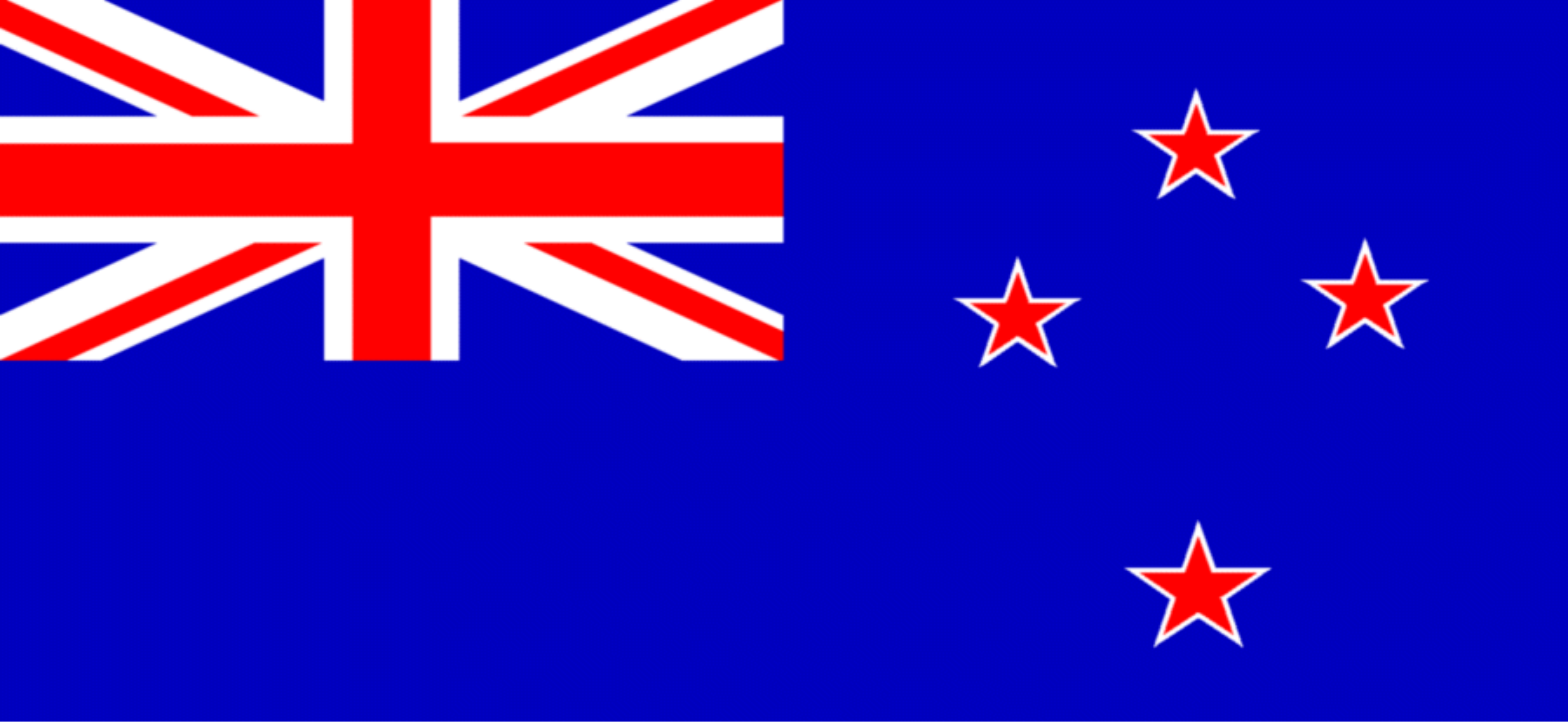
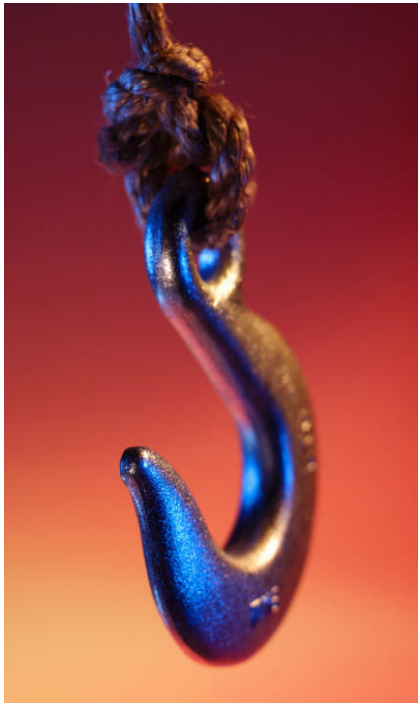


