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WEEKLY COMMENT: FRIDAY 19 SEPTEMBER 2014

1. This week I continue looking at the Foreign Investment Fund ("FIF") taxation regime by taking a brief look at the available FIF calculation methods, leading up to a more detailed discussion of the choice between methods next week. It is worth briefly summarising the key aspects of each of the calculation methods it, because they can result in different amounts of FIF income being returned. This makes the choice of method relevant.

2. The currency conversion rules are the same for all methods for which market values or income or expenditure amounts are required to be determined. Section EX 57 provides that each amount must be converted into NZ$ at the exchange rate that applies on the day of the relevant event, or all foreign currency amounts must be translated at the average of the close of trading spot exchange rates applying on the 15th of each month in the income year.

3. Prior to the enactment of the *Taxation (International Investment and Remedial Matters) Act 2012*, there were six calculation methods. Following enactment, two of the previously available methods cannot be used for income years beginning on or after 1 July 2011, and a new method, the Attributable FIF Income ("AFI") method is available for income years beginning on or after 1 July 2011, if the requirements for use are met. The use of the AFI method for indirectly held FIFs has been clarified/restricted by amendments in the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014* effective from the 2014-15 income year.

4. The methods available for income years beginning on or before 30 June 2011 are:

   (a) The Accounting Profits (AP) method (repealed for years starting after 30 June 2011).

   (b) The Branch Equivalent (BE) method (repealed and substituted for years starting after 30 June 2011).

   (c) The Fair Dividend Rate (FDR) method.

   (d) The Cost method.

   (e) The Comparative Value (CV) method.

   (f) The Deemed Rate of Return (DRR) method.

Repealed methods

5. The **Accounting Profits ("AP") method** is not available for use in income years commencing on or after 1 July 2011. The method is based on the accounting profits of the FIF reduced by any tax for which the person is personally liable and has paid during the year. The proportion of the accounting profit returned as FIF income is based on the person's income

interest. The use of this method can result in a FIF loss, which can be deducted against other income.

6. The **Branch Equivalent ("BE") method** is based on the CFC income calculations before the CFC rules changed on 1 April 2007. This method is also not available for income years commencing on or after 1 July 2011. The use of this method can also result in a FIF loss, but the loss cannot be used against other income. The loss is ring-fenced and can only be used against current or future income calculated under the BE method from FIFs from the same jurisdiction. The BE method has been replaced by the Attributable FIF Income ("AFI") method.

Currently available methods

7. The methods available for income years beginning on or after 1 July 2011 are:

   (a) The Fair Dividend Rate (FDR) method.

   (b) The Cost method.

   (c) The Comparative Value (CV) method.

   (d) The Deemed Rate of Return (DRR) method

   (e) The Attributable FIF Income method.

The Fair Dividend Rate (FDR) method

8. The FDR method is the default method for income years commencing on or after 1 July 2011. If a person is unable to use the new Attributable FIF income ("AFI") method or does not want to use the AFI method, the FDR method is the main alternative. The FDR method can be used for an attributing interest in a FIF that is an ordinary share and for which a market value is available.

9. FIF income is calculated under the FDR method at 5% of the opening market value of the FIF interest, plus an adjustment for interests acquired and sold within the same year (referred to as a "quick sale adjustment"). The method is modified for use by unit trusts and other entities that value their units periodically during the year by treating each unit valuation period as if it was a whole year.

10. The FDR method works on a pooled approach, rather than on an investment-by-investment approach, for investments that qualify. Under the FDR method purchases and sales of shares during the year are ignored, except when the shares are bought and sold in the same year and the "quick sale adjustment" applies. Inland Revenue has stated that market value information is not restricted to listed share prices. Other information that is verifiable and could be used includes published unit prices for redemptions and the net asset values at which units can be redeemed. However, exit values that incorporate a penalty for early withdrawal or redemption would not be acceptable.

11. Individual investors and family trusts may pool their interests in foreign companies and switch freely between the FDR and CV methods between income years, but not within the same income year. (An interest in a foreign superannuation scheme or a foreign life insurance policy is treated separately unless it is an interest in a company.)

