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WEEKLY COMMENT: FRIDAY 5 SEPTEMBER 2014

1. This week I commence looking at the Foreign Investment Fund ("FIF") taxation regime. There have been a number of changes to the taxation of FIFs in recent years and the sequential and piecemeal nature of the changes has meant that it can be difficult to understand the way in which FIFs are taxed in any particular income year. The recent changes to the taxation of FIFs are contained mainly in:

   (a) The *Taxation (International Investment and Remedial Matters) Act 2012*;

   (b) The *Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2014*; and

   (c) The *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014* (the latest amendments affect only the Australian resident FIFs exemption – see paragraph 18 below).

2. A few additional remedial changes are contained in the *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012* and the *Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013*.

Introduction

3. Taxation under the general tax rules can be broadly contrasted with taxation under the FIF tax regime as follows:

   (a) A New Zealand resident who holds New Zealand equities:

      (i) Will be taxed on dividends received (with credits for any imputation credits ("ICs") attached or resident withholding tax ("RWT") deducted).

      (ii) Will also be taxed on any gains on sale (and losses may be deductible), if the equities are held on revenue account (generally short-term trading holdings, but longer-term holdings could also be designated as revenue account property).

      (iii) Will not be taxed on gains on sale if the equities are held on capital account (long-term holdings).

   (b) Under the FIF tax regime, dividends from, and gains on sale of, foreign equities are not separately taxed. The income calculated under the FIF regime is the only income that is taxed. (There are a couple of "top-up" income tax exceptions to this general rule.)

4. However, there are two key differences between the taxation of New Zealand equities under the general tax rules and the taxation of foreign equities under the FIF tax regime:

   (a) Taxation under the FIF regime is on an accrual basis, whereas taxation of New Zealand equities is only on a realised basis: unrealised gains that may not eventually be realised could be taxed under the FIF regime; and

   (b) Losses are generally not deductible under the FIF regime (subject to exceptions for losses on fixed rate shares which are deductible and losses calculated under the Attributable FIF Income method which are ring-fenced and can be offset against future gains).

5. Over the next few weeks, I will be looking at:

   (a) Exemptions from the FIF tax regime: there are a number of these. Note that 'exemption' in this context means 'exemption from the FIF tax regime'. It does not mean 'exemption from NZ tax'. The general NZ tax rules (that apply to NZ equities) will apply to equities that are exempt from the FIF tax regime.

   (b) The 'transitional resident' exemption that applies to new migrants and the impact of FIF taxation.

   (c) The new rules for taxation of foreign dividends.

   (d) Entry and exit from the FIF tax regime: there are rules on becoming subject to tax under the FIF regime and on ceasing to be taxed under the FIF regime.

   (e) The choice of the calculation method: there are specified limitations that govern the choice of method, and the tax consequences of the methods can be different. I will also look at the consequences of changing methods.

   (f) The application of the FIF tax rules to rights to benefit from a foreign superannuation scheme or a foreign life insurance policy. From 1 April 2014 foreign superannuation interests are generally not taxed under the FIF regime unless they were acquired while a New Zealand tax resident.

   (g) The relationship between the FIF tax rules and the general rules and some advantages and disadvantages of holding equities that are taxed under the FIF tax regime compared to equities that are taxed under the general rules.

   (h) Some compliance aspects, such as the disclosure exemptions and the disclosure forms that must be completed (some of which must be completed on-line).

6. The main focus will be on the major new changes to the FIF tax rules that apply to income years beginning on or after 1 July 2011 contained in the *Taxation (International Investment and Remedial Matters) Act 2012* and the subsequent remedial changes affecting these rules. For standard balance date (31 March) taxpayers, these new rules have applied from the 2012-13 income year. The removal of interests in foreign superannuation schemes from the FIF tax regime (for most taxpayers) will also be reviewed.

Investments that are taxed under the FIF regime

7. There is a distinction between "a FIF" and "an attributing interest in a FIF". It is an *attributing interest in a FIF* which has a tax implication. An attributing interest in a FIF, under s. EX 29, is rights in any of the following categories held by a person (providing that none of the FIF exemptions apply):

<u>Category 1:</u> A direct income interest in a foreign company (which means a direct holding by the person of shares, shareholder decision-making rights, or the right to receive income or net assets, all of which are calculated under the rules in s. EX 30).

