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WEEKLY COMMENT: FRIDAY 12 SEPTEMBER 2014

1. Last week I commenced looking at the Foreign Investment Fund ("FIF") taxation regime. I looked at the FIF exemptions, including the removal of the Australian FIF exemption for holdings in Australian unit trusts and indirect holdings that equate to a direct holding of less than 10% contained in the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014*.

2. This week I look at the foreign dividend exemptions, the rules for which were enacted in the *Taxation (International Investment and Remedial Matters) Act 2012*. In addition, *Tax Information Bulletin* Vol. 24 No. 6 (July 2012) contains a summary of the foreign dividend exemptions on pages 19-20.

General exemption for dividends from FIFs

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

4. 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.

5. 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.

6. 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 (see paragraph 18 of last week's *Weekly Comment* 5 September 2014) 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.

7. 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.

8. 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.

9. 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

10. 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. However, there are a series of listed exclusions.

11. 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 (see paragraph 18 of last week's *Weekly Comment* 5 September 2014), 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.

12. 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.

13. The above exemptions were all discussed in last week's *Weekly Comment* 5 September 2014.

14. 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.

15. 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.

PIEs with non-portfolio interests in FIFs

16. A special tax regime applies to investments held through portfolio investment entities ("PIEs"). If the correct prescribed investor rate has been notified to the PIE by the investor, income from the PIE is excluded income and is not taxed.

17. Therefore, PIEs are not allowed to use the active income exemption for shares held in foreign companies:

(a) First, under s. EX 14, a PIE has FIF income, and not CFC income, for an interest in a CFC of 10% or more; and

(b) Second, the FIF exemption for CFCs in s. EX 34 does not apply to PIEs; and

(c) Third, under s. EX 46(3), a PIE is not allowed to use the AFI method, which means it cannot make use of the active income exemption for FIFs.

General rules for entering or leaving the FIF tax regime

18. 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 in last week's *Weekly Comment* 5 September 2014.

(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.

19. 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.

20. 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).

21. 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.

22. 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.

23. 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 in paragraph 20 above.

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