) and (b)). Section HL 13(2) provides a concession that the tax liability arising from this deemed disposal and acquisition can be spread over three years being the income year in which the entity becomes a PIE and the following two years.

Where an entity applies the new foreign investment fund rules (“FIF”) there is a deemed disposal and re-acquisition on the application day (section EX 54B(2)). Section EX 54B(3) provides a concession that the tax liability arising from this deemed disposal and acquisition can be spread over three years being the income year following the income year in which the disposal is treated as occurring and the following two years.

Preferred Solution

We suggest that there should be concessionary treatment in respect of imputation credits to allow the entity to distribute the benefit of imputation credits resulting from pre PIE tax obligations to the investors prior to becoming a PIE. There are two proposed solutions in respect of tax payments relating to tax liabilities arising prior to the entity becoming a PIE:

- the tax payments for pre PIE tax obligations result in a credit to the entity’s imputation credit account as at 30 September 2007; or
- an amendment to section ME 9(3) to allow further income tax payable resulting from a debit balance in a pre PTRE fund’s imputation credit account be allowed to be paid by 31 March following entry into the PIE regime with no late payment penalties (also assuring such payments are able to offset the tax liabilities referred above).

10. FDR and Australian Equities

Issue

Section EX 33C determines whether investments in Australian companies are subject to the foreign investment fund rules. For unit valuers that are PTRE's, as income is allocated to investors on a daily basis, this test needs to be at a single point in time or only affect future periods.

Background

For an investment in an Australian company to be excluded from the Foreign investment fund regime, Section EX 33C requires that the Australian company must be resident in Australia and not treated as resident in another country other than New Zealand under an Australian double tax agreement, have shares listed on an approved index, not be a entity described under schedule 4, Part B and must maintain a franking account.

Section EX 33C is being amended so that unit valuers only have to consider whether the Australian company is listed on an approved index at the first unit valuation period under EX 44B(1) for this section to apply. However, each of the remaining requirements must be met at all times during the income year.

For a unit valuer that is a Portfolio Tax Rate Entity ("PTRE") that elects under section HL 23 to file annually, the Act require income to be calculated and allocated daily to the investors. At any time during the year, an investor in a daily allocating PTRE can withdraw funds and be taxed on the income allocated. This can be either a full or partial withdraw. Tax on full withdrawals is required to be calculated accurately.

To achieve accurate taxation of withdrawals that there must be certainty about the income that is allocated to investors on a daily basis. The taxation treatment of an Australian company share can produce significantly different taxable income depending on whether or not the investment is exempt from the foreign investment fund rules. Should at any time during the year, the Australian company fail to meet

any of the tests that are required to be met at all times, the income allocated to past periods is no longer correct.

Any adjustment to this income would either need to be allocated to the original investor that received the original income or the investors at the time the change occurred. This creates an equity issue for the Trustee and Manager of the PTRE as the investors will have changed during the year. In the PIE environment, backdating of transactions is unlikely to occur due to the flow on effects of the allocation of income. It also potentially means that the requirement to accurately tax any full withdrawal may not be met.

In addition to the effect on past periods, information on Australian companies may not be readily available. Constant reviews of the equities held to determine the taxation position will add additional compliance costs on a fund.

Recommendation

Our preferred approach would be that, for unit valuers that are PTREs, the tests under EX 33C(2) only need to be considered at the first unit valuation period under EX 44B(1) for each year. Any subsequent change during the year will not be recognised until the first unit valuation period of the next year.

Alternatively, we request that any breaches of the tests in EX 33C(2)(a),(c), and (d) during the year, should apply only to future periods for unit valuers that are PTREs. The future period should only commence from a period that the unit valuer could have reasonably determined that the Australian company no longer meets the tests under section EX 33C(2).

11. Timing of Prescribed Investor Rate

Issue

We consider that the amendment to the definition of “portfolio investor rate” in the Taxation (KiwiSaver and Company Tax Rate Amendments) Act 2007 does not allow any updated prescribed investor rate to apply to previously allocated income even if no taxing event has occurred.

Background

The amendment to paragraph (b) of the definition of “portfolio investor rate” was to allow an investor to change his or her prescribed investor rate at any time during the year and for the updated PIR to apply to any amount that the tax liability had not already been calculated for. Once a taxing event such as a full withdrawal, partial withdrawal (for PIEs that elected to tax under section HL 23B), or attribution occurs the PIR is set and cannot be changed for amounts taxed at that taxing event. This interpretation is supported by the commentary in the special report of 17 May 2007 on the technical amendments to the Tax Amendment Act above.

The wording under paragraph (b)(iii) of the definition refers to the calculation of “the portfolio investor allocated income or portfolio investor allocation loss”. Section HL 23 states that the portfolio allocation period is one day for PIEs paying under this section. Section HL 24 states that the portfolio investor allocated income or loss must be calculated for each portfolio allocation period. We are concerned that as the portfolio investor allocated income or loss will be calculated daily the reference to the calculation of “the portfolio investor allocated income or portfolio investor allocation loss” will prevent an investor applying an updated prescribed investor rate to an earlier calculation period especially when no payment of tax has been made to Inland Revenue.

Officials have indicated they would support clarification of this definition.

Recommendation

We suggest that the paragraph (b)(iii) be amended to refer to calculation of the portfolio investment allocated income or portfolio investment allocated loss used for the purposes of payments payable under sections HL 23(2) and HL 23B.

KiwiSaver

Background

The introduction of the employee tax credit is seen as a positive move to further encourage New Zealanders to join KiwiSaver thus providing for their retirement and increasing New Zealanders savings rates. The legislation to enact the employee tax credit was drafted, and released as part of the budget and then passed under urgency.

