**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

# NZ Taxation of Foreign Investment Funds (FIFs)

## Presented by Arun David

## New Zealand Value Investors' Conference

## SKYCITY Auckland - 20 April 2012

# CONTENTS


| Sections | Paragraph Nos. | Page Nos |
|---|---|---|
| I Introduction | 1 – 5 | 3 |
| II Topics to be covered | 6 – 8 | 4 |
| III Investments taxed under the FIF rules | 9 -10 | 4 |
| IV Exemptions from the FIF tax regime | 11 - 33 | |
| • $50,000 minimum threshold for natural persons | 13 – 14 | 5 |
| • Limited $50,000 threshold for particular trusts | 15 – 16 | 6 |
| • Australian exemptions | 17 – 20 | 6 |
| • Exemptions for venture capital investments | 21 – 24 | 7 |
| • Terminating grey list company exemptions | 25 – 26 | 7 |
| • Grey list co. employee share purchase scheme | 27 | 8 |
| • Superannuation, pension and annuity exemptions | 28 | 8 |
| • CFC exemption | 29 – 30 | 8 |
| • Active income exemption from 1 July 2011 | 31 – 33 | 8 |
| V Transitional resident exemption | 34 – 37 | 9 |
| VI General entry and exit rules | 38 – 42 | 9 |
| VII The calculation methods | 43 – 67 | 10 |
| • The Accounting Profits (AP) method | 48 | 11 |
| • The Branch Equivalent (BE) method | 49 | 11 |
| • The Deemed Rate of Return (DRR) method | 50 – 51 | 11 |
| • The Comparative Value (CV) method | 52 – 56 | 11 |
| • The Fair Dividend Rate (FDR) method | 57 – 59 | 12 |
| • The Cost method | 60 – 64 | 12 |
| • The Attributed FIF Income (AFI) method | 65 – 67 | 13 |
| VIII The choice between methods | 68 – 79 | 14 |
| • Individuals/family trusts: ordinary shares | 69 – 73 | 14 |
| • Companies/Non-family trusts: ordinary shares | 74 – 76 | 16 |
| • Any person: non-ordinary shares | 77 – 78 | 17 |
| IX Changing between methods | 80 – 81 | 18 |
| X Foreign superannuation and life insurance | 82 – 95 | 18 |
| • Foreign superannuation and pension exemptions | 83 – 87 | 18 |
| • Choice between methods | 88 - 91 | 19 |
| • Cost and market value measurement | 92 - 95 | 20 |
| XI Deductibility of FIF losses | 96 | 21 |
| XII FIF tax rules and the general tax rules | 97 - 108 | 21 |

# 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. (Note, however, that there are a couple of "top-up" income tax exceptions to this general rule.)

## II Topics to be covered this afternoon

6. The key features that I wish to explore this afternoon are as follows:

   (a) Exemptions from the FIF tax regime: there are a number of these. Note, however, 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.

   (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.

   (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.

7. During the discussion we will consider the impact of the new rules affecting these features that will apply to income years beginning on or after 1 July 2011 contained in the Taxation (International Investment and Remedial Matters) Bill as reported from the committee of the whole House on 15 February 2012. For standard balance date (31 March) taxpayers, the new rules will apply from the 2012-13 income year.

8. Compliance aspects, such as the disclosure forms that must be completed (some of which must be completed on-line) and calculation worksheets are beyond the scope of this paper and will not be covered.

## III Investments taxed under the FIF rules

9. There are 3 types of foreign investments that are taxed under the FIF rules:

   1) Interests in a foreign company, measured by reference to direct income interests.

   2) Rights to benefit from a foreign superannuation scheme.

   3) Rights to benefit from a foreign life insurance policy.

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

# IV Exemptions from the FIF tax regime

11. 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 unrealised gains will also be taxable if the investments are held on revenue account.

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

**$50,000 minimum threshold for natural persons**

13. A natural person will not be taxed under the FIF tax regime in an income year if, at all times of the income year, the total cost, calculated under the FIF cost measurement rules, of all the investments that would otherwise be subject to the FIF tax regime does not exceed $50,000.

14. The following points are worth noting:

    (a) The $50,000 is a threshold rather than an exemption: if the total cost of FIF interests exceeds $50,000, all the FIF interest will be subject to tax under the FIF rules, and not just the excess costing more than $50,000.

