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NZ Taxation of Foreign Investment Funds (FIFs)

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I Introduction

1. New Zealand residents who invest in foreign equities are likely to find that the Foreign Investment Fund ("FIF") tax regime applies to them.

2. New Zealand residents are taxable on their worldwide income. The fact that they are taxable on income from foreign equities, therefore, should be no surprise. What is likely to come as a surprise (and, possibly, a shock) is:
   - The extreme complexity of the regime; and
   - The choices available with, sometimes, quite significantly different tax consequences for the same foreign equity holding.

3. The fact that income from foreign equities will be taxed under the FIF regime should not put off potential investors for two good reasons.

4. First, income tax is a tax on income – the higher the income, the higher the tax. If the expected return on foreign equities is going to be higher than the return on NZ equities, foreign investment is a good choice, despite the FIF taxation.

5. Second, let's put the FIF tax regime in context:

   (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.)

6. 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).

II Topics to be covered

7. The main features that I wish to explore are as follows:

   (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.The new rules for taxation of foreign dividends.

   (c) 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.

   (d) 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. We will also look at the consequences of changing methods.

   (e) 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.

   (f) 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.

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

8. 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.

9. More detailed compliance aspects, such as the calculation worksheets are beyond the scope of this paper and will not be covered.

10. These investments are taxed under the FIF rules even if they are held through a controlled foreign company (CFC).

III Investments taxed under the FIF rules

11. There is a distinction between "a FIF" and "an attributing interest in a FIF". It is only 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):

    Category 1: 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).

    Category 2: 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).

    Category 3: 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).

12. These investments are taxed under the FIF rules even if they are held through a controlled foreign company (CFC).

IV Exemptions from the FIF tax regime

13. 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.

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

$50,000 minimum threshold for natural persons

15. A natural person will not be taxed under the FIF tax regime in an income year 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.

16. 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.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.

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

(c) 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 are covered in paragraph 116 onwards below.

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

(e) 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.

(f) 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.

17. 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. 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.

Limited $50,000 minimum threshold for particular trusts

18. The $50,000 threshold, subject to the same rules and limitations as set out above, applies 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.
19. Family trusts do not fall within this limited range and therefore do not get the benefit of the $50,000 minimum threshold.

Australian exemptions

20. 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
21. 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.

22. There is a new exemption 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) 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.

23. There is an exemption that applies to rights to Australian regulated superannuation savings, which is discussed further in the Foreign Superannuation Entitlements and Life Insurance section of this paper.

Exemptions for venture capital investments

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

25. The following points are worth noting:

    (a) The company must migrate to a grey list country: 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.

26. The exemption also applies 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.

27. There is an exemption 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.

Exemption for employee share purchase scheme of a grey list company

28. There is a limited exemption from the FIF rules 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.

Exemption for FIFs affected by foreign exchange restrictions

29. 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.

CFC exemption

30. 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.

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

Terminated grey list company exemptions

32. 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).

33. 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.

Foreign Superannuation entitlement and foreign pension or annuity exemptions

34. These exemptions are considered in the Foreign Superannuation Entitlements and Life Insurance Policies section of this paper.

Active income exemption for income years beginning on 1 July 2011 onwards

35. For income years beginning on 1 July 2011 onwards, the Attributable FIF Income (AFI) method 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.

36. If the AFI method is used, there will be no FIF income if the FIF passes either of the following active income tests:

    (a) The default test is based on comparing passive income (calculated under modified CFC tax rules) to annual gross income (calculated under modified CFC tax rules). Passive income must be less than 5% of annual gross income.

    (b) If the FIF interest holder uses an applicable accounting standard (as described in the CFC rules) the test is based on comparing reported passive income (calculated under modified CFC tax rules) with reported revenue (calculated under modified CFC tax rules). Reported passive income must be less than 5% of reported revenue.

37. In either case, gross income, or reported revenue cannot be zero. There is no active income exemption available if the FIF's income is zero.

V Transitional resident exemption

38. 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.

39. 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.

40. 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".

    (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.

41. When a transitional resident holds a FIF interest when 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 AFI method 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.

VI FOREIGN DIVIDEND EXEMPTIONS

42. Dividends from FIFs are generally exempt, subject to some specific and complex exceptions.

General exemption for dividends from FIFs

43. The exemption is contained in s. EX 59 and, more specifically, s. CD 36(1), which states that an amount paid by a company to a person is not a dividend if, at the time the person derives the amount the person's interest in the company is an attributing interest (or would have been if the company had not been liquidated) and the person calculates their FIF income or loss in relation to the interest and the period in which the amount is paid using the comparative value ("CV") method, the deemed rate of return ("DRR") method, the fair dividend rate ("FDR") method or the cost method.

44. Section EX 59(2) states that in the above circumstances, the person is treated as not having any income from the interest for the period other than FIF income and, in particular, any dividends derived in the period from the interest and any income gained from disposing of the interest in the period are disregarded.

45. The above general exemption will not apply if the person uses the FDR method and the person's interest is an exempt Australian resident FIF under s. EX 35 at the beginning of the year in which the amount is derived. This is because:

    (a) In order for the general exemption for foreign dividends to apply, the interest must be an attributing interest in a FIF at the time the dividend is derived – i.e. the Australian

resident FIF exemption does not apply at that time because the person's interest in the FIF has dropped below 10%; and

(b) The FDR method is based on the opening market value, which is treated as zero if the person's interest was 10% or more at the beginning of the year because the Australian resident FIF exemption applied at that time; and

(c) If the general exemption applied in that year, the person would have an exempt dividend at the same time as zero FIF income under the FIF rules; and

(d) In the next year, the person would have an opening market value and calculate FIF income using the FDR method, and the general exemption for dividends from FIFs will apply.

46. The general dividend exemption does not apply if the Attributable FIF Income ("AFI") method is used to calculate FIF income. This is because the AFI method can result in the active income exemption, which would mean that no FIF income would be returned.

47. If an individual uses the AFI method and returns FIF income, the person would have to choose to be a BETA person under s OE 1 and s. OE 17 and maintain a branch equivalent tax account ("BETA") in order to avoid double taxation. Under s. OE 20, a credit balance in a BETA resulting from tax paid on FIF income calculated using the AFI method can be used to settle an income tax liability on dividends received from the FIF.

48. If a company uses the AFI method, the above general exemption for foreign dividends will not apply, but the specific company foreign dividends exemption discussed below will apply.

Foreign dividends derived by a NZ resident company

49. Section CW 9(1) states that a dividend from a foreign company is exempt income if derived by a company that is resident in New Zealand.

50. However, there are a series of listed exclusions. The first point to note is that the exclusions will not apply, and a foreign dividend will be exempt if:

(a) The dividend is from a FIF that is a controlled foreign company ("CFC"), the company that derives the dividend has an income interest in the CFC of 10% or more, and the company is not a portfolio investment entity ("PIE") – i.e. if the FIF "CFC exemption" in s. EX 34 applies; or

(b) The Australian resident FIF exemption in s. EX 35 applies and the company that derives the dividend is not a PIE, a superannuation scheme, a unit trust, a life insurer or a group investment fund.