Issue

There was no consultation with the industry and we believe minimal consultation with the Inland Revenue's (IRD's) KiwiSaver project team. As a result the legislation is unworkable in part.

Preferred Solution

Remedial legislation should be passed as part of the May Tax bill to ensure the Member Tax Credit legislation is workable for the IRD Providers and members. ISI would welcome the opportunity to work with the IRD to resolve the issues and ensure remedial legislation will work for KiwiSaver members, the IRD and providers.

We itemise below specific issues with each clause:

1. We recommend the following changes to new subpart KJ in clause 143 of the Bill.

1.1. Section KJ (1): Payment of Tax Credit to Fund Provider

Issue

No timeframe is stated within which the payment needs to be made by the IRD.

Preferred Solution

If our preferred solution to KJ4(2) is accepted then payment of the tax credit for a KiwiSaver member should be possible on receipt of the required information from the provider by the IRD as outlined in our comments on **68C (2) (3) and (4)**

Issue

No allowance is made for where a member has transferred or is transferring between schemes.

Preferred Solution

Payment of the tax credit by IRD should be made to the provider who is the member's current provider at the time of payment.

Issue

No allowance for payment of tax credit in exceptional circumstances (i.e. where a saver's account has been closed) to a saver or their estate.

Preferred Solution

Payment of the tax credit could be made to the saver or their estate where the saver has permanently emigrated or died before any tax credit due has been claimed. Please refer to our comments on **68C (2) (a) (ii)**

1.2. Section KJ 3 Tax Credit Calculations

Issue

The calculation is based on the number of days during the tax year the member is eligible. It is impractical for providers to request this information from all members and to change their systems to be able to record the required history of residency. Major systems changes would also be required to enable calculation based on a member's age and the number of days they are eligible. Providers would also be required to provide this information to the new provider when a members transfers. There is insufficient time for providers to make the required changes to their systems. The required changes would also increase the complexity and cost of running KiwiSaver schemes.

Preferred solution

Eligibility should be based on the member's status as on the last day of the tax credit year.

1.3 Section KJ 4 (1) Payment of Tax Credit by IR to a Provider

Issue

No timeframe is stated within which the payment needs to be made by the IRD.

Preferred Solution

If our preferred solution to KJ4(2) is accepted then payment of the tax credit for a KiwiSaver member should be possible on receipt of the required information from the provider by the IRD as outlined in our comments on **68C (2) (3) and (4)**.

Issue

No allowance is made for where a member has transferred or is transferring between schemes.

Preferred Solution

Payment should be made to the provider who is the member's current provider at the time of payment.

Issue

No allowance for payment of tax credit in exceptional circumstances (i.e. where a saver's account has been closed) to a saver or their estate.

Preferred Solution

Payment of the tax credit by IRD could be made to the saver or their estate where the saver has permanently emigrated or died before any tax credit due has been claimed.

Please refer to our comments on **68C (2) (a) (ii)**

1.4 KJ 4 (2) Splitting Tax Credits

Issue

Splitting tax credits on a pro rata basis between KiwiSaver and complying funds is impractical and will cause delays in payment because the IRD has to wait to receive information from all providers.

Preferred Solution

We recommend that the tax credit should first be paid to the member's KiwiSaver account if they have one. If the amount paid to the members KiwiSaver account is less than the annual limit then the balance should be paid to the member's complying funds on a first come basis until the annual limit is exhausted.

1.5 KJ 5 (3) Treatment of tax credit

Issues

The Rules state that: The Fund Provider must credit the amount of the tax credit pro rata across the investment products to which the person has subscribed. It is not clear whether the pro rata basis allows providers to pro rata based on the members current contribution fund split instructions or whether it must be pro rata based on current balances. Many provider systems are setup to pro rata based on the members current contribution instructions.

Preferred Solution

We recommend clarification that provider may credit the amount of the tax credit pro rata based either on current investment value or be based on the members current contribution split instructions.

1.6 K J 5 (6) Claw-back on Permanent Emigration

Issue

We believe that the claw-back will act as a disincentive to joining KiwiSaver especially for younger employees. The term Tax Credit implies that employees are receiving back part of the tax they have paid as an incentive to save. The claw-back will be viewed as a tax grab. We also see a clash between the Tax Credit claw-back and PIE rules. The member's accumulation may have to be refunded to the IRD leaving no interest to adjust to fund their PIE tax liability. This Liability will then be borne by the other investors in the KiwiSaver scheme. The claw-back is also complicated to implement for both providers and the IRD especially when members transfer between providers over the life of their KiwiSaver membership. We believe there is insufficient time to implement the required changes to enable tracking of tax credits within providers systems to enable this information to be passed between providers when members transfer.

Preferred Solution

We recommend that the claw-back be removed.

2. We recommend the following changes to new section 68C inserted in the Tax Administration Act by the Taxation (KiwiSaver and Company Tax Rate Amendments) Act 2007:

2.1 68C (2) (a) (ii)

Issue

The provider must claim tax credit on day prior to member ceasing membership (i.e. full withdrawal). KJ5 (3) requires the provider to credit the amount pro rata to the members investments. KJ5 (4) requires tax credits to vest to the person on receipt of payment from the IRD. These are not possible after full withdrawal.

Preferred Solution

We recommend that when a member exits KiwiSaver that on receipt of an account closure message from the saver's current provider that the IRD should remit any tax credit due directly to the member or their estate along with any other contributions which IRD are holding.

2.2 68C (2) (b) and (c)

Issue

This section requires providers to be reasonably satisfied of how many days during the tax credit year a person is eligible to receive the tax credit. We believe this is impractical and open to interpretation as to what constitutes being reasonably satisfied.