NZ Taxation of Foreign Investment Funds (FIFs)

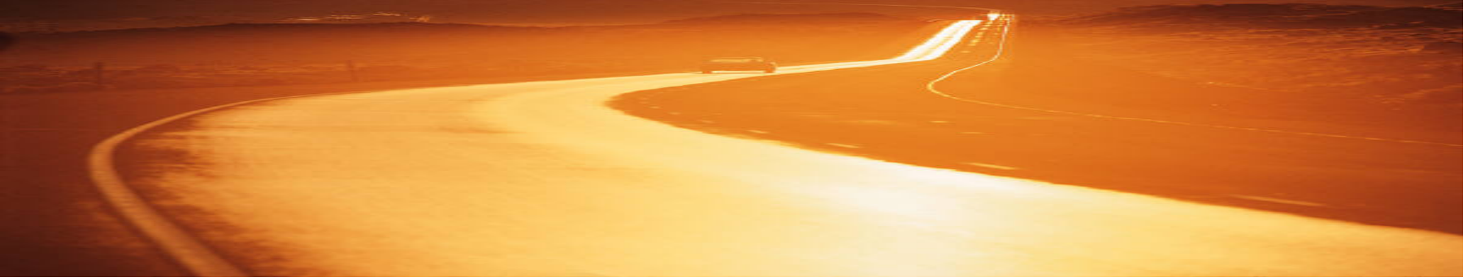
Presented by Arun David
Director, DavidCo Limited

New Zealand Value Investors' Conference
SKYCITY Auckland – 20 April 2012

Introduction



- The FIF tax regime is a set of special tax rules that apply to:
  - Interests in a foreign company, measured by reference to direct income interests
  - Rights to benefit from a foreign superannuation scheme
  - Rights to benefit from a foreign life insurance policy
  - FIFs held through Controlled Foreign Companies (CFCs)



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Topics this afternoon

- Exemptions from the FIF rules
- Transitional residents
- Entry and exit from the FIF rules
- Choice between calculation methods
- Super schemes and life policies
- FIF rules vs general tax rules

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Exemptions
$50,000 threshold

- **Applies only to natural persons**: family trusts not included
- **Threshold – not exemption**: if exceeded, the FIF rules apply to <u>all</u> interests
- Specified cost measurement rules
- Married and de facto couples can split joint interests

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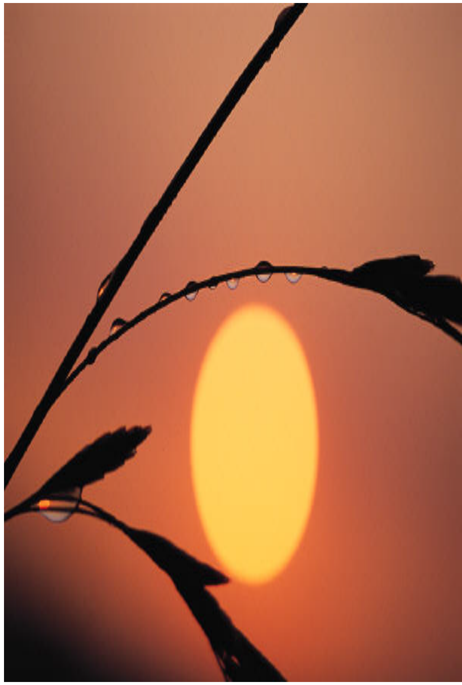
Exemptions
Australian exemptions



- Australian listed companies
- Australian unit trust with NZ RWT proxy and:
  - 25% minimum share turnover; or
  - 70% minimum distributions
- From 1 July 2011: New exemption for:
  - ≥ 10% interest in an Australian FIF;
  - Not for PIEs, super schemes, unit trusts, etc.

