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WEEKLY COMMENT: THURSDAY 6 SEPTEMBER 2012

1. On 24 July Inland Revenue released *Taxation of foreign superannuation – An officials' issues paper* ("the Paper"). Submissions closed on Monday 3rd September. The Paper proposes changing the rules for taxing *foreign retirement savings* held by New Zealand residents.

2. This week I look at the proposed changes in terms of:
   - What is proposed;
   - What foreign retirement savings are affected;
   - Taxpayers who must continue to use the FIF rules;
   - What the differences are between the "old" and the "new" FIF rules; and
   - Potential issues.

What is proposed

3. Interests in foreign retirement savings that the new proposals apply to will be taxable in New Zealand only on receipt:

   (a) The entire amount received from pensions and annuities will be taxable upon receipt.

   (b) A portion of lump sums will be taxable upon receipt, with the taxable portion being determined based on an "inclusion rate" that increases with the length of time the person has been in New Zealand.

   (c) Lump sums received within the first two years of becoming a New Zealand resident will be tax-free. A 15% inclusion rate will apply to receipts within 2 to 4 years of becoming a New Zealand resident. An inclusion rate of 30% will apply to receipts within 5 to 8 years of becoming a New Zealand resident. The inclusion rate then steadily increases until 100% of a lump sum received after 25 years of New Zealand residence will be taxed.

   (d) Transitional residents who receive lump sums during the 4 years of transitional residence will remain exempt from tax on such receipts. However, the inclusion rate that will apply from year 5 will be 30% - the same rate that would have applied had the person not been a transitional resident.

   (e) A temporary "amnesty" would allow persons who withdrew foreign superannuation as a lump sum between 1 January 2000 and 31 March 2011 and who did not comply with their tax obligations at the time to elect to use an inclusion rate of 15%, providing the transfer is disclosed to Inland Revenue before 1 April 2014.

   (f) Lump sum transfers to a New Zealand superannuation fund will be treated as receipts and the above rules would apply. Submissions were requested on whether a mechanism should

be introduced to allow the tax to be paid out of the transferred amount (as opposed to the tax payable being separately funded).

(g) The FIF rules will cease to apply to interests in foreign superannuation schemes. However, persons who returned FIF income in relation to an interest in a foreign superannuation scheme in the 2010-11 income year will continue to use the FIF rules for that interest.

(h) Contributions made after becoming tax resident in New Zealand will be tax deductible from lump sums (before the inclusion rate is applied) but only if such contributions were required to be made under the terms of the foreign superannuation scheme and were made from after-tax income New Zealand income.

What foreign retirement savings will be affected

4. The Paper is focused on "interests in a **foreign superannuation scheme** as defined in s. YA 1 of the Income Tax Act 2007.

5. In s. YA 1, **foreign superannuation scheme** means a **superannuation scheme** constituted outside New Zealand.

6. In s. YA 1, **superannuation scheme** means—

   (a) The trustees of a trust or a unit trust established by its trust deed mainly for the purposes of providing retirement benefits to beneficiaries who are natural persons or paying benefits to superannuation funds; or

   (b) A company that is not a unit trust, is not resident in New Zealand, and is established mainly for the purpose of providing retirement benefits to members or relatives of members who are natural persons; or

   (c) An arrangement constituted under an Act of the Parliament of New Zealand, other than the *Social Security Act 1964* mainly for the purpose of providing retirement benefits to natural persons; or

   (d) *An arrangement constituted under the legislation of a country, territory, state, or local authority outside New Zealand mainly for the purpose of providing retirement benefits to natural persons*. (emphasis added)

7. Paragraph 2.6 of the Paper sets out the affected types of foreign retirement savings as follows:

   "The scope of this review is limited to New Zealand tax-residents who hold interests in *defined contribution* or *defined benefit* foreign superannuation schemes. Pensions and lump sums received from a foreign Government would not be covered by the new rules unless the payments arose as a result of services provided by the individual to that government. Furthermore, *while New Zealand-residents may also have other overseas investments that they intend to use as retirement savings (for example, shares, bank deposits and real estate), this reform will not change the taxation of those investments*." (emphasis added)

8. Paragraph 2.2 of the Paper contains a description of defined benefit and defined contribution schemes as follows:

   "- Defined contribution schemes. These are generally where an individual and/or their employer contribute to a superannuation scheme. The amount eventually distributed to the individual represents those contributions plus investment earnings.

   - Defined benefit schemes. Under these schemes, the amount that is eventually distributed to the individual is pre-determined. An individual may or may not contribute directly to the

scheme. If the individual does contribute to the scheme, the amount received does not generally depend on the amount of their contributions."

9. Interests in foreign life insurance schemes are not included in the new proposals. It is stated in paragraph 2.28 of the Paper that:

   "Investments in life insurance schemes often have a savings element. In general, tax on foreign life insurance schemes is returned under the CV method. Officials are not aware of concerns regarding the current taxation of foreign life insurance."

10. While most "standard" foreign superannuation schemes will fall within the proposals, there will be difficulties in marginal cases, such as for example, US Individual retirement Accounts ("IRAs"). For example, paragraph (d) of the definition of **superannuation scheme** as set out in paragraph 6 above refers to "retirement benefits to natural *persons*" which suggests that the scheme must provide benefits to more than one person. Without more guidance, it could be quite complicated determining whether such specific, but quite common, types of retirement savings will be subject to the new rules or not.