    (b) The $50,000 threshold applies at all times in the year: this means that if the cost of FIF interests at any time in the year exceeds $50,000, the exemption will not apply.

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

    (d) The $50,000 minimum threshold includes the cost of interests in foreign superannuation schemes and life insurance policies.

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

    (f) 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.

    (g) 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.

    (h) The cost of the investments is measured as follows:

        (i) If the cost of investments cannot be specifically identified, cost is measured in a first-in-first-out (FIFO) basis.

        (ii) Costs incurred in kind are measured at market value at the time incurred.

        (iii) Excluded from costs is expenditure on financial arrangements, interest on money borrowed, and other holding costs.

        (iv) 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.

**Limited $50,000 minimum threshold for particular trusts**

15. The $50,000 threshold 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) The settlor is the ACC.
16. Family trusts do not fall within this limited range and therefore do not get the benefit of the $50,000 minimum threshold.

**Australian exemptions**

17. There is an exemption for investments 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/calculators/tool-name/tools-a/toii-fif-list-aust-share-exemption-2011.html
18. There is an exemption 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.
19. There is a new exemption that will apply 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; and
    (b) The exemption will not be available to PIEs, superannuation schemes, unit trusts, life insurers or group investment funds.

20. 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**

21. 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).

22. 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.

23. 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.

24. 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.

**Terminating grey list company exemptions**

25. The present exemption for a FIF interest that is a direct income interest of at least 10% in a grey list company is due to be abolished. The last income year it will apply to will be the income year that starts on or before 30 June 2011. This means that non-portfolio investments in the grey list companies will be subject to the FIF tax regime from income years beginning on 1 July 2011 onwards.

26. There is an exemption that is due to expire in the 2011–12 income year which essentially caters for New Zealand shareholders in GPG.

**Exemption for employee share purchase scheme of a grey list company**

27. 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 in a grey list country and either be the employer or own the New Zealand resident employer of the employee.
    (b) The shares must be acquired through employment under an agreement that satisfies the tax requirements to be an employee share purchase agreement.
    (c) There must be the NZ tax-required restrictions in the share purchase agreement applying to selling the shares.
    (d) Employees have up to 6 months from the date restrictions are lifted to dispose of their shares before the FIF rules apply to the shares.

**Foreign Superannuation entitlement and foreign pension or annuity exemptions**

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

**CFC exemption**

29. 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.
30. This exemption will not apply to a PIE for income years beginning on or after 1 July 2011.

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

31. 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.
32. 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.
33. 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

34. 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.

35. 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 residents.

36. A person who is a transitional resident for part of the year will have a FIF exemption for the part of the year during which the person is a transitional resident.

37. 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 General entry and exit rules

38. 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.

    (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.

39. The general rule in all these cases is that the person is treated as having sold the interest immediately before the FIF rules commence to apply and having 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.

40. There is a concession that applied to interests that became FIF interests as a result of the previous rule changes from 1 April 2007 onwards. Any tax liability arising from that

transition was able to be spread over 3 income years following the year in which the disposals and acquisitions were treated as having occurred.

41. The general 'sale and reacquisition at market value' rule has recently been extended so as to apply to inherited interests in grey list companies where a person inherited the interest before 1 April 2007, and that the cost of the interest was zero as a result of the inheritance. The concession referred to above also applies to a tax liability that arose as a result of the deemed disposal and reacquisition.

42. 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.

## VII The calculation methods

43. There are currently six calculation methods. New rules due to be enacted very soon will result in two of these methods becoming unavailable and a new method becoming available for income years beginning on or after 1 July 2011.

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

    (a) The Accounting Profits (AP) method.

    (b) The Branch Equivalent (BE) method.

    (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.

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

    (a) The Attributable FIF Income (AFI) method.

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

    (c) The Comparative Value (CV) method.

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

    (e) The Cost method.

46. A detailed examination of these methods is well 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.

47. Note that the currency conversion rules are the same for all methods for which market values or income or expenditure is required to be determined. The 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.

**The Accounting Profits (AP) method**

48. This 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.

**The Branch Equivalent (BE) method**

49. This 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 Deemed Rate of Return (DRR) method**

50. 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, and for the 2010-11 income year, was 8.52%. The DRR method cannot result in a FIF loss.

51. For income years commencing on or after 1 July 2011, the DRR method will be 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 Comparative Value (CV) method**

52. This method is an important method. It is the method that must be used for "non-ordinary shares" in a foreign company. It is also the method that is available by choice to individuals and family trusts if the FDR method results in an unacceptably high level of deemed income. 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.

