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WEEKLY COMMENT: FRIDAY 24 JANUARY 2014

1. The *Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill* ("the Bill") was reported from the Finance and Expenditure Committee on 28 November 2013, and contains a number of changes from the rules as originally introduced on 20 May 2013. The start date for the new rules is unchanged and remains 1 April 2014. In the past 3 weeks, I looked at a number of specific aspects of the new foreign superannuation withdrawals rules: the inclusions and exclusions, the circumstances in which the FIF rules will continue to apply, the 15% reduced rate amnesty for past non-compliance, the meaning of "assessable period" and the KiwiSaver withdrawal mechanism to fund tax liabilities.

2. This week I look at the two calculation methods: the *schedule method* (which is the default method), and the *formula method*, which can be chosen if the requirements to use it are met. These methods are used to determine the *part* of a foreign superannuation withdrawal that is not exempt from income tax (the "assessable withdrawal amount").

3. The topics covered this week are:

   (a) Using the formula method;

   (b) Recognised contributions;

   (c) Calculating the assessable withdrawal amount using the formula method;

   (d) Using the schedule method;

   (e) The schedule method calculation formula;

   (f) Following the Commentary example using the schedule method calculation formula.

4. Taxpayers will not be able to switch from the schedule method to the formula method.

Using the formula method

5. A person can choose to use the formula method given by s. CF 3(13) if:

   (a) The scheme is a *foreign defined contribution scheme* (which means a foreign superannuation scheme that allocates contributions to the scheme on a defined basis to individual members); and

   (b) The person has the information required for the application of the formula method; and

   (c) The person derives no withdrawal, other than a pension or annuity, from the scheme before 1 April 2014; and

   (d) The person has not used the schedule method for the interest in the scheme; and

(e) For a person who acquires the interest in the scheme from a deceased spouse or under a relationship agreement, the other person did not use the schedule method for the interest in the scheme; and

(f) The person chooses to use the formula method for the interest in the scheme.

6. It is stated on page 13 of the *Commentary* that:

“This method will tax actual investment gains derived while a person is a New Zealand resident (after the end of their exemption period). It was introduced following submissions on the issues paper.

To use this approach, a person is required to obtain the market value of the foreign superannuation interest at the time the exemption period ends, as well as information about contributions made and other necessary information. Requirements relating to the quality of information will apply.”

Recognised contributions

7. The value of a payment to the scheme is taken into account as a *recognised contribution* if the payment:

(a) Is made when the person is a New Zealand resident who is treated as a New Zealand resident under all applicable double tax agreements; and

(b) Is made by the person, by the person's employer, or for the benefit of the person; and

(c) Is required by the rules of the scheme; and

(d) Is subject to employer superannuation contribution tax or fringe benefit tax if made by the person's employer.

Calculating the assessable withdrawal amount using the formula method

8. The *assessable withdrawal amount* is calculated using the formula:

$$\textbf{gain x (grow rate - 1) x tax rate x (assessable years - 1) + gain}$$

9. *Let’s follow the Example on page 15 of the Commentary*: Thomas migrates to New Zealand with a foreign superannuation scheme worth NZ$100,000. Ten years after Thomas’ assessable period begins, his scheme is worth $180,000 and he withdraws a lump-sum amount of $60,000. Five years after this, his scheme is worth $150,000 and he withdraws the full amount. Thomas has made no contributions to the scheme while he has been New Zealand-resident.

10. *Gain* is the amount of the *distributed gain*, which under s. CF 3(9) is the part of a foreign superannuation withdrawal that is treated as consisting of gains made by the scheme during the assessable period, and is calculated as:

$$\textbf{(super withdrawal x calculated gains fraction) - other gains}$$

(a) *Super withdrawal* is the amount of the foreign superannuation withdrawal: Thomas’ first withdrawal 10 years after his assessable period begins is $60,000; Thomas’ second withdrawal 15 years after his assessable period begins is $150,000;

(b) *Calculated gains fraction* is the greater of zero and the amount calculated as:

$$\frac{\textbf{predistribution + withdrawals - value - contributions}}{\textbf{predistribution}}$$

(i) *Predistribution* is the value of the person's interest in the scheme immediately before they made their foreign superannuation withdrawal: for Thomas' first withdrawal, the predistribution is $180,000; for Thomas' second withdrawal, the predistribution is $150,000;

(ii) *Withdrawals* is the total amount of previous foreign superannuation withdrawals made in the assessable period: for Thomas' first withdrawal, "withdrawals" is zero; for Thomas' second withdrawal, "withdrawals" is $60,000;

(iii) *Value* is the value of the person's interest in the scheme at the beginning of the assessable period: for Thomas, this is $100,000, being the value of his interest when he migrated to New Zealand.