51. A foreign dividend received by a NZ resident company will not be exempt if neither of the above FIF exemptions (in s. EX 34 and EX 35) applies, and one of the following FIF exemptions applies:

(a) The exemption in s. EX 31 for ASX-listed Australian companies;

(b) The exemption in s. EX 32 for Australian unit trusts with adequate turnover or distributions;

(c) The 10-year exemption in s. Ex 36 for an interest in a venture capital company emigrating to grey list country;

(d) The 10-year exemption in s. EX 37 for a grey list company owning a New Zealand venture capital company;

(e) The exemption in s. EX 37B for a share in a grey list company acquired under a venture investment agreement; and

(f) The terminated GPG exemption in s. EX 39 for a grey list company with numerous New Zealand shareholders.

52. The above exemptions were all discussed earlier in Section IV.

53. Certain foreign dividends are always assessable when received by a NZ resident company. These are dividends paid in relation to:

(a) Rights that are a fixed-rate foreign equity; or

(b) Rights to a deductible foreign equity distribution.

54. These are defined terms in s. YA 1, but, broadly speaking, they refer to investments in the foreign company that are akin to debt and provide a fixed rate return to the investor company or the paying company is allowed a tax deduction for the dividends paid to the investor company.

VII General entry and exit rules

55. A person could become subject to the FIF tax regime in a number of ways:

(a) A person could be a transitional resident who becomes a New Zealand resident as explained above.

(b) A person could be a non-resident who becomes a New Zealand resident.

(c) The FIF rules could begin to apply because a FIF exemption ceases to apply (including the $50,000 threshold exemption).

(d) A New Zealand entity in which a person holds rights could migrate and become an FIF.

(e) Certain rights could have become FIF interests when the rules previously changed for income years beginning on 1 April 2007 onwards.

56. The general rule in all these cases is that the person is treated as having disposed of the interest immediately before the FIF rules commence to apply and having re-acquired the interest at market value at the time the FIF rules begin to apply. The person is treated as having received for the sale and paid for the repurchase an amount equal to the interest's market value.

57. Special rules apply if the person uses the AFI method:

(a) If the FIF tax regime begins to apply because the person becomes a NZ resident during an accounting period of the FIF, the FIF income or loss calculated under the AFI method is proportionately reduced, under s. EX 65, by the proportion of days in the FIF's accounting period that the person was a non-resident of NZ; and

(b) If the FIF tax regime begins to apply because an entity emigrated from NZ and became a FIF during an accounting period of the entity, the FIF income or loss calculated under the AFI method is proportionately reduced, under s. EX 66, by the proportion of days in the FIF's accounting period that the entity was not a FIF (and the prorating rule in s. EX 24 for CFCs moving into or out of NZ does not apply).

58. There are concessions that apply if the deemed disposal and re-acquisition gives rise to a tax liability in the case of:

(a) Interests that became FIF interests as a result of the previous rule changes from 1 April 2007 onwards: under s. EX 67, the tax liability can be spread over 3 income years following the year in which the disposal and re-acquisition is treated as having occurred; and

(b) Grey list FIFs inherited before 1 April 2007 for which the cost is zero: under s. EX 67B, the tax liability can be spread over 3 income years following the year in which the disposal and re-acquisition is treated as having occurred, but the gain is the greater of: the gain using the market value at the time of disposition or the gain using the market value at the time of the inheritance.

59. As in the case of entry into the regime, the FIF regime could cease to apply for a number of reasons:

(a) A person could cease to be a NZ resident; or

(b) A FIF exemption begins to apply or the person falls below the $50,000 threshold due to disposing of a FIF interest; or

(c) An entity in which a person holds rights ceases to be a FIF.

60. The general 'sale and reacquisition at market value' rule also applies when a person leaves NZ or ceases to be taxable under the FIF tax regime. The special rules when the AFI method is used also apply as explained above.

VIII The calculation methods

61. 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.

62. A detailed examination of these methods is beyond the scope this paper it, but 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.

63. 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.

64. 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 Deemed Rate of Return (DRR) method.
    (d) The Comparative Value (CV) method.
    (e) The Fair Dividend Rate (FDR) method.
    (f) The Cost method.

Repealed methods

65. The **Accounting Profits ("AP") method** is not available for 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.

66. 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

67. 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

68. 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.

69. 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.

70. 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.

71. 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.)

72. 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

73. 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 85 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

74. 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.

75. 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).

76. 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.

77. 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.

78. 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

79. 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 85 below) if a market value can be obtained.

80. 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.

81. 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.

82. 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.

83. 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.

84. 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.

85. 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.

86. 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.

Deemed rate of return method

87. 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.

88. 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.

89. 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

90. 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.

91. 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 92 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.

92. 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.

93. 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.

94. 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.

95. 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.

IX The choice between methods

96. The choice between methods is important because, as previously noted, different methods yield different results. In addition, the rule changes enacted in the *Taxation (International Investment and Remedial Matters) Act 2012* have had a significant impact on the choice of methods for income years beginning on or after 1 July 2011.

97. The available choices can be grouped into four main areas as follows:

    (a) Individuals and family trusts with a FIF interest that is an ordinary share in a foreign company;

    (b) Non-family trusts and companies with a FIF interest that is an ordinary share in a foreign company;

    (c) Any person with a FIF interest that is a non-ordinary share in a foreign company;

    (d) Any person with a FIF interest that is an entitlement to benefit from a foreign superannuation scheme or a foreign life insurance policy (this will be covered in the next section of this paper).

Individuals and family trusts with a FIF interest that is ordinary shares in a foreign company

98. If the person is a natural person (individual), or a trustee of a family trust, with a FIF interest that is an ordinary share in a foreign company, the choices for income years beginning before, and on or after, 1 July 2011 are as follows:

Individuals or family trusts with ordinary shares	**AP**	**BE**	**AFI**	**FDR**	**COST**	**CV**	**DRR**
Pre-1 July 2011 income years Default methods: For < 10%, FDR if practical, or Cost. For ≥ 10%, AP if allowed, or CV/DRR	✔	✔	✖	✔ Only < 10%	✔ Only < 10%	✔	✔
1 July 2011 onwards income years Default methods: FDR, if it is practical to use it. Cost, if it is not practical to use FDR.	✖	✖	✔	✔	✔	✔	✖

99. For **income years beginning before 1 July 2011**:

    (a) The AP method is the only method that can result in a FIF loss that can be deducted against other income. The shares must meet the requirements to use the method, as well as the accounting requirements:

(i) The shares must be quoted on a stock exchange or widely offered to the public; and

(ii) Audited financial statements prepared under GAAP (or the equivalent) must be readily available.