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Exemptions
Venture capital

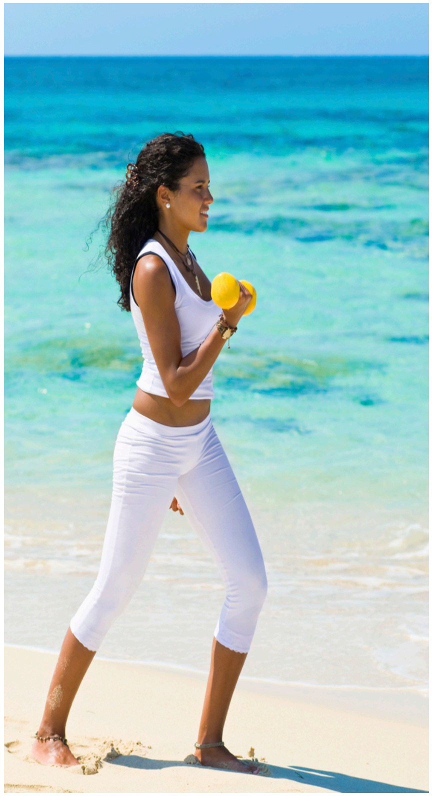
- Investments in NZ start-up companies that migrate to grey list countries
- Investment in grey list company that owns > 50% of a NZ start-up company
- Grey list company shares acquired under a venture investment agreement with the Venture Investment Fund

Exemptions
Employee share scheme

- Limited exemption for shares acquired through an employee share scheme:
  - Grey list company must be the employer or own the NZ employer company
  - Share purchase agreement must satisfy tax requirements
  - Share sales must be restricted in accordance with tax requirements

Exemptions
Active income

- AFI method can be used to access the CFC active income exemption
- Will apply to income years starting on or after 1 July 2011 (2012-13 income year for 31 March balance date taxpayers)
- 1 of 2 active income tests must be passed:
  - Default test: passive income must be < 5% of annual gross income
  - Applicable accounting standard test: Reported passive income < 5% of reported revenue
  - In either case, gross revenue ≠ zero



Exemptions
Transitional resident

- A natural person who becomes a NZ tax resident will be a transitional resident
- The period of transitional residence is 4 years starting from the 1st full month of NZ tax residence
- The FIF rules do not apply to a transitional resident
- It is possible to elect not to be a transitional resident
- FIF interests held when residence status changes from transitional to NZ resident are acquired at market value at the time

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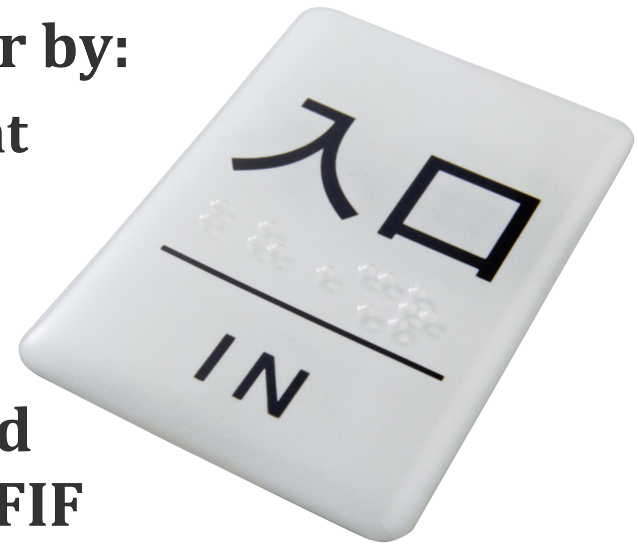
Entry and Exit Rules