12. It should be noted that for income years beginning on or before 30 June 2011, the FDR method could only be used for portfolio interests (i.e. direct FIF income interests, including

associates, of less than 10%), or for a foreign PIE equivalent held by a PIE or a life insurance company.

13. Four other points worthy of note are:

    (a) If the FDR method is used, it must be used for all interests that qualify for the use of the method. If, for example, the CV method is used for any attributing interests for which the FDR method could be used, the FDR method cannot be used in that year.

    (b) The use of the FDR method will not result in FIF losses.

    (c) The FDR method cannot be used for an attributing interest in a FIF that is a non-ordinary share as described in paragraph 25 below.

    (d) If a person cannot obtain a market value for an interest that is an ordinary share, the cost method is the next alternative.

The Cost method

14. The Cost method is the second choice default method for income years commencing on or after 1 July 2011. The method works on a similar basis to the FDR method: FIF income is calculated at 5% on the opening value of the FIF interest, plus a 'quick sale adjustment' for interests acquired and sold within the same year.

15. The differences between the Cost method and the FDR method are that:

    (a) The Cost method is applied on an interest-by-interest basis, rather than on a pooled basis; and

    (b) The opening value in the Cost method is calculated based on a 5% increment on the preceding year's opening value (an adjustment for the deemed FIF income for the previous year).

16. No tax is payable in the year in which the investment is acquired, as there would be no cost base at the start of the year. The cost base for each subsequent year (the "opening value") is adjusted by any sales and purchases in the previous year and increased by the FIF income for the previous year (5% of the "opening value" in the previous year), to account for the investment growth. Dividends are not subtracted from the opening value in the following year.

17. The main example of an interest for which the Cost method is allowed to be used would be a share in a foreign company that is not listed and for which it is not practical to apply the FDR method because opening market value cannot be determined except by an independent valuation.

18. Points worthy of note are:

    (a) In order to use the Cost method, the FIF interest must be an ordinary share and the person must not be able to obtain a market value except by independent valuation.

    (b) The use of the Cost method will not result in FIF losses.

The Comparative Value (CV) method

19. The CV method is an important method. It is the method that must be used for "non-ordinary shares" in a foreign company (see paragraph 25 below) if a market value can be obtained.

20. The CV method is also available by choice to individuals and trustees of a trust for the benefit of a loved one or charity (generally, family trusts) if, for example, the FDR method results in an unacceptably high level of deemed income. If the CV method is chosen for any FIF interests, the FDR method or cost method cannot be used for any other FIF interests. This implies that the CV method or AFI method must be able to be used for all attributing interests if the CV method is chosen.

21. The CV method is based on comparing the closing market value of the FIF interest plus all amounts derived in the year to the opening market value and all expenditure incurred during the year. The method captures the total return during the year, including capital gains and losses on sales and all dividend income. When the CV method is used for ordinary shares, the gains or losses on all of those shares are combined to produce an overall gain or loss for the year.

22. The main use of the CV method will be in circumstances where individuals and family trusts incur realised and/or unrealised losses. In such circumstances the CV method can result in there being no FIF income.

23. The CV method contains a "reduction of losses to zero" rule under which any loss that is calculated is ignored, unless the shares in question are "non-ordinary shares":

    (a) For income years commencing on or after 1 July 2011, the reduction of losses to zero rule applies across the board to all FIF holdings of ordinary shares.

    (b) For income years that commenced on or before 30 June 2011, the reduction of losses to zero rule did not apply to FIF holdings if the FIF was a foreign company and the direct income interest was at least 10% at all times in the year.

    (c) Before the 2009-10 income year, the reduction of losses to zero rule did not apply if the FIF holding was a foreign superannuation or life insurance interest.

24. The CV method must be used for non-ordinary shares. These are the only type of investments that, through using the CV method, can give rise to FIF losses that can be deducted against other income in income years commencing on or after 1 July 2011. The DRR method must be used if the CV method cannot be used.

25. There are six types of investments of a "guaranteed return" nature that are classified as non-ordinary shares:

    (a) Fixed-rate investments in foreign companies.