(b) The BE method can also result in a loss, but the loss is ring-fenced and can only be used against current or future BE income from FIFs in the same jurisdiction. The shares do not have to be listed, or meet the AP method accounting requirements, so the BE method can be useful for “start-up” investments, but information must be available for the Commissioner to check the calculations.

(c) The FDR method can only be used for FIF interests:

(i) Of less than 10% (at some time in the year if the FIF is a grey list company with dividends being taxable under s. CD 36(2), and at all times in the year if the FIF is not a grey list company); and

(ii) If the CV method is not chosen for any FIF interests for which the FDR method could have been used.

(d) The Cost method can only be used be used for FIF interests:

(i) Of less than 10% (at some time in the year if the FIF is a grey list company with dividends being taxable under s. CD 36(2), and at all times in the year if the FIF is not a grey list company); and

(ii) For which the FDR method is allowed (i.e. the CV method has not been chosen in the income year for any FIF interests for which the FDR method could have been used) but it is not practical to use the FDR method because the person cannot determine the market value of the interest at year-end except by independent valuation.

(e) The CV method includes realised and unrealised gains in the calculation of FIF income, so can be useful if the net return from FIFs is below the deemed 5% in the FDR and Cost methods. Individual investors and family trusts can switch freely between the CV and FDR methods on a portfolio basis. (As noted earlier, the portfolio includes shares and units in FIF interests less than 10%, but excludes life policies or superannuation entitlements unless they were issued by companies.)

(f) The DRR method can be used only if the income interest is at least 10%, and:

(i) The individual’s FIF interests don’t exceed $250,000, measured at book value if the DRR method was used the previous year, or otherwise at market value (*this option is not available to family trusts: family trusts cannot use the DRR method by meeting this requirement that FIF interests do not exceed $250,000*); or

(ii) It is not practical for the person to use the AP or CV methods; or

(iii) The person used the DRR method for the FIF interest in the previous year and must continue using it because it remains available for use.

100. The default methods, for income years beginning before 1 July 2011, if no method is chosen, are:

    (a) For FIF interests of less than 10% for which FDR is allowed:

        (i) The FDR method, if it is practical to use it; and

        (ii) The Cost method if it is not practical to use the FDR method.

    (b) For a direct income interest in a foreign company of at least 10%:

        (i) The AP method, if the availability and accounting requirements are met, and it is practical to use it; or

        (ii) The CV method, if use of the AP method is not allowed or not practical, and it is practical to use CV; or

        (iii) The DRR method, if use of the AP method is not allowed or practical, and it is not practical to use the CV method.

101. For **income years beginning on or after 1 July 2011**:

    (a) The AP and BE methods will not be available.

    (b) The AFI method can result in a loss, but the loss is ring-fenced and can only be used against current or future AFI income from FIFs from the same jurisdiction. The method can be used for a FIF interest that is an income interest in a foreign company, subject to the minimum income interest restriction discussed below. The AFI method will be useful for "start-up" investments for which losses are initially incurred. The AFI method can only be used if there is sufficient information to allow the Commissioner to check the calculations – either sufficient information to satisfy the active income test or the more detailed information required to calculate attributable income, and if either:

        (i) The person's income interest is at least 10% and the person is not a PIE; or

        (ii) The person's income interest is less than 10%, but, the FIF is a CFC and:

            a. The person cannot determine the market value at the beginning of the period except by independent valuation; and

            b. No person that is a listed company, a portfolio investment entity ("PIE"), a superannuation scheme, unit trust, group investment fund, or a trustee of as trust with any of these entities as a beneficiary, holds an income interest in the CFC of 10% or more.

    (c) The FDR method can be used for any income interest (the less than 10% restriction has been removed), providing that the person has not chosen to use the CV method for another FIF interest that is an ordinary share in a foreign company for which the FDR method could have been used [s. EX 46(8)(b)]. In other words, a person cannot "cherry-pick" between the FDR and CV methods in the same year depending on whether the actual return is below or above 5%.

    (d) The Cost method can only be used if the FDR method is allowed (i.e. the person has not chosen to use the CV method in the income year for some FIF interests that the FDR method could be used for), but it is not practical to use the FDR method because the person cannot determine the market value at the beginning of the year except by independent valuation.

(e) The CV method will continue to be available as it was for earlier income years. The method includes realised and unrealised gains in the calculation of FIF income, so will be useful if the net return from FIFs is below the deemed 5% in the FDR and Cost methods.

(f) The DRR method cannot be used for a FIF interest that is ordinary shares in a foreign company.

102. The default methods, for income years beginning on or after 1 July 2011, if no method is chosen, will be:

(a) The FDR method, if it is practical to use it; and

(b) The Cost method, if it is not practical to use the FDR method.

Non-family trusts and companies with a FIF interest that is ordinary shares in a foreign company

103. If the person is a trustee of a trust other than a trust that is for the benefit of as loved one or a charity (essentially not a family trust), or a company, and the FIF interest is an ordinary share in a foreign company, the choices for income years beginning before, and on or after, 1 July 2011 are as follows:

Non-family trusts or companies with ordinary shares	**AP**	**BE**	**AFI**	**FDR**	**COST**	**CV**	**DRR**
Pre-1 July 2011 income years Default methods: For < 10%, FDR if practical, or Cost. For ≥ 10%, AP if allowed, or CV/DRR	✔	✔	✖	✔ Only < 10%	✔ Only < 10%	✔ Only ≥ 10%	✔ Only if no AP/ CV
1 July 2011 onwards income years Default methods: FDR, if it is practical to use it. Cost, if it is not practical to use FDR.	✖	✖	✔	✔	✔	✖	✖

104. For **income years beginning before 1 July 2011**, the main distinctions in the case of trusts that are not family trusts and companies, with a FIF interest that is an ordinary share in a foreign company, are:

(a) The FDR method can be used for FIF interests of 10% or more, if the trust or the company is a portfolio investment entity ("PIE") and the FIF is a foreign PIE equivalent.

(b) The CV method cannot be used for FIF interests of less than 10%.

(c) As is the case with family trusts, the DRR method can only be used by non-family trusts or by companies for FIF interests of at least 10%, and for which the other DRR method requirements (excluding the $250,000 threshold requirement) are met. The

method cannot be used by meeting the requirement that FIF interests do not exceed $250,000.

105. For **income years beginning on or after 1 July 2011**, the main distinctions in the case of trusts that are not family trusts, and companies, with a FIF interest that is an ordinary share in a foreign company, are:

    (a) A PIE (either a trust or a company) cannot use the AFI method.

    (b) A company, or a trust that is not a family trust, cannot use the CV method.

    (c) Consequently there is no restriction on the use of the FDR method by a company or a non-family trust, because the CV method cannot be used.