Preferred Solution

Eligibility should be based on the member's status as of the last day of the tax credit year. Members should be required to advise providers of any change in eligibility and providers should be able to rely on the last advice received from members.

2.3 68C (2) (3) and (4)

Issue

These clauses require the provider to send a claim to the IRD detailing the member's credit contributions for the year. The claim will not be for the full entitlement as IRD could potentially hold eligible contributions that have not yet been paid to the provider (refer IRD's media statement 2nd July 2007). This will mean that some members will not receive their full credit if IR does not consider contributions they hold. It also requires providers to track eligible contributions so that these can be advised to new providers when the member transfers. There is insufficient time for providers to make the required changes to their systems. The required changes would also increase the complexity and cost of running KiwiSaver schemes.

Preferred Solution

The requirement for a provider to furnish a claim to the IRD should be removed and replaced with the requirement to furnish the IRD with a statement detailing sufficient information to enable IRD to calculate the member's tax credit for the tax credit year. We see this information as:

- The contributed value of any eligible contributions for the member tax credit year received directly by the provider that have not been received via the IRD.
- The details and rules of any mortgage diversion facility in place for the member.
- The members date of birth.
- The members residency status as at 30 June.

3. "Void" KiwiSaver Contracts

Issue

We are concerned at the potential risk to providers / trustees and or remaining KiwiSaver members if contributions are considered void and refundable as a result of an enrolment in error or late opt out. The securities have been issued in good faith and any gain or loss of value should be borne by the person who held the securities regardless of their ineligibility under the KiwiSaver Act.

Preferred Solution

A new clause should be added to the KiwiSaver Act that states a person is deemed to be an eligible KiwiSaver member for any period of time between their enrolment and later withdrawal as a result of a late opt out or ineligibility under the KiwiSaver membership criteria. The clause should also state that the refund of any contributions received by the provider will be refunded at the current market value to the IRD who will then refund the balance after reclaiming crown contributions to the original payer of the contribution.

4. Reduction in employer contributions when employer already contributing to a non-KiwiSaver scheme/complying superannuation fund.

Issues

Section: 101D

Our understanding of the intention of this section is as follows:

If an employer offers staff who commenced employment prior to 1 April 2008 access to a staff super scheme and the staff super scheme was in place on or before 17 May 2007, the employer contributions to this staff scheme can be used to reduce the level of compulsory employer contributions to a KiwiSaver scheme (subject to immediate vesting).

Section 101D(c)(i) and (ii) do not seem to achieve this result for employees who commence employment between 18 May 2007 and 1 April 2008. An employee that starts between 18 May 2007 and 1 April 2008 cannot have access to the employee scheme on 17 May 2007 as they were not employed at this time. Therefore employer contributions for employees that commence work between 18 May 2007 and 1 April 2008 will not reduce the minimum employer contribution to a KiwiSaver scheme.

Preferred Solution

Amend 101D(c)(ii) by adding the following on the end (after 17 May 2007) "and access to this registered superannuation scheme for employees who commence employment in the period 18 May 2007 to 31 March 2008 (inclusive)."

5. 101G Rules: providers Treatment of tax credit

Issues

The rule states that: a provider must credit the amount of compulsory employer contribution they receive on a pro rata across the investment products to which the member has subscribed or has been allocated. It is not clear whether the pro rata basis allows providers to pro rata based on the current contribution splits elected by the member or whether it must be pro rata based on current investment account balances. Many provider systems are setup to pro rata based on the members current contribution instructions.

Preferred Solution

We recommend clarification that provider may credit the amount of compulsory employer contribution they receive pro rata based either on current investment value or be based on the members current contribution split instructions.

6. 235 Regulations relating to mortgage diversion facility

(6) Section 229(2)(i) is replaced by the following

Issues

229 (i) (i) limits the amount that can be diverted to a Mortgage as “half of the person’s contribution rate for their KiwiSaver Scheme.

A provider does not know the members salary or wages and does not know the members contribution rate. It is assumed that the contribution compliance (of salary and contribution rate) is completed by the central administrator.

Preferred Solution

Reword this clause to be half of the amount received by a provider as an employee contribution via the IRD.

7. KiwiSaver Amendment Regulations 2007

20 (4) Fee Subsidy.

Issue

The provider must credit each instalment of the fee subsidy on a pro rata basis across the investment products of the KiwiSaver scheme to which the member has subscribed or been allocated.

It is not clear whether the pro rata basis allows providers to pro rata based on the current contribution splits elected by the member or whether it must be pro rata based on current investment account balances. Many provider systems are setup to pro rata based on the members current contribution instructions.

Preferred Solution

We recommend clarification that provider may credit the amount of Fee Subsidy they receive pro rata based either on current investment value or be based on the members current contribution split instructions.

27 What scheme provider must do to participate in mortgage diversion facility

“(b) ensure that each amount forwarded to the mortgagee complies with section 229(2)(i) (which requires the amount to be capped at half of the person’s contribution rate and fixed dollar amount).

Issue

A provider does not know the members salary or wages and does not know the members contribution rate.

Preferred Solution

Reword this clause to be half of the amount received by a provider as an employee contribution via the IRD.

Life Insurance

Background

Life insurance companies generally pay income tax on the life office base, and use this tax as a credit to meet their liability under the policyholder base.

In respect of investments in offshore equities, the amount taxed in the life office base under the Fair Dividend Rate (FDR) will generally equate to 5% of the opening value of the relevant equities. This will be different from the returns credited to policyholder reserves, which will be based on accounting results; accordingly, there is a potential mismatch of the amounts being brought into tax under the two bases.