<u>Category 2:</u> An interest in a foreign superannuation scheme divided as follows:

a) Up to 31 March 2014, rights to benefit from a foreign superannuation scheme as a beneficiary or member; and

b) From 1 April 2014, a "FIF superannuation interest" held as a beneficiary or member (meaning an interest in a foreign superannuation scheme acquired, other than as matrimonial property or under a will, while a NZ tax resident, or a foreign superannuation interest that has been treated as a FIF in the past and continues to treated as a FIF for tax purposes).

<u>Category 3:</u> Rights to benefit from a foreign life insurance policy in relation to which a FIF is the insurer (i.e. the insurer is a foreign company, a foreign superannuation scheme or an insurer under a life insurance policy that is not offered or entered into in NZ).

8. These investments are taxed under the FIF tax regime even if they are held through a controlled foreign company ("CFC").

Exemptions from the FIF tax regime

9. There are a number of exemptions from the FIF tax rules. As previously noted, these are not exemptions from New Zealand tax. Investments that are exempt from the FIF rules will be taxed under general income tax rules: dividends will be taxable and realised gains will also be taxable if the investments are held on revenue account.

10. There are no disclosure requirements for exempt FIF interests.

(a) $50,000 minimum threshold for natural persons

11. A natural person will not be taxed under the FIF tax regime in an income year, under s. CQ 5(1)(d), if:

(a) At all of the time during the income year that the person is a NZ tax resident, the total cost, calculated under the FIF cost measurement rules in s. EX 68, of all their attributing interests in FIFs, is not more than $50,000; and

(b) The person does not elect to calculate and return FIF income or loss from an attributing interest in a FIF in the income year (this ability to elect applies to income years beginning on or after 1 July 2011); and

(c) The person has not elected, in a tax return for one of the preceding 4 years (beginning on or after 1 July 2011), to return FIF income when at all times during that year while the person was a NZ tax resident, the total cost of their attributing interest in FIFs was not more than $50,000.

12. The following points are worth noting:

(a) The $50,000 is a threshold rather than an exemption: if the total cost of attributing interests in FIFs exceeds $50,000, all the attributing interests in FIFs will be subject to tax under the FIF rules, and not just the excess costing more than $50,000.

(b) The $50,000 threshold applies at all times in the year that the person is a NZ tax resident: this means that if the cost of attributing interests in FIFs at any time in the year the person is tax resident in NZ exceeds $50,000, the exemption will not apply.

(c) The $50,000 minimum threshold takes into account brokerage fees if these form part of the cost of acquiring any shares.

(d) The $50,000 minimum threshold includes the cost of an attributing interest that is a life insurance policy, and an attributing interest in foreign superannuation scheme first acquired while a NZ tax resident (a "FIF superannuation interest"). An interest in a superannuation scheme that was treated as an attributing interest in a tax return filed before 20 May 2013 is also a FIF superannuation interest, but the use of the $50,000 exemption would result in the interest in that superannuation scheme ceasing to be an attributing interest and, therefore, subject to the new superannuation withdrawal tax. FIFs that are foreign superannuation entitlements and life insurance will be covered in coming weeks, but refer also to Weekly Comment 10 January 2014.

(e) Deemed disposals or acquisitions under the FIF rules can be ignored when determining whether the $50,000 threshold is breached.

(f) It is possible for a married couple or a couple in a de facto relationship or civil union to qualify for a total $100,000 threshold by halving investments jointly owned.

(g) A special rule applies to determining the cost of investments acquired before 1 January 2000: the market value of such investments at 1 April 2007 may be halved and treated as the cost of such investments.

13. The cost of the investments is measured, under s. EX 68, as follows:

(a) If the cost of investments cannot be specifically identified, cost is measured in a first-in-first-out (FIFO) basis.

(b) If the interest is acquired as the result of a share split, non-taxable bonus issue, or similar, and the acquisition is not income for the person, the cost of the interest is a fair allocation, based on the market value at the time of the split, of the cost of the original property that is split.

(c) Costs incurred in kind are measured at market value at the time incurred.

(d) Excluded from costs is expenditure on financial arrangements, interest on money borrowed, and other holding costs.

(e) If the interest is a right to benefit from a life insurance policy, the cost does not include premiums paid for life cover in earlier years that do not increase the policy's surrender value.

(f) NZ shareholders in GPG who acquired their interests before 1 January 2005 can choose to treat the market value at the beginning of the 2013-13 income year as the cost.