Any person with a FIF interest that is non-ordinary shares in a foreign company

106. If the person holds a FIF interest that is a non-ordinary share in a foreign company, the choices for income years beginning before, and on or after, 1 July 2011 are as follows:

Any person with non-ordinary shares	**AP**	**BE**	**AFI**	**FDR**	**COST**	**CV**	**DRR**
Pre-1 July 2011 income years Default methods: CV, if it is practical to use it. DRR, if it is not practical to use CV.	✖	✖	✖	✖	✖	✔	✔ Only if no CV
1 July 2011 onwards income years Default methods: CV, if it is practical to use it. DRR, if it is not practical to use CV.	✖	✖	✖	✖	✖	✔	✔ Only if no CV

107. For years commencing before, and on or after, 1 July 2011, the CV method must be used for a FIF interest that is a non-ordinary share in a foreign company, unless it is not practical because the person cannot determine the market value of the attributing interest at the end of the income year. If the CV method cannot be used, the DRR method must be used.

Any person with a FIF interest that is a foreign superannuation scheme entitlement or a foreign life insurance policy

108. This is covered in the section on Foreign Superannuation Entitlements and Life Insurance Policies.

X Changing between methods

109. The general rule is that must be no change unless it is allowed. Once a person uses a particular calculation method to calculate FIF income or loss for an attributing interest in a FIF for a particular period, they must use the same method for interests in the FIF for

the next period unless they are allowed to change. Section EX 62 provides a set of rules that limit an investor's ability to change from a FIF calculation method that they are currently using to a different FIF calculation method.

110. A change will be allowed if:

    (a) A method is no longer available, due to a change in the law: a person who used the AP method before it was repealed can change to any other method, and a person who used the BE method before it was repealed can change to the AFI method; or

    (b) The requirements to use the method are no longer met: a person can change from the AFI method if the requirements to use the AFI method are no longer met – for example, the income interest goes below 10% or the FIF is no longer a CFC; or

    (c) It becomes impossible to use the method because information to perform the calculations is no longer available: a person can change from the AFI method if the information required can no longer be obtained – this could, for example, occur when the active income test is no longer satisfied, resulting in the need for more detailed information to calculate attributable income under the default tax test; or

    (d) The Commissioner agrees to a requested change.

111. Apart from the above, a person is allowed one "free" change, for each particular FIF, to or from the AFI method. The person must simply notify the Commissioner of the change and the reason for the change of method.

112. A person who wishes to change to or from the AFI method for a second time, for a particular FIF, must not only notify the Commissioner of the change, but must also be able to show that a change in circumstances has significantly altered the person's ability to obtain sufficient information to use the AFI method and altering their income tax liability is not the principal purpose or effect of the change.

113. Taxpayers can change to using the FDR method from any of the AP, BE or DRR methods in the first income year on or after 1 July 2011, because these method are no longer available for a FIF interest that is an ordinary share in a foreign company. Taxpayers can change to using the FDR method from using the Cost method at any time if it becomes possible to obtain a market value at the start of the year by, for example, the FIF becoming listed on a stock exchange.

114. Taxpayers can stop using the FDR method and change to another method if it becomes impossible to obtain a market valuation at the start of the year other than by independent valuation.

115. Natural persons and trustees of a trust for the benefit of a loved one or a charity (generally family trusts) can change between the FDR and the CV methods from one year to the next without restriction. However, if the CV method is used in a year for a FIF that the FDR method could have been used for, the FDR method cannot be used in that year.

XI Foreign superannuation entitlements and life insurance policies

116. FIF interests include:

  (a) Rights to benefit from a life insurance policy in relation to which a FIF is the insurer (subject to the death benefit exemption discussed immediately below);

  (b) Until 31 March 2014: rights to benefit from a *foreign superannuation scheme*, as a beneficiary or a member; and

  (c) From 1 April 2014: a *FIF superannuation interest* held as a beneficiary or a member.

Exemption for a death benefit from a life insurance policy

117. There is an exemption, in s. EX 45, for FIF income arising solely from receiving a death benefit under a life insurance policy. The exemption applies if the person or the deceased, referred to as the "contracting party" entered into the contract giving rise to the benefit:

  (a) Before 2 July 1992 and the benefit was not increased by voluntary action after that time; or

  (b) When the contracting party was not a NZ resident and had been a non-resident of NZ for at least 10 years and the benefit was not increased by voluntary action after the contracting party became a NZ resident.

What is a foreign superannuation scheme

118. A *foreign superannuation scheme* is a defined term, and includes trusts, unit trust and non-resident companies established mainly for the purpose of providing retirement benefits to beneficiaries (which might include paying benefits to NZ superannuation funds), members or relatives of members who are natural persons.

119. When the new rules were introduced in April 2014, officials discussed a submission suggesting the definition of a foreign superannuation scheme should include a number of common United States superannuation products and retirement savings schemes. Officials were of the view that the definition of foreign superannuation scheme is reasonably broad, and would likely include the schemes the submitter mentioned. However, officials undertook to provide more specific clarification in a guidance document rather than in legislation. To date there has been no specific pronouncement on this point.

Foreign superannuation exemptions to 31 March 2014

120. Until 31 March 3014, there were three exemptions available to individuals for foreign superannuation entitlements and pensions or annuities:

  (a) An exemption, in s. EX 33, for an interest in Australian regulated superannuation savings: a FIF interest was exempt from the FIF tax regime if it is an interest in an Australian approved deposit fund, an Australian exempt public sector superannuation scheme, an Australian regulated superannuation fund, or an Australian retirement savings account;

(b) An exemption, in s. EX 42, for foreign employment-related superannuation entitlements that accrued while a non-resident, or during the period that the person would be regarded as a transitional resident;

(c) An exemption, in s. EX 43, for a foreign pension or annuity acquired while the person was a non-resident, or within 3 years of becoming a NZ resident: this exemption continues to apply post-31 March 2014.

121. The requirements for the exemption for foreign employment-related superannuation entitlements that accrued while non-resident were as follows:

(a) The rights must have been acquired through the person's employment or self-employment; and

(b) Contributions must be linked to the person's income; and

(c) Contributions should have been made only by the person or the person's employer; and

(d) The benefits must not be capable of assignment except in very limited, specified, circumstances.

122. Until 6 May, the exemption in s. EX 42 applied only to foreign employment-related superannuation entitlements that accrued while the person was a non-resident or during the period that the person would have met the requirements to be a transitional resident. Amounts that accrued after the person became a NZ resident were taxable under the FIF tax regime. Changes enacted with effect from 7 May 2012 meant that rights that accrued after a person became a NZ resident (for example, after ceasing to be a transitional resident) that related to the FIF interest that accrued during the period of non-residence or transitional residence, were also exempt.

123. The exemption, in s. EX 43, from the FIF regime for rights of a natural person to benefit from a pension or annuity provided by a FIF, continues to apply, if:

(a) The rights were acquired while non-resident, or in the first 3 years after becoming NZ tax resident, or through transferring an interest in a NZ superannuation fund in anticipation of ceasing to be resident; and

(b) The benefits are not able to be assigned, other than under a matrimonial property agreement, or surrendered without suffering a substantial decrease in the present value.