Life insurers will derive gains on disposal of New Zealand and Australian-listed equities; where these assets are held through a Portfolio Investment Entity (PIE), such gains may be accessed tax free by deriving an exempt dividend on redemption of units in the PIE. Where these gains are credited to policyholder reserves, they will be brought into tax, resulting in a further mismatch.

Clauses 77 and 78 attempt to adjust the policyholder base liability, in order to restrict the amount brought into tax to the amount that will be taxed in the life office base. The policyholder base formula is amended to take account of a “PIE adjustment” and an “FDR adjustment”.

The PIE adjustment is only available to assets held within a “portfolio investment-linked life fund”, and amounts to $0.9 \times$ the difference between accounting income and FDR income, plus $0.9 \times$ the difference between accounting income and exempt Australasian gains. A “portfolio investment-linked life fund” is defined as a fund in which investments are held under a life insurance policy, where benefits under the policy are directly linked to the value of the investments held in the fund, and where the fund has become a PIE under section HL12.

The FDR adjustment is $0.4 \times$ the difference between accounting income and FDR income.

1. Scope of PIE adjustment is too restrictive

Issue

Any individual or corporate investor can derive exempt gains on disposal of New Zealand and Australian-listed equities, by holding the assets through a PIE and deriving exempt redemption dividends. Accordingly, all such income should be excluded from the life office and policyholder base calculations.

Similar exempt gains will be derived in respect of assets backing conventional policies (whole of life and endowment business), and it is possible that the shareholder might also participate in some of these gains.

It is unreasonable to restrict the policyholder base relief to linked products only, when any other investor can access such gains free of tax.

Preferred Solution

The notion of a “portfolio investment-linked life fund” should be removed. Instead, all exempt Australasian equity gains that are credited to policyholder reserves should be removed from the policyholder base calculation. This should apply where shares are held directly, and also where the gains are derived from holdings in a PIE.

Similarly, there should be an explicit exemption in the life office base for all such gains, not just gains connected with linked policies (Issue 2 below).

2. Provision for life office base

Issue

The commentary to the bill states at page 99 that life insurers will be able to elect to have realised Australasian equity gains from linked products excluded from both the life office base and policyholder tax calculations.

It appears that the life office base exemption is given through clause 83, allowing the linked business to elect to be a PIE. Presumably, a life insurer can access tax free gains through a PIE as described above, but the Bill does not offer an election to exclude gains on directly held Australasian equities from the life office base.

Preferred Solution

The bill should include an express provision to exclude gains on all Australasian equities from the life office base. As stated under issue 1 above, this should extend to all such assets, not just assets held under linked policies.

3. Definition of PIE adjustment – direct versus PIE holdings

Issue

The definition of the PIE adjustment only envisages holdings of shares as described in section CX44C. The insurer could hold the shares directly, or through a PIE. Gains can be accessed tax free through a PIE, and direct holdings should have the same treatment.

Preferred Solution

Amend the definition of the PIE adjustment to include gains on Australasian equities derived from a PIE.

4. 0.9 and 0.4 Factors

Issue

The PIE adjustment is applied to 90% of the difference between accounting and taxable amounts, whereas the FDR adjustment uses a 40% scaling factor. In both cases, if the insurer is able to provide an accurate calculation, the amount of the adjustment should be applied to 100% of accounting income that is credited to policyholder reserves. Many insurers could support such a calculation on an asset by asset basis.

There can be situations where accounting reserves are not the same as tax reserves, and this would need to be dealt with separately.

Preferred Solution

The 0.9 and 0.4 factors should be a fall back option where insurers cannot quantify the exact amount of accounting income credited to policyholder reserves and the corresponding taxable amount.

Further work is required to cater for situations where accounting and tax policy reserves differ.

5. Definition of Property

Issue

In the proposed sections EY42B and EY42C, the adjustments are made “to the extent to which property that the life insurer holds to support actuarial reserves...”

This phrase is not defined, and could be difficult to interpret in cases where insurance contracts prescribe participation in certain pools of assets by both shareholder and policyholder.

Preferred Solution

The PIE and FDR adjustments should be made by determining the actual amount of accounting income credited to policyholder reserves, and comparing this to the corresponding taxable amount.

Again, further work is required to cater for situations where accounting and tax policy reserves differ.

6. Definition of “FIF result”

Issue

In clause 78, the FIF result is defined as the gains and losses for the income year (a) calculated according to accepted accounting practice, and (b) not different materially from the amounts of FIF income or loss that would have arisen for the property in the absence of the law enacting FDR. The commentary states that the intention is that comparative value is used.

This clause is problematic for two reasons; first, the term “materially” is not defined, and secondly, it is not clear what should happen where the two amounts are materially different.

Preferred Solution

Logically, amounts that are credited to policyholder reserves are based on gains and losses reported in the financial statements, determine by accepted accounting practice. Accordingly, any adjustment to policyholder base taxation should follow the same logic. It is therefore arguable that the reference to being materially similar to comparative value income is unnecessary. This would also remove any difficulties arising in respect of assets where a market value is not readily available, such as unlisted equities.

7. Rate of tax applied to linked products

Issue

Linked products are subjected to tax at the corporate rate of 33%. This is excessive in light of the fact that industry data shows that the typical investor is either in or approaching retirement. These products are not being sold to new customers in any significant volume.

Preferred Solution

Linked products should be taxed in the life office base at 19.5% as a proxy rate, and the income removed from the policyholder base by way of exemption. This would give an equitable outcome for most investors similar to a PIE, but without the complexity of individual attribution that is prohibited by the legacy systems on which these products are typically administered.