(b) Limited $50,000 minimum threshold for particular trusts

14. The $50,000 threshold, subject to the same rules and limitations as set out above, applies, under s. CQ 5(1)(e), to the following small range of trusts:

(a) The trust of the estate of a deceased person: the threshold applies for the first 5 years after the person's death.

(b) A trust where a court orders the settlor to pay damages or compensation to the beneficiary, and

(i) The settlor is a relative or guardian of the beneficiary; or

(ii) The settlor is the estate of a deceased person.

(c) A trust of which the settlor is the ACC.

15. Family trusts do not fall within this limited range and therefore do not get the benefit of the $50,000 minimum threshold.

(c) Australian exemptions

16. There is an exemption, under s. EX 31, for shares in Australian resident listed companies. The following points are worth noting:

(a) The exemption only applies if the Australian resident company is required to have a franking account under Australian tax law.

(b) Australian unit trusts therefore do not qualify for this exemption because they are not required to have a franking account.

(c) Inland Revenue publishes a list annually of Australian companies to which the exemption will apply. The list is not exhaustive and investors are not required to rely on the list. The link to the list (to copy and paste into your browser) is set out below:

http://www.ird.govt.nz/resources/8/9/8966ad76-5565-48d2-a3bf-cc49940f0723/ir871-2014.pdf

17. There is an exemption, under s. EX 32, for units in an Australian tax resident unit trust, provided that there is an RWT proxy in relation to payments from the unit trust (a NZ entity that administers payments and deducts RWT) and the unit trust meets either of the following tests:

(a) A 25% minimum share turnover test, under which total net realised gains for the year must be at least 25% of total net unrealised gains at year-end (calculated only on profitable shares); or

(b) A 70% minimum distribution test, under which total distributions for the year must be at least 70% of total distributable gains for the year.

18. There is a new exemption, under s. EX 35, that applies to income years commencing on or after 1 July 2011 for Australian resident FIFs generally (i.e. listed and unlisted Australian companies), if the income interest held is at least 10%. The following points are worth noting:

(a) The FIF must be resident in Australia and subject to Australian tax; this potentially includes Australian superannuation schemes and life insurance companies, providing the income interest held by the NZ investor is at least 10%.

(b) The exemption will not be available to FIF investors that are PIEs, superannuation schemes, unit trusts, life insurers or group investment funds.

(c) Under and amendment in s. 93 of th*e Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014*, for income years beginning on or after 1 July 2014, this exemption will not apply to Australian unit trusts unless the unit trust is subject to tax in Australia on its income in the same way as a company.

(d) Under amendments to s. EX 50(6) and (7) and s. EX 58 in s. 95 and s. 97 of the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014*, applying to the 2014-15 and later income years, the exemption will not be available for an indirect attributing interest in an Australian resident FIF if that indirect interest is less than 10%, even if the direct interest in the CFC or upper level FIF is 10% or more.

19. There is an exemption that applies to rights to Australian regulated superannuation savings, which will be covered when foreign superannuation entitlements and life insurance is covered in coming weeks.

(d) Exemptions for venture capital investments

20. There is an exemption, under s. EX 36, for venture capital investments in New Zealand resident start-up companies that migrate offshore (for example, to gain access to additional equity financing).

21. The following points are worth noting:

(a) The company must migrate to a grey list country (as listed in Schedule 24 Part A): Australia, Canada, Germany, Japan, Norway, Spain, the UK or the US.

(b) The investor must have acquired the shares before the company migrated and before the shares were listed.

(c) The foreign (grey list) company must have a fixed establishment in New Zealand which has at least $1 million of expenditure each year or 10 full-time employees or contractors providing services.

(d) Before migrating the company should have been tax resident in New Zealand for a minimum of 12 months and had the majority of its assets and employees in New Zealand for at least a year.

(e) The exemption lasts for 10 years from the income year in which the company migrates.

(f) The shares would enter the FIF rules at market value at the end of the ten-year exemption period.

22. The exemption also applies, under s. EX 37, to shares in a grey list company that owns more than 50% of a New Zealand company that meets the above criteria. This is meant to cater for situations where shares in a grey-list company are received in exchange for shares in a New Zealand resident company. The 10-year exemption starts from the income year in which the grey list company acquires a majority of the shares of the New Zealand resident company.

23. There is an exemption, under s. EX 37B, for shares in a grey list company acquired under a venture investment agreement, at the same time and on the same terms as an acquisition of an interest in the same FIF by the Venture Investment Fund or a company owned by the Venture Investment Fund.