FIF taxation of foreign superannuation from 1 April 2014

124. From 1 April 2014, the second category of an attributing interest in a FIF is a "FIF superannuation interest" held as a beneficiary or member. Section EX 42B states that a person's right to benefit from a foreign superannuation scheme as a beneficiary or a member is not an attributing interest in the foreign superannuation scheme if the right is not a FIF superannuation interest for the person. Instead, a special new tax regime applies to foreign superannuation withdrawals from 1 April 2014.

125. *FIF superannuation interest* is a defined term in s. YA 1, in relation to a person and *each* income year, as an interest held by the person, in a foreign superannuation scheme as a beneficiary or member:

(a) Acquired when the person was a NZ resident, other than by a transfer from a spouse who acquired the interest when a non-resident, upon the death of that spouse or upon the dissolution of the marriage; or

(b) Acquired when the person was a non-resident and the following requirements are satisfied:

(i) The interest was an attributing interest for an income year ending before 1 April 2014; and

(ii) The person treated the interest as an attributing interest in the tax return for that year filed before 20 May 2013; and

(iii) The person held the interest from that income year to the beginning of the current year; and

(iv) The person treated the interest as an attributing interest in all prior tax returns from when the interest was an attributing interest.

126. If a person was a NZ resident when the interest in the foreign superannuation scheme was acquired, the interest will remain an interest in a FIF and gains will be taxed on an accrual basis, subject to the exception noted above (transfer from a spouse who acquired the interest when non-resident). There is also an exception for an interest in a foreign scheme acquired through a transfer of an interest in another (non-Australian) foreign scheme acquired when non-resident. Interests that satisfy the exceptions will not remain FIFs unless the compliance requirements in paragraph (b) above are met.

127. If a person has two or more interests in foreign superannuation schemes, the criteria are assessed per interest (not just once for that person). Note, however, that this definition does not require there to actually be FIF income or a FIF loss – the FIF income could be zero: the requirement is only that the interest was treated as an attributing interest.

128. The ability to continue using the FIF rules for foreign superannuation interests is a concession. Officials recognised that if the new withdrawals taxation rules applied to FIF interests, there could be double taxation to the extent that amounts had been taxed on an accrued basis. Therefore, the FIF rules cannot be used for a foreign superannuation interest that does not meet the specific requirements to be a FIF superannuation interest. This means that if the person fails to treat a FIF superannuation interest as an attributing interest in any subsequent income year, the interest will cease to be a FIF from then on.

129. Where there is a double tax agreement in force, a FIF disclosure form is not required. Officials did not consider that any special rules are needed. The person must be able to show that they were subject to the FIF rules and complied with their obligations under the FIF rules, including correctly returning FIF income (if there was any) in respect of the FIF interest.

Choice between methods for a FIF superannuation interest or rights to benefit from a foreign life insurance policy

130. If the person holds a FIF interest that is a FIF superannuation interest or rights to benefit from a foreign life insurance policy where a FIF is the insurer, the choices for income years beginning before, and those beginning on or after, 1 July 2011 are as follows:

Any person with a FIF superannuation interest or rights to benefit from a foreign life insurance policy where a FIF is the insurer	AP	BE	AFI	FDR	COST	CV	DRR
Pre-1 July 2011 income years Default methods: CV, if it is practical to use it. DRR, if it is not practical to use CV.	✖	✖	✖	✔	✔	✔	✔
1 July 2011 onwards income years Default methods: FDR, if it is practical to use it. Cost, if it is not practical to use FDR.	✖	✖	✖	✔	✔	✔	✖

131. For **income years beginning before 1 July 2011**, FIF income from a FIF superannuation interest or from rights to benefit from a foreign life insurance policy where the FIF is the insurer, can be calculated:

(a) Using the DRR method, by:

(i) A natural person (individual) whose FIF interests don't exceed $250,000 (measured at book value if the DRR method was used the previous year, or otherwise measured at market value); or

(ii) 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

(iii) By any person who used the DRR method previously and is not allowed to change methods.

(b) Using any of the CV, FDR or Cost methods:

(i) The use of the FDR method will be governed by whether it is possible to determine the market value at the beginning of the year.

(ii) The use of the Cost method would result in the FIF interest being taxed at 5% of the opening value each year based on a deemed increase of 5% per annum of the original cost.

(c) The AP and BE methods cannot be used: they are only available for FIF interests in foreign companies.

(d) The default method, if no method is chosen, is CV. If it is not practical to use CV, the default method is DRR.

132. For **income years beginning on or after 1 July 2011**, FIF income from a FIF superannuation interest or from rights to benefit from a foreign life insurance policy where the FIF is the insurer, can be calculated using any of the CV, FDR or Cost methods:

(a) The use of the FDR method will be governed by whether it is possible to determine the market value at the beginning of the year.

(b) The use of the Cost method would result in the FIF interest being taxed at 5% of the opening value each year based on a deemed increase of 5% per annum of the original cost.

(c) The default method, if no method is chosen, is FDR. If it is not practical to use FDR, the default method is the Cost method.

133. The rules on changing between methods are the same as those already set out earlier in this paper.

Superannuation schemes and life insurance policies cost and market value measurement rules

134. If it is not possible to measure the cost of a FIF interest because of multiple acquisitions and/or disposals, the cost is measured on a first-in-first-out (FIFO) basis.

135. 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.

136. If it is necessary to determine the market value of rights to benefit under a life insurance policy, when a person becomes subject to the FIF tax regime by becoming a NZ resident or an exemption ceasing to apply, the surrender value of the policy is treated as the market value.

137. If it is not reasonably practical for a person to calculate the market value of rights to benefit under a FIF superannuation interest, and the person has not derived any material gain from the entitlement at the time, the total costs incurred up to that time in acquiring the entitlement is treated as the market value.

XII Key issues relating to the use of the AFI method

138. The AFI method allows a person to use the active business test. The first point to note that a person is regarded as using the AFI method even if the active business test is passed and there is no attributable FIF income or loss.

139. The AFI method is applied as if the FIF was a CFC, with two important differences:

    (a) The requirements for applying the active business test using accounting information are significantly relaxed; and

    (b) The rules requiring "look-through" to an underlying FIF are also less onerous.

Applying the accounting standards active business test to FIFs

140. When the active business test using accounting standards is applied under the AFI method for FIFs, information from accounts prepared for the FIF using United States generally accepted accounting principles ("US GAAP") is permitted to be used. This is in addition to information from accounts prepared under NZ IFRS ("IFRS") or International IFRS ("IFRSE"). (Information from US GAAP accounts cannot be used for the active business test for a CFC.)