Any concerns about a resurrection of these products could be dealt with by grandfathering provisions

Research and Development

Background

The move to provide an incentive to undertake research and development is welcomed by the ISI, as further encouragement to expand the knowledge base in New Zealand. We note that this brings New Zealand in line with most other jurisdictions that provide incentives to invest in research.

While the general thrust of the reform is welcomed there are a number of specific concerns that ISI have.

1. Research and Development result ownership

Issue

The industry occasionally bands together to develop solutions to problems. A prime example can be illustrated with KiwiSaver. The industry has largely been operated in a cooperative manner; this may or may not qualify for the R & D credit. However, the current proposals exclude such cooperative development as a company has to own the results. When a cooperative approach is taken all of the participating parties own the result.

Preferred Solution

That it is the activity which drives the credit and not the ownership. In a cooperative or combined approach each participant would be entitled to a credit based on their contribution. Expansion of section LH8.

2. Internal Software Development Cap

Issue

The most significant concern the industry has is the restriction of \$2 million (unless the minister approves a higher amount). Both internal and external software development is expensive and a \$2million cap provides little scope for large scale software projects.

A number of ISI members have large internal information technology sections. These internal sections undertake maintenance etc, but are also involved in systems development work which would undoubtedly qualify for an R&D credit. Examples of this can be illustrated by the PIE and Kiwisaver developments. A cap of \$2 million is simply inadequate and when considered against the turnover of our members is very small and unlikely to be reasonable. While we note the ability to apply to the Minister, the criteria provided in the legislation are of concern. These criteria focus on the New Zealand economy while many of the members are large corporates. When viewed as part of the NZ economy, an internal software development would be difficult to show a 'substantial net benefit' to New Zealand.

Preferred Solution

That the reference to a \$2 million cap is removed. If a cap is required, and we question the value of this, it is referred back to the individual company e.g. a percentage of some fixed measure. Further, if the cap is retained, the criteria that the Minister can use to allow a greater tax credit claim is narrowed to bring it in line with the rest of the section; i.e. it does benefit the growth of knowledge of the company

Other Matters

1. Clause 51 (EW 19)

For clarity ISI recommends that the heading to the amended section is “Choice among YTM, Straight Line and Mark to Market”.

Further, to avoid conflict with Clause 47 (new section 15B), that EW 19 be amended by replacing the words “A person who...” with the words “If the person is not required to use the IFRIS method under EW15B, a person may”

2. Grouping of Unlisted Property Funds

Background

It is common for property funds to hold their investments via a number of subsidiaries. Where the property fund becomes a PIE the following provisions apply.

Section IG 1(2) provides that a PIE can not be included in a “group of companies”. This has been amended by clause 37 of the Taxation (Kiwisaver and Company Tax Rate Amendments) Bill (now enacted) (the “First May Bill”) to modify this so that only a portfolio tax rate entity (“PTRE”) can not be included in a “group of companies”. Section IG 1(2) is then referred to in the definition of “wholly-owned group of companies” contained in section IG 1(3).

Whether an entity can be included in a group of companies is relevant to the application of the grouping of losses provisions contained in section IG 1. It is also relevant to the exempt income provisions for wholly-owned groups contained in section CW 10.

Issue

An unlisted property fund that elects to become a PIE will be a PTRE and will be unable to be a member of a “group of companies” or “wholly-owned group of companies”. Therefore, an unlisted property fund and its subsidiaries will be unable to offset losses or pay or receive exempt dividends within a wholly-owned group.

Preferred Solution

The definition of “group of companies” contained in section IG 1(2) is modified to exclude PTREs that are not unlisted property funds. This will ensure that listed property funds and unlisted property funds receive the same treatment in respect of loss offsets and exempt dividends between subsidiaries.

3. Tax Rates

Background

ISI is very supportive of the reduction in the corporate tax rate and corresponding reduction in the Portfolio Investor Rate

3.1 Resident Withholding Tax

Issue

A Major concern associated with this is the potential increase in compliance costs associated with the requirement to deduct Resident Withholding Tax from dividends after the phased introduction of the reduced imputation credits.

There seems little benefit in levying RWT on dividends for the additional 3% tax on fully imputed dividends (30/70 ratio).

Preferred Solution

Reduce the RWT on dividends to match the corporate tax rate of 30%.

3.2 Imputation Credit Ratio

Issue

Additionally the two year period enabling corporates to distribute based on the 33/67 ratio seems restrictive. Based on the tax having been paid, corporates should be able to distribute imputation credits at the higher ratio while those credits exist. Anti-streaming rules already exist for protection at the revenue base.

Preferred Solution

That imputation credits are able to be continued to be passed out at the 33/67 ratio. Alternatively a longer period of transition is provided (for example, five years).

4. Section EW 15B

Background

Section EW 15B requires taxpayers to use the IFRS method if the financial reports are prepared using NZIAS 39. EW 15C (2) allows financial arrangements to be measured for tax purposes by applying IAS 39 or applying a Determination under EW 15(5). Section EW 24 also requires a consistent use of method for same or similar arrangements.

Issue

Given that financial institutions can hold similar types of financial arrangements for different purposes, we consider it necessary to clarify that applying IAS 39 under EW 15 C(2) for some financial arrangements and applying a determination under EW 15(5) for similar types of financial arrangements is still applying the IFRS method, and therefore conforms with the consistency requirements of EW 24 and EW 25.

Preferred Solution

We suggest two changes to provide the required clarity:

EW 24 should only be applicable to people who do not apply the IFRS method; and Amend EW 14(2)(aa) to read The IFRS method, to which sections EW 15B and EW 15C are relevant. The IFRS method includes the methods outlined in section EW 15C(5).