53. The CV method captures the total return during the year, including capital gains and losses on sales and all dividend income. Its main use 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.

54. 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", or the FIF is a foreign company and the direct income interest is at least 10% at all times in the year. (The rule was amended from the 2009-10 income year so that foreign superannuation and life insurance interests are subject to this rule.) For income years beginning on or after 1

July 2011, the "reduction of losses to zero" rule will apply to FIF interests of 10% or more, so only losses incurred on non-ordinary shares can be deducted.

55. 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. No losses will arise if the DRR method is used.

56. 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.

**The Fair Dividend Rate (FDR) method**

57. This method will be the new default method for income years commencing on or after 1 July 2011. FIF income is calculated under this 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.

58. The 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.

59. Individual investors and family trusts can switch freely between FDR and CV methods on a portfolio basis (i.e. by pooling their FIF interests in foreign companies of less than 10%) between income years – but not within the same year. (A portfolio will not include interests in a foreign superannuation scheme or life insurance policy unless they are interests in companies.) If the FDR method is used, it must be used for all interests that qualify for the use of the method. The use of the FDR method will not result in FIF losses.

**The cost method**

60. This method will be the new 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.

61. The differences between this method and the FDR method are that:

    (a) This 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).

62. 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.

63. The main example of an interest for which the cost method is allowed to be used would be shares in a foreign company that are 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.

64. The use of the Cost method will not result in FIF losses.

**The Attributed FIF Income (AFI) Method**

65. This method can be used to calculate FIF income for income years that commence on or after 1 July 2011. It 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. A primary requirement is that there should be sufficient information available, on request, for review by the Commissioner to support the calculations.

66. The use of this 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 referred to earlier.

67. This 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.

## VIII The choice between methods

68. The choice between methods is important because, as previously noted, different methods yield different results. In addition, the rule changes to be enacted shortly will have a

significant impact on the choice of methods for income years beginning on or after 1 July 2011.

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

69. 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 | DRR | CV | FDR | COST |
|---|---|---|---|---|---|---|---|
| Pre-1 July 2011 income years<br>Default methods:<br>For < 10%, FDR if practical, or Cost.<br>For ≥ 10%, AP if allowed, or CV/DRR | ✔ | ✔ | ✖ | ✔ | ✔ | ✔ | ✔ |
| 1 July 2011 onwards income years<br>Default methods:<br>FDR, if it is practical to use it.<br>Cost, if it is not practical to use FDR. | ✖ | ✖ | ✔ | ✖ | ✔ | ✔ | ✔ |

70. 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 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 on the basis 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.

(d) 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.)

(e) 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, and at all times in the year if the FIF is not a grey list company); and

(ii) For which the CV method is not chosen when the FDR method could have been used.

(f) 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, 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 but not practical because the person cannot determine the market value of the interest at year-end except by independent valuation.

71. 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.

72. 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 will be generally be available when the BE method was previously used, subject to the requirement that the income interest be at least 10% if the market value at the beginning of the period can be determined. The method will be useful for "start-up" investments for which losses are initially incurred. The AFI method can be used if there is sufficient information to allow the Commissioner to check the calculations, and if either:

(i) The person's income interest is at least 10%; or

(ii) 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. An income interest of at least 10% in the FIF is not held by any entity 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.

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

(d) 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.

(e) The FDR method can be used for any interest (the less than 10% restriction will be removed), providing that the person has not chosen to use the CV method for another FIF interest for which the FDR method could have been used. 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%.

(f) The Cost method can only be used if the FDR method is allowed, but not practical because the person cannot determine the market value at the beginning of the year except by independent valuation.

73. 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**

74. If the person is a trustee of a trust that is 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** | **DRR** | **CV** | **FDR** | **COST** |
|---|---|---|---|---|---|---|---|
| Pre-1 July 2011 income years<br>Default methods:<br>For < 10%, FDR if practical, or Cost.<br>For ≥ 10%, AP if allowed, or CV/DRR | ✔ | ✔ | ✖ | ✔ Only if no AP/ CV | ✔ Only ≥ 10% | ✔ | ✔ |
| 1 July 2011 onwards income years<br>Default methods:<br>FDR, if it is practical to use it.<br>Cost, if it is not practical to use FDR. | ✖ | ✖ | ✔ | ✖ | ✖ | ✔ | ✔ |

75. For **income years beginning before 1 July 2011**, the main distinctions in the case of trusts that are not family trusts, or companies, are:

    (a) 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 on the basis that FIF interests do not exceed $250,000.