141. However, the FIF's income must be included in accounts prepared under IFRS or IFRSE – either through the FIF's accounts being consolidated into the IFRS or IFRSE accounts, or through the FIF's income being included using the equity method (in IAS 28 or IAS 31) or by inclusion of dividends and fair value changes (under IAS 39).

142. If the FIF income, based on the income interest, that is included in the IFRS or IFRSE accounts, is consistent with the corresponding proportion of income in the FIF's own accounts, the information from the FIF's own accounts (which could be accounts prepared under US GAAP) can be used without adjustment when applying the active business test. If the FIF's profit in the IFRS or IFRSE accounts does not correspond to the proportion that reflects the income interest in the FIF's own accounts, the underlying information will need to be adjusted accordingly when used in the active business test.

143. In addition, the IFRS or IFRSE accounts that include the FIF income must be audited by a chartered accountant who is independent of the FIF and the NZ holder of the FIF interest, and the auditor must provide an unqualified audit opinion. This is apparently so that whatever accounting standard may be used by the FIF itself, the resulting income will be subject to an audit that checks compliance with IFRS or IFRSE.

Applying the active business test to a group of FIFs

144. Under sections EX 50(4B) and EX 50(7B), the active business test applied to a group of FIFs is different from the active business test applied to a group of CFCs in three respects:

    (a) The top tier FIF must have more than a 50% voting interest in the lower tier foreign companies (it is not necessary for the NZ investor to have more than a 50% income interest in each FIF, as would be the case if they were CFCs);

    (b) The foreign companies included in the FIF group can be in different countries, providing that none of the companies is a CFC (whereas all CFCs in a group must be in the same country); and

    (c) Minority interests do not have to be removed when using FIF financial information to calculate whether the active income test is passed (whereas the CFC rules require minority interests to be removed).

Exceptions to the "look-through" rule for underlying FIFs

145. When the AFI method is used for a top tier FIF, the default rule is to "look-through" the FIF and apply the FIF rules to an underlying FIF. (This is not the case if any other FIF calculation method is used because, as stated in s. EX 29(2), the other methods only deal with direct FIF interests.) However, there are several exceptions to the "look-through" rule when the AFI method is used:

    (a) The first exception to the "look-through" rule, under s. EX 50(6), is when the indirect income interest would not be an attributing interest for the person if held as a direct income interest because, for example, a FIF exemption applies. As noted earlier, under amendments to s. EX 50(6) and (7) and s. EX 58 in s. 95 and s. 97 of th*e Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014*, applying to the 2014-15 and later income years, the exemption in s. EX 35 will not be available for an indirect attributing interest in an Australian resident FIF if that indirect interest corresponds to a direct income interest of less than 10%, even if the direct interest in the CFC or upper level FIF is 10% or more. If the exemption is not available, the "look-through" rule applies to the underlying Australian FIF.

    (b) The second exception to the "look-through" rule, under s. EX 50 7B(a)(i), is when the NZ holder of the top tier FIF can demonstrate that the underlying FIF meets the requirements to apply the AFI method and passes the active business test.

    (c) The third exception to the "look-through" rule, under s. EX 50(7B)(a)(ii), is when the lower tier FIF is part of the same test group as the top tier FIF and the group passes the active income test. As noted earlier, for a lower tier FIF to be part of a group, the top tier FIF must have a more than 50% voting interest.

    (d) The fourth exception to the "look-through" rule, under s. EX 50(7B)(b) and EX 50(7C), is when the top tier FIF passes a modified active income test that includes additional amounts that relate to its shareholdings in underlying foreign companies. There are specific requirements to be met if this exception is to apply:

        (i) The top tier FIF must pass the active business test on its own, before any amounts relating to underlying FIFs are taken into consideration;

        (ii) After passing the test on its own, the test is conducted a second time, with the income (or loss) amounts from the underlying FIF(s) included in the item "added passive" and also in the item "reported revenue";

        (iii) The amounts can be a share of the associate's profits recognised under the equity method under NZIAS 28 or an equivalent IFRSE or US GAAP standard: this could be a net amount, or even a negative amount, if, for example, one underlying FIF had a profit and another underlying FIF had a loss;

        (iv) Alternatively, the amounts could be recognised under proportionate consolidation under NZIAS 31 or an equivalent IFRSE or US GAAP standard (if, for example, the top tier FIF has income from a joint venture);

        (v) Alternatively, the amounts could be dividends from the underlying FIF and fair value changes under NZIAS 39 or an equivalent IFRSE or US GAAP standard: in

this case, s. EX 50(4B)(q)(ii) does not allow the dividends to be also included in the formula item "removed passive".

(vi) For an example on how this fourth exception operates, refer to pages 29-30 of Tax Information Bulleting Vol. 24, No. 6, July 2012.

Exemption for intra-group payments when using the AFI method

146. Attributable income is calculated for a FIF using the AFI method in more or less the same way as for a CFC. However, the exemptions for intra-group payments are slightly different:

(a) It is not necessary for the paying and receiving FIF to be associated companies (as is the case with CFCs), however, they must be commonly controlled – i.e. there must be a group of persons who hold more than a 50% voting interest in both the paying and receiving companies – s. EX 50(4C)(ab).

(b) The paying company must be a FIF for which the AFI method is used, and be a company that would be a non-attributing CFC or FIF – s. EX 50(4C)(a) & (b).

(c) Both the paying and the receiving company must be resident and subject to tax in the same jurisdiction.

Intra-group payments concession for "look-through" entities such as US LLCs

147. As noted above, both the paying and receiving companies must both be subject to tax in the same jurisdiction in order for the intra-group payment exemptions to apply. The rules are relaxed slightly if the paying company is not subject to tax, but the receiving company is subject to tax – as would be the case if the paying company is a "look-through" entity, such as a US LLC.

148. There are some additional specific requirements that must be met if this concession is to apply:

(a) Both the paying and the receiving company must be tax resident in the same country under s. YD 3 (which does not necessarily require the companies to be liable for tax in the country of residence);

(b) The paying company must be wholly owned, under the laws of NZ and the foreign country, by another FIF or CFC resident in the same country;

(c) The other FIF or CFC must be liable to tax in the foreign country in the same period as the paying CFC or FIF would have been liable for tax if it was not a "look-through" entity;

(d) Neither the paying FIF, nor the receiving FIF or CFC can be treated as a dual resident;

(e) Neither the paying FIF nor the receiving FIF or CFC can have a fixed establishment or a permanent establishment outside the country.

149. Note that this concession does not apply to the situation where the receiving company is not subject to tax – such as, for example, if the receiving company is a US LLC, unless the

receiving LLC itself meets the other requirements above – i.e. is itself owned by a FIF or a CFC that is also resident in the US and subject to tax in the US.

Elective attributing FIFs

150. A taxpayer can elect, under s. EX 73, not to apply the active business test to a FIF for which they use the AFI method. For such an "elective attributing FIF", there is a full calculation of attributable income.