(e) Exemption for employee share purchase scheme of a grey list company

24. There is a limited exemption from the FIF rules, under s. EX 38, for individuals who owned shares in a foreign company acquired through an employee share purchase scheme. The following points are worth noting:

(a) The foreign company must be resident and subject to tax in a grey list country (listed in Schedule 24 Part A) and either be the employer or own the New Zealand resident employer of the employee.

(b) The shares must be acquired through a share purchase agreement, which is an agreement to sell or issue shares to an employee entered into in connection with the employee's employment.

(c) The share purchase agreement must include a restriction on the disposal of the shares, which had not expired at the beginning of the year or had expired for less than 6 months at the beginning of the year.

(d) Employees have a minimum period of 6 months from the date restrictions are lifted to dispose of their shares before the FIF rules apply to the shares.

(f) Exemption for FIFs affected by foreign exchange restrictions

25. Under s. EX 40, a natural person's rights in a FIF are not an attributing interest if, and to the extent to which:

    (a) The rights were acquired before becoming a NZ resident or before exchange controls were imposed by the relevant foreign country or before 2 July 1992; and

    (b) The exchange controls prevent the person from deriving amounts from the rights or from disposal of the rights in NZ dollars or consideration readily convertible into NZ dollars.

(g) CFC exemption

26. Under s. EX 34, a person's rights in a FIF are exempt from the FIF regime if:

    (a) The FIF is a CFC at the time; and

    (b) The person has an income interest of 10% or more in the CFC.

27. This exemption does not apply to a PIE in income years beginning on or after 1 July 2011.

(h) Terminated grey list company exemptions

28. The previous exemption for a FIF interest that is a direct income interest of at least 10% in a grey list company has been abolished. The last income year it applied to was the income year that started on or before 30 June 2011. Non-portfolio investments in the grey list companies are subject to the FIF tax regime in income years beginning on 1 July 2011 onwards (providing another exemption does not apply).

29. Another previous exemption for New Zealand shareholders in GPG expired with effect from the 2011–12 income year which essentially caters for New Zealand shareholders in GPG.

(i) Foreign Superannuation entitlement and foreign pension or annuity exemptions

30. These exemptions will be discussed in coming weeks when looking at Foreign Superannuation Entitlements and Life Insurance Policies generally.

(j) Transitional resident exemption

31. A person who is a transitional resident at all times in the year will not have FIF income in the income year. A person is a transitional resident if:

    (a) The person becomes tax resident in New Zealand (under the tax residence tests); and

(b) For a continuous period of at least 10 years before that the person was a non-resident; and

(c) The person was not a transitional resident in NZ before the period of non-residence.

32. A natural person who meets the requirements to be a transitional resident, and does not elect not to be a transitional resident (it is possible to choose not to be a transitional resident) is treated as a transitional resident for 4 years commencing from the first full month of New Zealand tax residence.

33. A person who is a transitional resident for part of the year will have an exemption from the FIF tax regime for the years, and any part of a year, during which the person is a transitional resident:

(a) A specific exemption in s. EX 41 for attributing interests in Categories 2 and 3 now essentially applies only to an interest in a foreign life insurance policy, because a transitional resident's interest in a foreign superannuation scheme cannot be a "FIF superannuation interest"; and

(b) A general exemption in s. HR 8(1) and s. CW 27 for income that is a foreign-sourced amount will cover attributing interests in Category 1 – i.e. direct income interests in foreign companies.

34. When a transitional resident holds a FIF interest at the time of ceasing to be a transitional resident and becoming a New Zealand tax resident, the person is generally treated as having bought the FIF interest at market value at the time immediately after the change of residence status, and is treated as not holding the FIF interest while a transitional resident. If the transitional resident chooses to use the Attributable FIF Income method (see paragraph 35 below) for the FIF interest, the transitional resident's income interest while a transitional resident is treated as zero for the purposes of the AFI calculation.

(k) Active income exemption for income years beginning on or after 1 July 2011

35. For income years beginning on or after 1 July 2011, the Attributable FIF Income (AFI) method in s. EX 50 can be used in order to access the active income exemption. The rules for the AFI method are based on the controlled foreign company (CFC) rules with a number of modifications. The AFI method and the active income exemption will be covered in coming weeks when the FIF calculation methods are covered.

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