(iv) *Contributions* is the amount of recognised contributions to the interest in the scheme made before the distribution time: for Thomas, this is zero, as he has not made any recognised contributions;

(v) For Thomas' first withdrawal, his "calculated gains fraction" under section CF 3(11) is:

$$\frac{\$180{,}000 + \$0 - \$100{,}000 - \$0}{\$180{,}000} = \frac{4}{9}$$

(vi) For Thomas' second withdrawal, his "calculated gains fraction" under section CF 3(11) is:

$$\frac{\$150{,}000 + \$60{,}000 - \$100{,}000 - \$0}{\$150{,}000} = \frac{11}{15}$$

(c) *Other gains* is the total distributed gains previously calculated under this formula for previous withdrawals in the assessable period: For Thomas' first withdrawal, "other gains" is zero, as he has not distributed gains previously calculated. For Thomas' second withdrawal, "other gains" are $26,667, calculated as below.

(d) For Thomas' first withdrawal, his "distributed gain" or *gain* is:

$$\left(\$60{,}000 \times \frac{4}{9}\right) - \$0 = \$26{,}667$$

(e) For Thomas' second withdrawal, his "distributed gain" or *gain* is:

$$\left(\$150{,}000 \times \frac{11}{15}\right) - \$26{,}667 = \$83{,}333$$

11. Interest will be charged on the amount of taxable New Zealand gains to account for the deferral benefit that the person obtains by not paying tax on accrual (similar to the use-of-money interest rules). The interest will be payable at the same rate as the average growth of the person's superannuation interest over the number of years of residence. The interest component is given by:

$$\textbf{gain} \times (\textbf{grow rate} - 1) \times \textbf{tax rate} \times (\textbf{assessable years} - 1)$$

(a) Grow rate is:

$$\left(\frac{\textbf{accrued total}}{\textbf{value}}\right)^{\frac{1}{\textbf{assessable years}}}$$

(b) *Accrued total* is the value of the interest in the scheme immediately before the distribution time, *increased by* the value of distributions from the interest in the scheme before the distribution time, and *reduced by* the value of recognised contributions made to the scheme in an assessable period before the distribution time.

(c) *Assessable years* is the greater of 1 and the number of tax years beginning in an assessable period and before the distribution time.

(d) *Tax rate* is the tax rate referred to in Schedule 6, Part A, Table 1, Row 1. This is currently 28% (note: this is different from the rate originally proposed of 33%).

12. Thomas' grow rates for the first and second withdrawals are calculated as follows:

(a) For Thomas' first withdrawal, the accrued total is:

$$\textbf{Predistribution value + earlier distributions - contributions} = \$180{,}000 + 0 - 0 = \$180{,}000$$

(b) For Thomas' second withdrawal, the accrued total is:

$$\$150{,}000 + \$60{,}000 - 0 = \$210{,}000$$

(c) Value is $100,000 for both the first and the second withdrawal.

(d) The assessable period is 10 for the first withdrawal and 15 for the second withdrawal.

(e) For the first withdrawal:

$$\textbf{grow rate} = \left(\frac{180{,}000}{100{,}000}\right)^{\frac{1}{10}} = 1.0605$$

(f) For the second withdrawal:

$$\textbf{grow rate} = \left(\frac{210{,}000}{100{,}000}\right)^{\frac{1}{15}} = 1.0507$$

13. Thomas' assessable withdrawal amount for each of the first and second withdrawals is calculated as follows:

    (a) For Thomas' first withdrawal, the assessable withdrawal amount under the formula method is:

$$\textbf{gain} \times (\textbf{grow rate} - 1) \times \textbf{tax rate} \times (\textbf{assessable years} - 1) + \textbf{gain}$$

$$= \$26{,}667 \times (1.0605 - 1) \times 0.28 \times (10 - 1) + \$26{,}667 = \$30{,}732.65$$

    (b) For Thomas' second withdrawal, the assessable withdrawal amount under the formula method is:

$$= \$83{,}333 \times (1.0507 - 1) \times 0.28 \times (15 - 1) + \$83{,}333 = \$99{,}894.93$$

Using the schedule method

14. The schedule method is the default method for taxing foreign superannuation withdrawals, and must be used to calculate a person's assessable withdrawal amount if:

    (a) The person cannot use the formula method; or

    (b) The person chooses not to use the formula method.