List of ISI Members

ISI Members

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

Associate Members

Bell Gully Buddle Weir
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

Appendix A

27 June 2007

Jivan Grewal
Analyst
Competition, Trade and Investment
Ministry of Economic Development
PO Box 1473
WELLINGTON 6140

Dear Jivan

KiwiSaver – Industry Response to Media Criticism from Gareth Morgan

Further to our recent discussion I provide the following comments in response to media criticism from Gareth Morgan of competitive KiwiSaver providers, made in the media and at public meetings.

The industry is concerned that Dr Morgan's recent comments, designed to promote his own KiwiSaver scheme, contain misrepresentations, are grossly misleading and may be placing pressure on Officials to respond through the inclusion of additional precautions within the KiwiSaver regulations. Dr Morgan's comments are a publicity campaign creating an impression that there are serious problems in the New Zealand funds management industry that demand a regulatory response. This is simply not supported by the facts.

Dr Morgan's media comments have been directed at the following areas:

- Hidden fees and charges.
- Reserve funds.
- Unit pricing errors.
- Pooling of funds.
- Life insurers.
- Independence of financial advisers.

The industry response is as follows:

1. General Observation

- (i) Dr Morgan is marketing a KiwiSaver product with the same market, same legislation, in direct competition to those that he criticises. His criticism should be heard in the context of his own vested interest.

- (ii) Dr Morgan, as principal of his economic adviser business “Infometrics”, provided a report for ISI in 1998 which was the basis for the ISI Report on Retirement Savings – “A Wake-up Call” and in August 1999, a discussion document “Towards an Ideal Taxation Regime”. Dr Morgan actively supported and promoted “A Wake-up Call” to Politicians, Officials and the media, on behalf of ISI. At this time there was no suggestion that Dr Morgan held any concerns regarding fund management industry practices. The inference from Dr Morgan’s participation was that he supported higher levels of retirement savings through the funds management industry.
- (iii) ISI members have adhered to all legislation applying to managed funds and superannuation schemes, including the Securities Act, Fair Trading Act and Consumer Guarantees Act. With one exception that is not relevant to the comments made by Dr Morgan, we are not aware of any serious breach of legislation by ISI members within the past 20 years (possibly longer). [Some Australian funds did breach Section 37A of the Securities Act, this related to failure by the fund to advise of changes that were not material. The breaches were voluntarily disclosed by the Australian funds to the Securities Commission and the Ministry of Economic Development when they became aware they had breached the Act.]
- (iv) In December 2004, the Securities Commission issued the outcome of an inquiry into fund managers pricing practises. This followed investigations by the New York Attorney General, Elliot Spitzer, and ASIC in Australia. Although not totally relevant to Dr Morgan’s allegations, the Securities Commission findings supported the industry practises in respect of unit pricing practices.
- (v) KiwiSaver will operate in an environment of close regulator and market scrutiny, initially from the Government Actuary in the approval process, reasonableness of fees and annual reporting process, by independent professional trustees, independent industry commentators (eg Eriksen & Co, Melville Jessup Weaver and others) and a wide range of financial media commentators.

2. Specific Response to Gareth Morgan’s Comments

- (i) *Hidden Fees and Charges*
All KiwiSaver funds will be subject to the following process (both at approval and ongoing):
 1. KiwiSaver will be governed by strict regulations that place considerable onus on trustees to manage the funds in the best interests of investors.
 2. All KiwiSaver schemes are reviewed by the Government Actuary before approval and registration to ensure all fees and charges are fully disclosed and are not unreasonable.

3. The six default providers (AMP, AXA, ASB, ING, Mercers and Tower) and others involved in the default selection provider process but not finally selected, have been reviewed by an independent Government-appointed panel and carefully selected before being formally appointed by the Minister of Finance.
4. The KiwiSaver Act contains provision for the Government Actuary to direct that a scheme is operated in a specific manor or apply for cancellation of registration of a KiwiSaver scheme that fails to operate in an acceptable manner.
5. KiwiSaver products will be managed in accordance with a Trust Deed. Each product will have an “Independent Trustee” who together with any other trustees, must ensure that the plan is administered in accordance with the Trust Deed and the law.
6. Reporting to investors will be required to meet reporting standards prescribed by the KiwiSaver legislation and regulations.

The Securities Act and Regulations coupled with the KiwiSaver process require full disclosure of all fees and charges payable for KiwiSaver schemes. KiwiSaver providers are required to register their prospectus with the Securities Commission before marketing their product.

It is interesting to note that Gareth Morgan’s own KiwiSaver fund’s trust deed fee provision mirrors that of the industry and is almost identical to one ISI member who utilises the same legal adviser.

Dr Morgan’s suggestions that the industry will apply hidden fees and charges is misleading and suggests the Government Actuary approval process, the Securities Act, Independent trustees, and the Securities Commission, will all be ineffective in their purpose and the conduct of their responsibilities.

(ii) *Reserve Fund*

For Gareth Morgan to raise reserving as an issue is both misleading and inaccurate.

Reserve Funds refers to the old (but still acceptable) practice involving life insurance based savings products where a ‘reserves pool’ was

developed to “smooth” future bonus declarations or declared interest rates – this has no relevance to managed funds or any KiwiSaver schemes that I am aware of.

Today, Employer’s Reserve Accounts occur within an employer sponsored superannuation fund within very specific circumstances involving unvested employer contributions. Employers use vesting to encourage staff retention and reward loyalty.

When an employee resigns from an employer sponsored scheme the employee is entitled to retain his/her contributions and a portion of the employer contributions (up to 100%) as specified by the “vesting terms” contained in the Trust Deed. Any unvested portion are maintained in an employer’s reserve account. The employer has options how these can be applied including having these returned to the employer, spread it across the other employees or using the Employer’s Reserve Account to subsidise their employee’s fees. The treatment of unvested employer contributions is solely at the discretion of the employer, not the fund manager.