- Entry into the FIF tax rules could occur by:
  - Transitional resident becoming resident
  - Exemption ceasing to apply
  - NZ entity migrates and becomes a FIF
- General rule: FIF interests are sold and reacquired at market value when the FIF rules start to apply
- Same rule when FIF rules cease to apply



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Six currently available Calculation methods

- The Accounting Profits (AP) method (Terminating)
- The Branch Equivalent (BE) method (Terminating)
- The Deemed Rate of Return (DRR) method
- The Comparative Value (CV) method
- The Fair Dividend Rate (FDR) method
- The Cost method

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Income years starting on or after 1 July 2011(generally 2012-13)

Five calculation methods

- **The Attributable FIF Income (AFI) method**
- **The Deemed Rate of Return (DRR) method**
- **The Comparative Value (CV) method**
- **The Fair Dividend Rate (FDR) method**
- **The Cost method**

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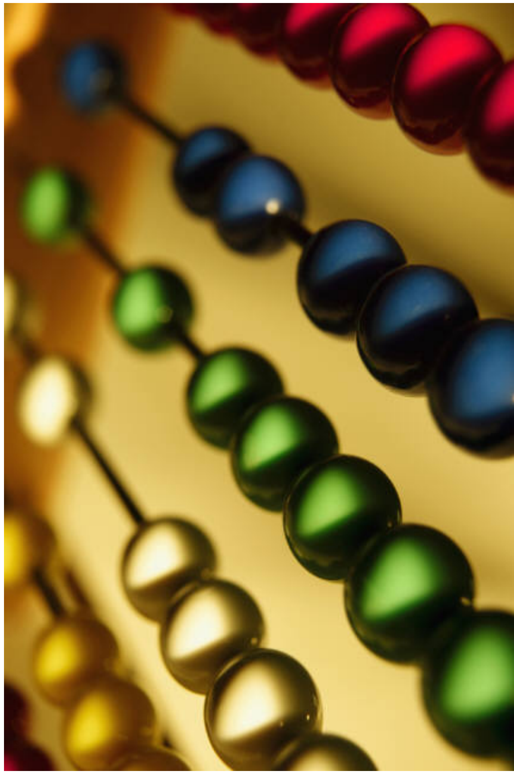
Accounting Profits (AP)

- Not available for income years starting on or after 1 July 2011 (2012-13 for 1 April starts)
- Based on after-tax accounting profits of the FIF
- Further reduction for tax the person is personally liable for
- FIF income is a proportion based on the person's income interest
- Can result in a FIF loss that is deductible from other income



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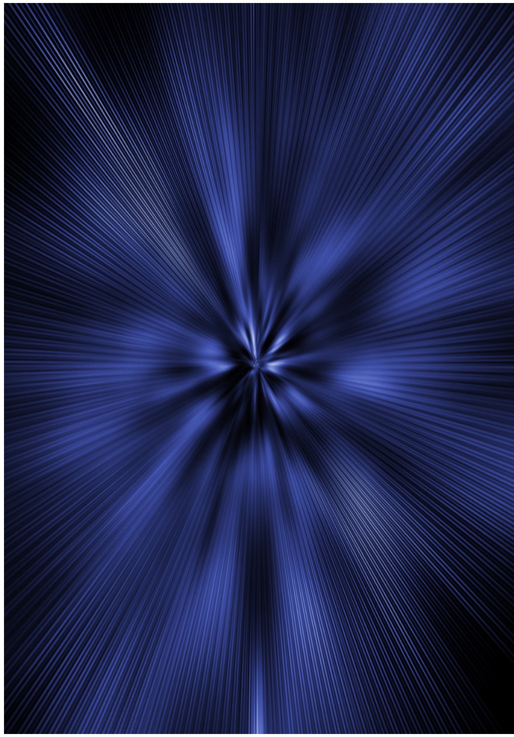
Branch Equivalent (BE)