15. The schedule method deems a certain amount of the lump-sum receipt to be investment gains, based on the person's years of residence. The approach uses fractions that represent the proportion of the lump-sum receipt to be included in assessable income. The schedule year fractions increase with years of residence. The remainder of the lump-sum receipt is not assessable.

The schedule method calculation formula

16. The assessable withdrawal amount under the schedule method is calculated using the formula:

$$(\textbf{super withdrawal} - \textbf{contributions left}) \times \textbf{schedule year fraction}$$

Super withdrawal: Is the amount of the foreign superannuation withdrawal;

Contributions left: Is the lesser of:

(a) The amount of the super withdrawal; and

(b) The total **recognised contributions** under s. CF 3(16) – see paragraph 7 above - made in the assessable period before the distribution time, reduced, for each earlier foreign superannuation withdrawal, *other than a pension or an annuity*, made in the assessable period before the distribution time, by the lesser of:

    (i) The amount of the earlier withdrawal; and

    (ii) The value of the item contributions left, immediately before the time of the earlier withdrawal.

Schedule year fraction: Is the fraction given in schedule 33, column 2 of the row for which the entry in column 1 corresponds to the greater of 1 and the number of income years beginning:

(a) In the *assessable period* for the person under s. CF 3(5B); and

(b) Before the *distribution time*.

17. The "contributions left" item in the formula must meet the requirements as set out in paragraph 7 above. It is noted on page 13 of the *Commentary* that:

    "The contributions that are able to be deducted are restricted in this manner because the schedule rates already include an implicit allowance for contributions. For example, for the year one schedule rate, 4.76% of the withdrawal is treated as taxable New Zealand-sourced gains and the remainder is treated as non-taxable amounts (that is, contributions as well as gains derived while non-resident)."

18. With respect to the schedule year fraction, it is stated on page 10 of the *Commentary* that:

    "The fractions in proposed schedule 33 are set at the rate necessary to put a person who leaves their foreign superannuation overseas in the same position as if they had instead transferred their superannuation to New Zealand and paid tax on investment gains as they accrued. Given the assumptions (including a 5% post-tax interest rate in the foreign scheme), a person should conceptually be indifferent between keeping their superannuation overseas and transferring it to New Zealand. Further discussion of the policy rationale behind the schedule method can be found in the annex to the issues paper. …

    The appropriate "schedule year fraction" to use is identified by calculating the number of income years beginning in the assessable period, before the person receives the lump sum. In short, *this is the number of income years which begin after the person is a New Zealand resident and after their four-year "exemption period" ends*. The effect of counting a person's years of residence from the end of the exemption period is to treat them as being non-resident during the exemption period. Gains which accrue during those four years will not be clawed back and taxed on receipt." (emphasis added)

19. For example:

    (a) If Lucy's assessable period begins on 1 August 2020, and she withdraws a lump sum on 27 January 2024, there are *three income years* that begin in Lucy's assessable period, the first one starting from 1 April 2021 so Lucy is required to use the schedule year fraction for year three.

    (b) If the withdrawal is made in the first part year after the person's exemption has ended, so that the number of income years beginning in the person's assessable period is zero, the person should use the schedule year fraction associated with year one. For example, if Karen's assessable period begins on 1 October 2020, and she withdraws a lump sum of on 5 February 2021, Karen is required to use the schedule year fraction for year one because the withdrawal was made between 1 October 2020 and 31 March 2022.

20. Proposed new schedule 33 provides the full schedule of rates per year of residence.

Following the Commentary example using the schedule method calculation formula

21. Let's again follow the Example on page 15 of the Commentary as set out in paragraph 9 above:
    (a) For Thomas' first withdrawal, the schedule year fraction for year 10 is 44.39%. Therefore, Thomas' assessable withdrawal amount under the schedule method will be $26,634. This compares with $30,732.65 under the formula method, as calculated in paragraph 13 above.
    (b) For Thomas' second withdrawal, the schedule year fraction for year 15 is 64.08%. Therefore, Thomas' assessable withdrawal amount under the schedule method will be $96,120. This compares with $99,894.93 under the formula method, as calculated in paragraph 13 above.
22. In this case, the schedule method provides better answers for both withdrawals. A comparison between methods will need to be made for the first withdrawal. Remember that taxpayers will not be able to switch from the schedule method to the formula method.

Detailed PDF attachment on the new rules

23. The PDF attachment *Withdrawals From Foreign Superannuation Schemes* contains all of the details.

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