As the PIE taxation regime will fully allocate fund earnings to scheme members the sort of reserving that Gareth Morgan appears to refer to is inconsistent with the way PIEs operate.

Important points:

- (a) The PIE tax regime requires full allocation of fund earnings to member accounts.
- (b) Within an employer sponsored scheme any reserve fund is administered strictly in accordance with the Trust Deed.
- (c) All decisions relating to the Employer’s Reserve Account are the sole responsibility of the employer, within the rules of the Trust Deed. [The fund manager has no involvement or influence in any decision.]

For Gareth Morgan to imply that fund managers will be able to manipulate “reserve funds” is absolutely incorrect and deliberately misleading.

(iii) *Unit Pricing Errors*

Garth Morgan has publicly stated that “surprisingly errors only occur in favour of the fund manager”.

Managed funds are complex financial instruments involving many transactions and unit pricing errors may occur from time to time. Internal audit processes will quickly uncover errors. Managed Funds are also subject to independent audit requirements from major audit companies. Pricing discrepancies would be picked up through these audit processes.

It is important to note any errors occur equally with as many in favour of the investor – and when they have occurred they have been promptly remedied.

The Securities Commission’s report in December 2004 indicated a high degree of satisfaction with fund managers processes for unit pricing (although it must be noted the report was not specifically looking at unit pricing errors).

It is also important to note that unit pricing is the standard best practice used by fund managers in New Zealand and Australia, and in major investment markets such as the US, the UK and Europe.

We note that the fee comparisons on the Gareth Morgan KiwiSaver website contain a “0.25% unitising mis-pricing factor” (ie the comparison implies that competitive fund managers other than Gareth Morgan will systematically make a 0.25% error at the savers cost). This is totally unacceptable.

Dr Morgan’s allegations have no foundations and can only be seen as mischievous and aimed at discrediting competition.

(iv) *Pooling and Unitising*

Gareth Morgan implies that pooling of funds is a bad practice; we believe from his Prospectus that he will also be pooling his client’s assets.

Pooling of funds for investment purposes is an accepted worldwide practice.

Pooling provides cost efficiencies (ie each transaction costs less), asset/security diversification and access to specialist fund managers. All represent major advantages. For example, the most efficient and effective way for individuals to invest in property is to invest through a pooled managed fund or listed entity providing exposure to a number of properties. Pooled funds provide accurate and independently verified statements to individual investors. Pooling is recognised as a significant advantage to investors in managed funds.

We note that the Gareth Morgan KiwiSaver (GMK) Scheme allows members to invest in three investment portfolios – Conservative, Balanced or Growth. It appears to be pure semantics as to whether these portfolios are ‘pooled’ or not. From their descriptions in the GMK investment statement and prospectus, the operation of these portfolios is indistinguishable from any other scheme’s conservative, balanced or growth fund – GMK members have interests in three diversified ‘pools’ of assets.

To imply that such a widespread and internationally recognised industry practice as pooling is somehow questionable while at the same time offering ‘diversified’ funds is mischievous in the extreme.

(v) *Life Insurance*

Dr Morgan deliberately uses outmoded terminology by referring to the industry as “life insurers”, implying there is something wrong with the life insurance industry. The life insurance industry has for nearly 100 years served consumers well and that record continues.

Dr Morgan fails to acknowledge that, as a KiwiSaver scheme is a trust, it is and must be a separate entity from any life insurer that might be part of a financial services group. The scheme is governed by the trust deed and the trustees must ensure that it is run appropriately. A life insurer in a financial services group may provide contracted services to the trustees but it will not have any role in the scheme governance or interest in its assets other than as a provider of services.

That Dr Morgan should attempt to create doubt on competing KiwiSaver products by referring to “life insurers” is a mischievous practice that deserves no credit.

(vi) *Independence of Financial Advisers*

Morgan has repeatedly criticised the independency of financial advisers and has often linked this with his criticism of fund managers.

Where advice is provided by employees and or advisers who have direct association (ie not independent) with a fund manager, this situation is clearly outlined in the disclosure documentation provided to investors.

Where the adviser is Independent, the fund manager in these circumstances has no influence over the actions of the adviser and has no direct responsibility for the actions of the Independent adviser.

You are aware of the review of financial intermediaries, a process that has been actively encouraged by ISI members. We have been at risk of irritating MED Officials by calling for faster progress in the implementation of tighter regulation.

We resent the approach taken by Dr Morgan, particularly in light of the fact that the introduction of his own KiwiSaver scheme has compromised his position as an “independent adviser”.

Conclusion

We trust that these comments will provide useful background information to balance the regrettable media comments of a competitor.

We have attempted to limit our comments above to the specific issues. However, we note the following quote from Dr Morgan:

“to service serious long-term savers and to ensure they get value for money. We realise that there will be people that join KiwiSaver solely to obtain the government’s \$1,000 kick-start, or the first-home subsidy; or who start with good intentions but turn out to be part-time savers on contributions holidays more often than not. These folk don’t interest us.”

Obviously, Dr Morgan has a very clear target market in mind that does not include first-time employees on a low wage.

The website goes on to make it very clear the low-incomed are not his target:

“We want to attract people that are willing to take KiwiSaver seriously. Our fees have been structured in the way set out below because we are not prepared to have individual members with persistently low balances being unduly subsidised by other members or ourselves”.

Our understanding is that Government introduced KiwiSaver as a low cost, work-based, easily accessible retirement savings scheme for all New Zealanders. KiwiSaver schemes offered by ISI members are designed for the wider market consistent with the spirit of the Government’s intentions.