- Not available for income years starting on or after 1 July 2011 (2012-13 for 1 April)
- Based on applying old CFC calculation rules
- FIF income is a proportion based on the person's income interest
- Can result in a FIF loss that can only be deducted from BE income from the same jurisdiction

Deemed Rate of Return (DRR)

- Based on applying a deemed rate for the year to opening book value
- Opening book value each year is adjusted for increases in the previous year
- Deemed rate for 2010-11 is 8.52%
- From 2012-13 DRR can be used only for guaranteed return shares
- Cannot result in a FIF loss



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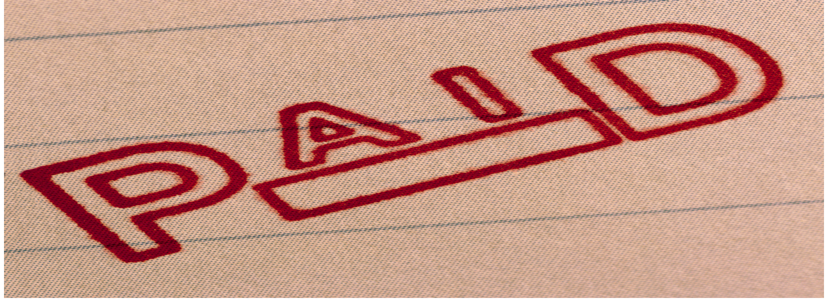
Comparative Value (CV)

- Important method:
  - Must be used for guaranteed return shares
  - Individuals and family trusts can use CV for ordinary shares
- Compares closing market value plus income to opening market value plus expenditure
- Captures capital gains and losses
- Cannot result in a FIF loss except for guaranteed return shares or ≥ 10% interests



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Fair Dividend Rate (FDR)

- Important method:
  - Will be the new default method from 2012-13 for 31 March balance dates
  - Currently only for interests < 10%, but under new rules available for all interests
- FIF income is 5% of opening market value (plus a 'quick sale adjustment' for interests bought and sold in the same year)
- Works on a pooled investments approach
- Cannot result in a FIF loss

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Cost method

- Will be the new second choice default method from 2012-13 for 31 March balance dates
- Used when opening market value cannot easily be obtained (e.g. unlisted shares)
- FIF income is 5% of opening value (plus a ‘quick sale adjustment’ for interests bought and sold in the same year)
- Opening value is the previous year’s opening value increased by 5%
- Method is applied interest-by-interest
- Cannot result in a FIF loss

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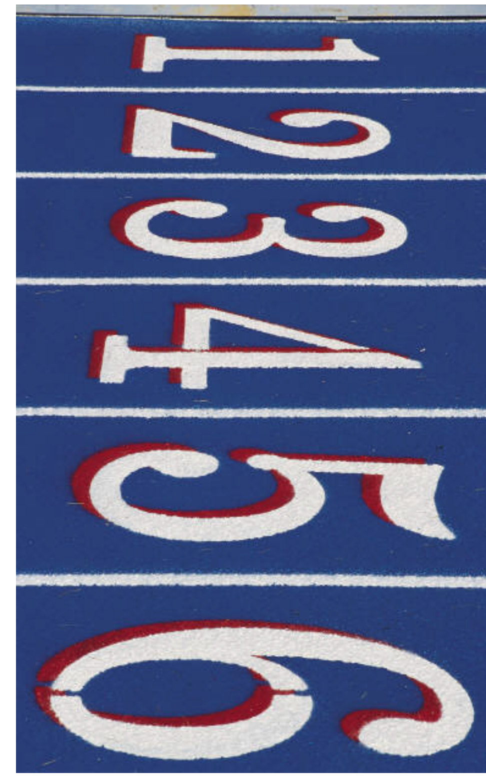
Attributed FIF Income (AFI)