151. A FIF cannot be an elective attributing FIF if it carries on a business of banking or insurance or is controlled by somebody who does.

152. An election for a FIF to be an elective attributing FIF is prospective – it applies from the year following the year in which notice is provided to the Commissioner, although Inland Revenue has some discretion to allow a late election.

153. An election cannot be easily revoked. The concern is apparently that an election can be revoked after attributing deductions have been taken but before the corresponding attributable income arises. A revocation must not be made for a purpose or effect of reducing a tax liability and Inland Revenue must agree to the revocation in writing.

154. However, an election can expire automatically if the FIF ceases to be a FIF for which the taxpayer uses the AFI method: for example, if a FIF exemption commences to apply.

155. Notices of election or revocation must be in a letter containing the relevant details, including the identity of the FIF and the period for which the election is made, and be sent to competent.authority@ird.govt.nz

156. Strict rules apply to the use of the losses from an elective attributing FIF:

    (a) The losses are tagged with the name of the FIF and the election commencement year;

    (b) In addition to jurisdictional ring-fencing, tagged losses may only be used against FIF income from the same FIF, or from another FIF with the same election commencement year;

    (c) Tagged losses cannot be used against attributable income from a non-elective attributing FIF, even from the same country;

    (d) Unused tagged losses are forfeited if the election made in respect of the FIF expires or is revoked;

    (e) Losses in the year of revocation will be normal attributed losses from that year, or not recognised at all.

XIII Deductibility of FIF losses

157. Section DN 5(1) states that a person is allowed a deduction for a FIF loss. Section DN 7 states that a FIF loss is calculated using the relevant FIF calculation method.

158. The ability to deduct FIF losses has already been covered when the various methods were discussed. To summarise:

(a) FIF losses resulting from the use of the existing AP method can be deducted from other (non-FIF) income. This method cannot be used in income years beginning on or after 1 July 2011.

(b) FIF losses resulting from the use of the BE method will be ring-fenced and can only be deduced from current or future FIF income calculated using the BE or AFI methods. There are restrictions on the extent to which losses calculated using the BE method can be carried forward and deducted from income calculated using the AFI method.

(c) FIF losses resulting from the use of the AFI method will be ring-fenced and can only be deduced from current or future FIF income calculated using the AFI method.

(d) FIF losses calculated using the CV method, on portfolio FIF interests (i.e. that are not FIF interests of 10% or more in a foreign company) are ignored under the 'reduction of losses to zero' rule, except for FIF interests that are non-ordinary shares.

(e) FIF losses calculated using the CV method, on non-portfolio FIF interests in a foreign company of 10% or more at all times in the year, may be deducted from other (non-FIF) income in income years beginning before 1 July 2011. In income years beginning on or after 1 July, the 'reduction of losses to zero' rule will also apply to non-portfolio FIF interests of 10% or more.

(f) FIF losses calculated using the CV method for non-ordinary shares may be deducted from other (non-FIF) income.

(g) No FIF losses can arise under the DRR, FDR or Cost methods.

Jurisdictional ring-fencing rule for deducting FIF losses

159. Under s. DN 5(2), the deduction for a FIF loss calculated under the AFI method is subject to the jurisdictional ring-fencing rule in s. DN 8. The ring-fencing rule, as it applies to elective attributing FIFs, was described earlier.

160. If the FIF net loss is from a FIF that is not an elective attributing FIF, the person is allowed a deduction in the income year up to the amount of:

(a) The total attributed CFC income of the person for the income year from CFCs resident in the same country as the FIF for the relevant accounting period; and

(b) The total FIF income, calculated using the AFI method, of the person for the income year from other FIFs resident in the same country for the relevant accounting period.

161. If the FIF net loss is from a FIF that is an elective attributing FIF, as discussed earlier, the person's deduction in the income year is limited to:

(a) The total attributed CFC income of the person for the income year from CFCs resident in the same country as the FIF for the accounting period, and elective attributing CFCs in the income year with the same election commencement year as the FIF; and

(b) The total FIF income, calculated using the AFI method, of the person for the income year from other FIFs resident in the same country as the FIF for the accounting period, and elective attributing FIFs in the income year with the same election commencement year as the FIF.

Rules for carrying forward and offsetting FIF losses

162. Subpart IQ applies when, for a country and a tax year, a person has:

    (a) A FIF net loss for the tax year; or

    (b) A FIF net loss carried forward from an earlier tax year; or

    (c) FIF income calculated under the BE or the AFI method and another person makes available to the person an amount of attributed CFC net loss or FIF net loss.

163. An attributed FIF net loss arises on the last day of the tax year in which the loss is attributed. Note that:

    (a) A person's FIF net loss can be carried forward to a tax year only if the person, if a company, meets the minimum shareholding continuity requirements of 49% as set out in s. IA 5.

    (b) FIF net losses carried forward must be used, according to s. IA 9, in the order in which they arose, and adjusted as required if assessments are amended.

164. Special rules for making a FIF loss available to another company in the group apply, under s. IQ 4, when a company has a net FIF loss from the current year, or carried forward from an earlier year, remaining after applying it against its own FIF income for the current year:

    (a) The group of companies must be a wholly-owned group;

    (b) The usual shareholding commonality requirements for group tax loss offsets apply;

    (c) The part-year loss offset rules in subpart IP do not apply;

    (d) The maximum FIF loss offset that a company can make use of in an income year is determined after deducting the company's own FIF and CFC losses from the same jurisdiction, either incurred in that year or brought forward.

165. There are specific rules that apply, under s. IQ 2, when FIF income for a tax year and a particular jurisdiction, is set off against a FIF net loss carried forward or set off against a loss made available, under s. IQ 4, by another company in the same group.

166. The total FIF net loss for a FIF that is not an elective attributing FIF that can be subtracted from a person's income in a tax year is the lesser of:

    (a) The CFC and FIF income from FIFs and CFCs resident in the same jurisdiction in the accounting period corresponding to the tax year; or

    (b) The FIF's net loss carried forward or made available by another group company, either as a whole (if the year is "after transition" – i.e. an income year beginning on or after 1 July 2009) or in part (if the year is an income year beginning on or before 30 June 2009, in which case the carried forward BE loss is able to be "converted" into a "equivalent CFC loss" and treated as a CFC loss from then on).

167. If, for some reason, the lesser amount referred to above cannot be fully used in the tax year, it ceases to be a FIF loss, under s. IQ 2(3), and becomes an ordinary loss to carry forward and use without being jurisdictionally ring-fenced or limited to FIF income.

168. For an elective attributing FIF, the rules are adjusted so that the net loss that can be subtracted is limited to the lesser of the income from elective attributing FIFs with the same election commencement year, or the FIF loss carried forward as described above.