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

    (c) 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.

76. 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, are:

    (a) A trust or a company that is a PIE 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**

77. 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** | **DRR** | **CV** | **FDR** | **COST** |
|---|---|---|---|---|---|---|---|
| Pre-1 July 2011 income years<br>Default methods:<br>CV, if it is practical to use it.<br>DRR, if it is not practical to use CV. | ✖ | ✖ | ✖ | ✔ Only if no CV | ✔ | ✖ | ✖ |
| 1 July 2011 onwards income years<br>Default methods:<br>CV, if it is practical to use it.<br>DRR, if it is not practical to use CV. | ✖ | ✖ | ✖ | ✔ Only if no CV | ✔ | ✖ | ✖ |

78. There will be no change to the rules applying to FIF interests that are non-ordinary shares. The CV method must be used, unless it is not practical because the person cannot determine the market value of the attributing interest at the end of the income year. In that case, 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**

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

# IX Changing between methods

80. 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.

81. A change will be allowed if:
    (a) A method is no longer available, due to a change in the law; or
    (b) The requirements to use the method are no longer met; or
    (c) It becomes impossible to use the method because information to perform the calculations is no longer available; or
    (d) The Commissioner agrees to a requested change.

# X Foreign superannuation entitlements and life insurance policies

82. FIF interests include a right to benefit from a foreign superannuation scheme or a life insurance policy offered and entered into outside NZ.

**Foreign superannuation entitlement and pension or annuity exemptions**

83. There are three exemptions available to individuals for foreign superannuation entitlements and pensions or annuities:
    (a) An exemption for an interest in Australian regulated superannuation savings;
    (b) An exemption 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 for a foreign pension or annuity acquired while the person was a non-resident, or within 3 years of becoming a NZ resident;

84. A FIF interest is 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.

85. There is an exemption for 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. The requirements for the exemption are 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.

86. This exemption is to be significantly extended under new laws to be passed shortly. The changes will apply from the date of enactment. The change will mean that rights that accrue after the person becomes a NZ resident (for example, after ceasing to be a transitional resident) that relate to the FIF interest that accrued during the period of non-residence or transitional residence, will be exempt. At present, all rights that accrue after becoming a NZ resident are taxable under the FIF tax regime.

87. There is an exemption from the FIF regime for rights of a natural person to benefit from a pension or annuity provided by a FIF 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.

**Choice between methods for a FIF interest that is a foreign superannuation scheme entitlement or a foreign life insurance policy**

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

| **Any person with a foreign superannuation scheme entitlement or a foreign life insurance policy** | **AP** | **BE** | **AFI** | **DRR** | **CV** | **FDR** | **COST** |
|---|---|---|---|---|---|---|---|
| Pre-1 July 2011 income years<br>Default methods:<br>CV, if it is practical to use it.<br>DRR, if it is not practical to use CV. | ✖ | ✖ | ✖ | ✔ | ✔ | ✔ | ✔ |
| 1 July 2011 onwards income years<br>Default methods:<br>FDR, if it is practical to use it.<br>Cost, if it is not practical to use FDR. | ✖ | ✖ | ✖ | ✖ | ✔ | ✔ | ✔ |

89. For **income years beginning before 1 July 2011**, FIF income from an entitlement to benefit from a foreign superannuation scheme or a foreign life insurance policy, 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 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.

90. For **income years beginning on or after 1 July 2011**, FIF income from an entitlement to benefit from a foreign superannuation scheme or a foreign life insurance policy, 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.

91. 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**

92. 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.

93. 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.

94. 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.

95. If it is not reasonably practical for a person to calculate the market value of rights to benefit under a superannuation scheme, 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.

## XI Deductibility of FIF losses

96. 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.

## XII Relationship between the FIF tax rules and the general rules

97. 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.

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

99. 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.

100. There is an exception to the general rule: However, due to the rule changes to be enacted shortly, the exception is different for income years starting before 1 July 2011 and on or after 1 July 2011.

101. 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.

102. Under the new rules to be enacted shortly, 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.

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

104. 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.

105. 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.

106. 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%.

107. 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.

108. 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"!