Taxpayers who must continue to use the FIF rules

11. It is stated in paragraph 4.4 of the Paper that:

    ".. this paper proposes that those who returned FIF income for the 2010–11 income year by 31 March 2012 can continue to use the FIF rules for future periods (that is, they would be grandparented). The 2010–11 income year is appropriate as it is the most recent year for which all FIF returns must have already been filed. These people would not be taxed under the proposed new rules when they receive a pension or lump sum."

12. Taken literally, this means that:

    (a) Persons who were subject to the FIF rules in relation to an interest in a foreign superannuation scheme <u>and</u> returned FIF income in relation to that interest in 2010-11 will continue to use the FIF rules. However, such persons will be subject to the new FIF rules in income years commencing on or after 1 July 2011 (see paragraph **X** below).

    (b) Persons who were subject to the FIF rules in relation to an interest in a foreign superannuation scheme but returned no FIF income in relation to that interest in 2010-11 will not continue to use the FIF rules.

    (c) Persons who were partially subject to the FIF rules in relation to an interest in a foreign superannuation scheme under section EX 42 (under the old FIF rules – see paragraph **X** below) <u>and</u> who returned FIF income in relation to that interest in 2010-11 will continue to use the FIF rules – but the difficult questions remain regarding whether receipts are from rights accrued before or after NZ tax residence and the NZ tax treatment;

    (d) Persons who were not subject to the FIF rules in relation to an interest in a foreign superannuation scheme in 2010-11 but became subject to the FIF rules in 2011-12 (either the old FIF rules or the new FIF rules, depending on whether their income year commenced before 1 July or after 30 June 2011 – see paragraph **X** below) will not continue to use the FIF rules and will have any tax paid on their FIF income in 2011-12 refunded (page 3 of the *Policy Advice Division factsheet*);

    (e) Persons who were exempt from the FIF rules in 2010-11, because they were transitional residents, or because section EX 42 applied, or because their total FIF interests did not exceed the $50,000 threshold, or because the exemption for Australian regulated

superannuation savings applied, will not use the FIF rules and the new proposals will apply.

(f) Persons who returned FIF income in 2010-11 under the old FIF rules, but who become exempt from 2011-12 under the new FIF rules will not be able to rely on the FIF exemption for receipts, and the new proposals will apply.

What the differences are between the "old" and the "new" FIF rules

13. The FIF rules have been significantly amended by the provisions of the *Taxation (International Investment and Remedial Matters) Act 2012* ("the new FIF rules") which apply to income years commencing on or after 1 July 2011. The FIF rules before the amendments take effect ("the old FIF rules") applied for the 2010-11 income year. The FIF methods available for foreign superannuation interests under the old rules were CV, DRR, FDR or Cost.

14. There were no restrictions on the use of the CV, FDR or Cost methods, but the DRR method could only be used:

    (a) By a natural person with a total value of attributing interests in FIFs held by the person, at all times in the income year, ≤ $250,000 valuing each interest at:

        (i) Its book value at the end of the previous income year, if the person held the interest then and used the DRR method to calculate FIF income for all attributing interests in the previous income year; and

        (ii) Its market value in other cases; or

    (b) By any person who is not able to use the CV method, because the person cannot determine the market value of the attributing interest at the end of the income year; or

    (c) By a person who is required to continue using the DRR method by section EX 62.

15. The DRR for the 2010-11 income year was 8.52%. If no method is chosen, the default method was CV, and if it was not practical to use CV, the DRR method.

16. The ability to use the DRR method for foreign superannuation interests has been repealed, with effect from income years beginning on or after 1 July 2011. Under the new rules, there are still no restrictions on the use of the CV, FDR or Cost methods. If no method is chosen, the default method is FDR, and if it is not practical to use FDR, the Cost method.

17. The CV method taxes the increase in the value of the investment by taking the difference in value at the start and the end of the year. CV is the only method that allows any foreign tax paid by the person to be taken into account – the value at the start of the year is increased by any tax paid by the person during the year. No loss can be claimed for any decrease in the value of the investment.

18. Under the FDR and Cost methods a deemed 5% return is taxed. The FDR method can be used when a market value for the interest at the start of the year is available. Otherwise, the Cost method can be used.

19. The exemption in section EX 42 has been significantly changed under the new rules. All rights that accrue in relation to rights held before a person first becomes a New Zealand resident (whether as a result of ceasing to be a transitional resident or otherwise) will be exempt from the FIF regime if the other "lock-out" requirements of section EX 42 are met.

Potential issues

20. It is possible that some persons who were subject to the FIF rules may not have had any FIF income to return in 2010-11. For example, if the CV method was used and foreign tax was paid on a receipt during the year, there may have been no FIF income. Such persons would become subject to the new rules.

21. Section EX 42 has always been difficult to apply. The New Zealand tax treatment of receipts from foreign schemes that were partially exempt is uncertain.

22. The changes to s. EX 42 may mean that some persons who were subject to the FIF regime in 2010-11 will become exempt. Such persons would have become subject to the general (non-FIF) tax rules anyway, but from now on they will be subject to the new proposals.

23. Persons who remain subject to the FIF rules and who were previously forced to use the DRR method will benefit from the changes to the FIF rules. Similarly, persons who returned FIF income in 2010-11, but who have little or no FIF income under the CV method in 2011-12 and later income years will also benefit, as their receipts will remain tax-free.

24. Clearly, there will be winners and losers. The challenge, where persons have a choice of whether to withdraw their interests or not, will be to work out the most tax-effective way of doing so in terms of timing of receipts.

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