    (b) Non-participating redeemable investments in foreign companies.

    (c) Investments that involve an obligation to return an amount to the investor that exceeds the issue price of the investment.

    (d) Investments in non-resident entities whose assets comprise 80% or more New Zealand dollar denominated debt.

    (e) Investments in a unlisted non-resident company or a listed foreign portfolio investment entity ("PIE") equivalent whose assets comprise 80% or more fixed rate foreign equities or financial arrangements providing funds to a third party.

    (f) Investments that the Commissioner determines are excluded from the FDR method and for which the CV method must, therefore, be used.

26. Points worthy of note are:
    (a) The CV method will not result in losses for any type of FIF other than non-ordinary shares.
    (b) If a market value cannot be obtained for non-ordinary shares, the Deemed Rate of Return ("DRR") method must be used.
    (c) If the DRR method is used for non-ordinary shares, no losses will result.

The Deemed Rate of Return ("DRR") method

27. This method is based on applying a deemed rate for the relevant year to the opening book value of the FIF interest. Increases in the interest are brought to account under this method by treating the opening book value as equal to the closing book value at the end of the previous year after including all increases in the FIF interest in the previous year. The deemed rate is set by Order in Council each year.

28. The deemed rate of return is based on taking an average of the five-year Government stock rate at the end of each quarter, to which a 4% margin is added. For the 2013-14 income year it is 7.99%, up from 6.91% in the 2012-13 income year. The DRR method cannot result in a FIF loss.

29. For income years commencing on or after 1 July 2011, the DRR method is virtually inapplicable. It can only be used for a FIF interest that is a non-ordinary share in a foreign company, and then only if the CV method cannot be used because it is not practical to determine the market value of the FIF interest at the end of the income year.

The Attributed FIF Income (AFI) method

30. The AFI method can be used to calculate FIF income for income years that commence on or after 1 July 2011. The method involves the calculation of the income from the FIF using the net CFC attributable income/(loss) calculation rules. There are a number of modifications to the CFC rules.

31. The use of the AFI method is restricted:
    (a) The method can only be used for interests in FIFs that are companies (and not for foreign superannuation schemes or foreign life insurance policies).
    (b) A primary requirement is that there should be sufficient information available, on request, for review by the Commissioner to support the calculations relating to applying the active business test or the calculation of attributable income.
    (c) Portfolio investment entities ("PIEs") that hold interests in foreign companies cannot use the AFI method.
    (d) Subject to the specific exception discussed in paragraph 32 below, a person must hold a 10% or greater income interest in a foreign company to use the AFI method, but this can be held indirectly through a CFC or through another FIF for which the AFI method is used.

32. A person with less than a 10% interest in a foreign company may nevertheless be able to use the AFI method if:

    (a) The foreign company is a CFC and a market value for the shares in the CFC is not available except by independent valuation (note that a person – including associates - with a less than 10% interest uses the FIF rules even if the company is a CFC); and

    (b) Neither the person nor any person with an interest of 10% or more in the CFC is a listed company, group investment fund, superannuation fund, unit trust, PIE, or a trustee of a trust with a beneficiary who is one of the previously mentioned persons.

33. Note that the rules that apply to indirectly held interests in FIFs have been clarified in the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014* with effect from the 2014-15 income year:

    (a) The pre-existing rules determined indirect interests in a way that could allow an indirect interest of less than 10% to be treated as if it was 10% or more (if the interest in the higher level FIF or CFC exceeded 10%);

    (b) From the 2014-15 income year onwards, amendments to s. EX 50 and EX 58 will mean that the attributing interest from an indirect holding will be determined as if it was held directly.

34. The use of the AFI method can result in an exemption from the FIF rules under the active income exemption in the CFC rules. In order for the exemption to apply, the FIF must pass one of the two active income tests – the default tax method under which attributable income is less than 5% of total gross income, or the accounting profits test under which reported passive income is less than 5% of reported gross income.

35. The AFI method can also be useful for investments in new foreign start-up companies that result in initial losses. The losses will be ring-fenced and may only be used against future income, calculated using the AFI method, from FIFs from the same jurisdiction.

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