DavidCo Limited
CHARTERED ACCOUNTANTS

Level 2, Shortland Chambers
70 Shortland Street, Auckland
PO Box 2380, Shortland Street
Auckland 1140
T +64 9 921 6885
F +64 9 921 6889
M +64 21 639 710
E arun.david@davidco.co.nz
W www.davidco.co.nz

WEEKLY COMMENT: FRIDAY 14 JUNE 2013

1. The *Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill* ("the Bill") was introduced on 20 May 2013. Last week I looked at the inclusions and exclusions in the new foreign superannuation withdrawals rules, which will apply from 1 April 2014. This week and next week, I look at the new methods for calculating taxable income.

2. The two methods are the *schedule method* (which is the default method), and the *formula method*, which can be chosen if the requirements to use it are met. In both cases, the assessability of the withdrawal will depend on identifying the correct *assessable period*, which is the period during which a withdrawal will be taxable income. Both methods are used to determine the *part* of a foreign superannuation withdrawal that is not exempt from income tax (the "assessable withdrawal amount").

3. The topics covered this week are:

   (a) The assessable period; and

   (b) The formula method.

Determining the assessable period

4. The assessable period is the period during which the exemptions discussed in last week's *Weekly Comment* will not apply. It is the period:

   (a) That begins on the latest of:

      (i) When the person is treated, under s. CF 3(18), as acquiring the interest in the scheme; or

      (ii) When the person becomes a New Zealand resident; or

      (iii) When the person's exemption period under s. CF 3(4) (as discussed in last week's *Weekly Comment*) ends; and

   (b) Ends when the person becomes a non-resident.

5. A person is treated, under s. CF 3(18), as acquiring the interest in the scheme:

   (a) *General rule if none of the specific rules in paragraphs (b) to (d) apply*: When the first contribution is made, by or for the person, to the superannuation scheme, to acquire the rights to benefit as a beneficiary or member from the distributions.

   (b) *Specific rule covering rights transferred from another superannuation scheme*: If the person has converted rights in a former superannuation scheme to corresponding rights of the person in the current superannuation scheme, when the person acquired the rights

in the former scheme; transfers between two foreign schemes will generally not be taxed; instead, withdrawals will be taxed based on the duration of residence since the interest in the *first* scheme was acquired, so the assessable period will begin on the date the interest in the first scheme was acquired; or

(c) *Specific rule covering rights transferred from another person*: If the person has acquired rights in the superannuation scheme from another person, other than by a transfer from the estate of a deceased New Zealand resident, when the person acquired the rights; the transfer will be taxable to the transferor based on their years of residence, if the transferor is a New Zealand resident. The recipient's assessable period will begin *when they first acquire the interest from the transferor*, if they are a New Zealand resident (for example, a relationship split, where a relationship property agreement may transfer all or part of an interest in a foreign superannuation scheme from one party to the other); or

(d) *Specific rule covering rights transferred from the deceased estate of a New Zealand resident*: If the person has acquired rights in the superannuation scheme by a transfer from the estate of a deceased New Zealand resident after the beginning of the assessable period for the deceased person, the beginning of the assessable period for the deceased person.

6. It is stated on page 9 of the *Commentary* that:

   "If the person acquired the interest while they were non-resident, the assessable period will start when their exemption period ends.

   If the person acquired the interest while they were resident, they are not eligible for an exemption period. Their assessable period will start when they acquire the interest."

7. Note also that:

   (a) For someone who loses residency and then becomes resident again, it is possible to have more than one assessable period: In this situation, the applicable assessable periods will be aggregated.

   (b) The assessable period will be determined for each specific foreign superannuation interest, based on the number of years of residence since the interest in *that* particular interest was acquired; it is possible that a person might have different assessable periods for different interests - for example, a person migrates to New Zealand with an interest in a foreign superannuation scheme and they acquire an interest in another scheme while they are New Zealand-resident: the assessable period for the first interest will begin when their four-year exemption period ends and for the second interest it will begin when the second interest is acquired.

The formula method

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

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

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

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

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

(e) For a person who acquires the interest in the scheme as a bequest from a deceased New Zealand resident, the deceased person did not use the schedule method for the interest in the scheme; and

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

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

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

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

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

    (a) Is made when the person is a New Zealand resident and is a non-resident under no double tax agreement; and

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

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

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

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

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

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

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

$$(\textbf{super withdrawal} \times \textbf{calculated gains fraction}) - \textbf{gains out}$$

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

$$\text{gain out x (grow rate - 1) x tax rate x (assessable years - 1)}$$

(a) Grow rate is:

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

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

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

(d) *Tax rate* is the tax rate given by Schedule 1, Part A, Table 1, Row 4. This is currently the top marginal rate of 33%.

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

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

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

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

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

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

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

(e) For the first withdrawal:

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

(f) For the second withdrawal:

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

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

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

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

$$\textbf{= \$26,667 x (1.0605 -1) x 0.33 x (10 - 1) + \$26,667 = \$31,458.66}$$

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

= $83,333 x (1.0507 -1) x 0.33 x (15 - 1) + $83,333 = $102,852.42

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

Detailed PDF attachment on the new rules

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

Arun David, Director

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