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WEEKLY COMMENT: FRIDAY 3 OCTOBER 2014

1. This week I continue looking at the Foreign Investment Fund ("FIF") taxation regime by taking a look at entitlements to benefit from a foreign superannuation scheme or a foreign life insurance policy. The FIF taxation rules that apply to an entitlement to benefit from a foreign superannuation scheme were significantly changed by *Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2014*, effective from 1 April 2014.

2. 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

3. 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

4. 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.

5. 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

6. 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.
7. 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.
8. 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.
9. 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

10. 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 (discussed in *Weekly Comment* 3-24 January 2014, with details available in the attached PDF *Foreign Superannuation Withdrawals Taxation*).

11. *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.

12. 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.

13. 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.

14. 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.

15. 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

16. 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.	✖	✖	✖	✔	✔	✔	✖

17. 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.

18. 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.

19. The rules on changing between methods are the same as those discussed in last week's *Weekly Comment*.

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

20. 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.

21. 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.

22. 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.

23. 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.

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