Gareth Morgan’s KiwiSaver scheme contains a minimum fee of \$200 which has been reduced/discounted to \$50 until July 2009. In order not to be impacted by this increase, Gareth Morgan’s clients will need to have an investment balance of \$20,000 by 1 July 2009.

To reach a balance of \$20,000, investors will need to contribute 4% of an annual salary of approximately \$180,000. The reality is that where KiwiSaver is concerned Dr Morgan is interested in less than 5% of the working population.

We are happy to meet and provide any further explanation necessary.

The industry is confident that it meets global best practice. We welcome competition and fully expect further players to enter the market.

We also acknowledge the need for robust legislation that provides high levels of protection for investors. It is in no ones interests for unacceptable practices to occur to the disadvantage of investors. Nor indeed is it in the interest of potential investors for competitors to create uncertainty through inaccurate and misleading comment through the media or for such anti-competitive practices to lead to overly prescriptive regulation and controls.

For your information we attach a copy of a media release from ING which will provide an insight of how seriously ISI members take their responsibilities to KiwiSaver investors.

Yours sincerely

Vance Arkininstall
CHIEF EXECUTIVE

cc: Justine Gilliland, Acting Manager, Competition, Trade and Investment

Appendix B

11 July 2007

Jivan Grewal
Analyst
Competition, Trade and Investment
Ministry of Economic Development
PO Box 1473
WELLINGTON 6140

Dear Jivan

KiwiSaver – ISI Response to Gareth Morgan’s Submission to the Finance and Expenditure Select Committee

Further to previous correspondence (27 June 2007) regarding Gareth Morgan’s criticism of the funds management industry, I refer to a copy of Dr Morgan’s submission to the Finance and Expenditure Select Committee which appears on his website (copy attached). Dr Morgan’s comments are not correct and are misleading.

Once again it is important to view Dr Morgan’s comments within the following context:

1. Dr Morgan has made public his submission prior to the Select Committee public hearings – we understand this is a breach of protocol (however, we acknowledge that this is a matter for the Select Committee). The industry feels constrained in any public response in recognition of the Select Committee process and protocols.
2. Dr Morgan in his opening paragraphs refers to “...systemic industry risk of the kind that New York Attorney General Eliot Spitzer has discovered pervades the life insurance business. The same multinational companies operate in New Zealand and it would be naïve to believe they didn’t practice the same “cheating of consumers” that Spitzer had found them to pursue in US”

Our comments in reply to these claims are as follows:

- (i) It is unreasonable to make a general claim that the same multinational companies operate in NZ as providers of KiwiSaver products:

Many NZ KiwiSaver products are multinational organisations but the majority of these have no connection with the US or Eliot Spitzers investigations.

We are aware that Mercers had a connection with the Marsh organisation who issued a public apology and reached a settlement with the US authorities. We are advised that this association was disclosed by Mercers to Officials during the rigorous process of being appointed as a default provider. In NZ it is our understanding that Mercers have an exemplary record in financial services.

We understand that the AON group was mentioned in the Spitzer investigations. AON in NZ are offering a KiwiSaver product. We cannot comment as AON is not an ISI member.

The point is that we believe it is grossly unreasonable to attempt to tarnish the reputation of NZ KiwiSaver providers via such sweeping generalisations.

- (ii) Dr Morgan refers in general to life insurance business – KiwiSaver products are provided by specialist fund managers not life insurers. Although we do acknowledge some KiwiSaver providers do have a life insurance company within their corporate structure, it is not the life insurance company that will be providing KiwiSaver products.

This generalised comment is misleading.

- (iii) The New York Attorney General, Eliot Spitzer, did uncover serious issues relating to the unit pricing practices of US fund managers.

These related to ‘market timing’ and ‘late trading practices’. Both of which created opportunities for a fund to exploit stale fund prices (in the case of market timing) or allowed trading to preferred investors after the market had closed (late trading).

As a result of the US discoveries, the Securities Commission undertook a review of NZ practices in 2004 (ASIC in Australia undertook a similar review).

On 6 August 2004, the chairman of Australian Securities and Investments Commission (ASIC) issued a media release which stated “During the Review ASIC found no evidence of systemic or large-scale use of improper investment practices in the Australian managed funds industry” (copy attached).

The Securities Commission released its findings on 22 December, and issued a media statement dated 3 February 2005. The Commission reported a favourable outcome for the industry in its report.

In the media release the Commission stated that “neither market timing or late trading was commonly practiced in New Zealand” (copy of both the Securities Commission Media Release and Report is attached).

For Dr Morgan to claim that a systemic industry risk of the kind Mr Spitzer discovered in the US pervades in the industry in NZ does not stand up to the scrutiny.

Given the close links between the NZ and Australian funds management market, the ASIC findings, which reflected the Securities Commission findings, are relevant.

- (iv) Dr Morgan's comments need to be taken in context that his independence is compromised as he is also a KiwiSaver provider.
- (v) In his submission to the Finance and Expenditure Select Committee, Dr Morgan repeats his claims about unit pricing, pooling, hidden fees and charges and reserves. We have addressed these misleading and factually incorrect claims in our earlier letter to you dated 27 June 2007.

As always we are very happy to put together a small team of specialists to meet with you if this will assist.

Once again, we reiterate our strong belief that there is no substance to Dr Morgan's claims and that Government can be assured that the current protections provided by KiwiSaver legislation and associated legislation (ie Securities Act) will provide very effective security for the protection of KiwiSavers.

Yours sincerely

Vance Arkininstall
CHIEF EXECUTIVE

cc: Justine Gilliland, Acting Manager, Competition, Trade and Investment