Treatment of BE losses incurred in income years commencing before 1 July 2009

169. The CFC rules changed significantly in income years commencing on or after 1 July 2009. For FIF losses calculated using the branch equivalent ("BE") method, which employed the "old" CFC rules, a complex set of "conversion" rules were introduced. These are contained in s. IQ 2B. The key points are:

    (a) The main thrust of the rules is that a BE loss carried forward to an income year beginning on or after 1 July 2009 can be converted into an "equivalent CFC loss".

    (b) A BE Loss that is converted ceases to be a BE loss. The equivalent CFC loss is treated as arising on the last day of the conversion year.

    (c) A person can elect that a BE loss not be carried forward under the conversion rules.

170. The conversion method involves determining the "jurisdictional income ratio" for each year, which is the ratio of BE income for the year to FIF income calculated using the AFI method. This ratio is then used to convert the BE loss for that year into an equivalent CFC loss, which is carried forward subject to the current jurisdictional; ring-fencing and loss utilisation rules.

Effect of FIF net loss if AFI method not available

171. A special rule applies when a person is required to change from using the BE method to the AFI method for a FIF, for income years beginning on or after 1 July 2011, and the person is not able to use the AFI method because the interest is less than 10% and the person does not have any FIF interest in the jurisdiction for which the AFI method could be used, and also does not have an income interest of 10% or more in a CFC in the same jurisdiction.

172. In such circumstances the person is allowed, under s. IQ 2C, to deduct the BE loss up to the amount of the FIF's income, and carry the excess BE loss forward.

XIV FIF disclosure requirements

173. Section 61 of the *Tax Administration Act 1994* requires taxpayers to disclose an attributing interest in a FIF that is held at any time in the income year. The Commissioner can exempt a person from this requirement. The 2014 exemption is published as *2014 International Tax Disclosure Exemption ITR25* and applies for the income year ended 31 March 2014.

174. In summary, the 2014 disclosure exemption **removes** the requirement of a resident to disclose:

    (a) An interest of less than 10% in a foreign company if it is not an attributing interest in a FIF or if it falls within the $50,000 de minimis exemption. The de minimis exemption does not apply to a person that has opted not to use the de minimis exemption. Such a person must disclose FIF income or loss in any of the four subsequent income years even if the total cost of all attributing interests is $50,000 or less.

    (b) If the resident **is not** a widely-held entity, an attributing interest in a FIF that is an income interest of less than 10%, if the foreign entity is incorporated (in the case of a company) or otherwise tax resident in a treaty country or territory, and the fair dividend rate or comparative value method of calculation is used.

    (c) If the resident **is** a widely-held entity, an attributing interest in a FIF that is an income interest of less than 10% if the fair dividend rate or comparative value method is used for the interest. The resident is instead required to disclose the end-of-year New Zealand dollar market value of all such investments split by the jurisdiction in which the attributing interest in a FIF is held or listed.

175. The 2014 disclosure exemption also removes the requirement for a non-resident or transitional resident to disclose interests held in foreign companies and FIFs.

176. The forms for the disclosure of FIF interests are as follows:

    (a) IR443 form for the deemed rate of return method;

    (b) IR445 form for the fair dividend rate method (for widely-held entities);

    (c) IR446 form for the comparative value method (for widely-held entities);

    (d) IR447 form for the fair dividend rate method (for individuals or non-widely-held entities);

    (e) IR448 form for the comparative value method (for individuals or non-widely-held entities);

    (f) IR449 form for the cost method;

    (g) IR458 electronic form for the attributable FIF income method (this form can also be used to make electronic disclosures for all other methods).

177. The IR445 and IR446 forms, which reflect the disclosure for fair dividend rate and comparative value for *widely-held entities*, must be filed online. As discussed above this disclosure is by country rather than by individual investment. In order to be exempt from the general requirements, the alternative disclosure must be made electronically.

178. The IR447, IR448 and IR449 forms, applying to the fair dividend rate and comparative value methods for *individuals or non widely-held entities* as well as the cost method for all taxpayers, may be completed online. In that case, the online Form is the same as the one used for the IR445 and IR446.

XV Relationship between the FIF tax rules and the general rules

179. In an income year when a person's FIF interest is taxed under the FIF tax regime, the general rule is that the person is treated as not having any income from the FIF interest for the period other than FIF income. In particular, any dividends from the interest and any gains on sale are disregarded.

180. However, the quid pro quo is that no losses can be deducted other than under the FIF rules.

181. This general rule does not apply to FIF interests for which the AP or BE methods are used (in income years starting before 1 July 2011) or for which the AFI method is used (in income years starting on or after 1 July 2011). Persons who elect to use these methods would generally hold income interests of at least 10%, in which case, dividends would be exempt under general rules.

182. There is an exception to the general rule: the exception is different for income years starting before 1 July 2011 and on or after 1 July 2011.

183. The exception for income years starting before 1 July 2011 is: If the FDR method is used for a FIF that is a grey list company, and the person's interest at the beginning of the year was at least 10% (in which case, the existing FIF grey list exemption would have applied but for the reduction in the interest to below 10%) dividends and gains on sale can be taxed under the general rules. This is an anti-avoidance rule aimed at situations where the dividends received would exceed the deemed 5% income calculated using the FDR method.

184. For income years starting on or after 1 July 2011, the exemption for FIF interests of at least 10% in grey list companies is being replaced with an exemption for interests of at least 10% in Australian resident FIFs. Consequently, the exception for income years starting before 1 July 2011 is: If the FDR method is used for a FIF that is an Australian resident company, and the person's interest at the beginning of the year was at least 10% (in which case, the new Australian FIF exemption would apply but for the reduction in the interest to below 10%) dividends and gains on sale can be taxed under the general rules.

185. Income that is taxed under the FIF rules is not taxed under the general rules, subject to the very specific exceptions referred to above.

186. This can provide opportunities: to take an obvious example, if the returns exceed 5% and the FDR method is used, the maximum income that will be taxed each year will be 5% of the opening market value.

187. Gains on sales of shares held on revenue account are not separately taxed if the shares are taxed under the FIF tax regime. Such gains are mandatorily taxed under the FIF tax regime only if the shares are non-ordinary shares.

188. For individuals and family trusts, the CV method can be a "back-stop" that reduces the taxable income to the actual amount if it is less than 5%.

189. The ability to continue to use the FIF tax regime for foreign superannuation interests acquired while non-resident is a concession. A failure to comply with the requirements will result in withdrawals being taxed under the withdrawals tax regime instead, and there would be double taxation to the extent that withdrawals have been previously taxed on an accrual basis under the FIF tax regime.

190. The concept underlying the FIF tax regime is that NZ residents should be taxed on their worldwide income. The regime is not meant to be a deterrent against foreign investments.

191. However, it should by now be obvious that effective (i.e. minimum tax) compliance with the regime is not a walk in the park. In the publication *A Guide to Foreign Investment Funds and the Fair Dividend Rate* (IR 461 August 2010) Inland Revenue helpfully suggests that where there is a choice between methods (which is the case for most FIF interests), "you should see your (tax) agent or financial advisor"!