- Will be available for interests ≥ 10% (and interests < 10% in specified circumstances) from 2012-13 for 31 March balance dates
- FIF income is calculated using the net attributable CFC income/(loss) rules, substantially modified
- Income will be exempt if the CFC active income tests are passed
- Can result in a FIF loss that can only be deducted from AFI income from the same jurisdiction
- Useful for investments in foreign start-up companies with initial losses

Choice between methods:

Individuals & family trusts holding ordinary shares

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	AP	BE	AFI	DRR	CV	FDR	COST
Income years starting pre-1 July 2011	✔ 1st Default for ≥ 10%	✔	✖	✔	✔ 2nd Default for ≥ 10%	✔ Default for < 10%	✔ 3rd Default for ≥ 10%
Income years starting post-30 June 2011	✖	✖	✔	✖	✔	✔ Default	✔ 2nd Default

Choice between methods:

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Companies & non-family trusts holding ordinary shares

	AP	BE	AFI	DRR	CV	FDR	COST
Income years starting pre-1 July 2011	✔ 1st Default for ≥ 10%	✔	✖	✔ Only if no AP/ CV	✔ Only ≥ 10% 2nd Default	✔ Default for < 10%	✔
Income years starting post-30 June 2011	✖	✖	✔	✖	✖	✔ Default	✔ 2nd Default

Choice between methods:

All persons holding guaranteed return shares

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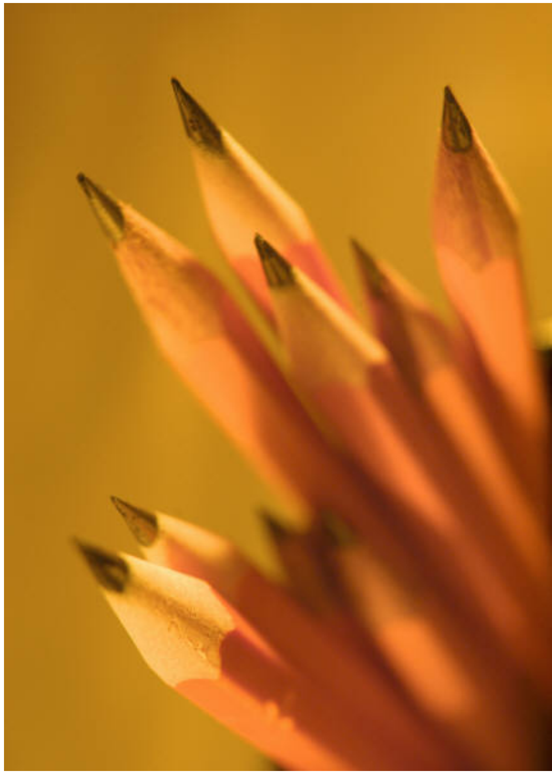
	AP	BE	AFI	DRR	CV	FDR	COST
Income years starting pre-1 July 2011	✖	✖	✖	✔ Only if no CV	✔ Default	✖	✖
Income years starting post-30 June 2011	✖	✖	✖	✔ Only if no CV	✔ Default	✖	✖

Changing methods

- General rule: once a person starts using a method for a FIF, no change unless allowed
- A change will be allowed if:
  - A method is no longer available due to a law change
  - Requirements for the method are not met
  - Information is not available
  - The Commissioner agrees to a change



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Three Superannuation Exemptions

- Australian regulated superannuation savings
- Foreign employment-related superannuation entitlements that accrued while a non-resident
- Foreign pension or annuity acquired while a non-resident or within 3 years of becoming a resident

Foreign employment-related superannuation

- Rights must have been acquired through employment or self-employment
- Contributions must be linked to income
- Contributions only by the person or the employer
- Benefits cannot be assigned except in very limited circumstances

Foreign employment-related superannuation

Extension of exemption

- The exemption is to be significantly extended under new laws to be passed
- Rights that continue to accrue after becoming NZ resident will be exempt to the extent they relate only to rights that accrued while a non-resident or a transitional resident
- The extension will apply from the date of enactment

Choice between methods:

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All persons holding superannuation or life insurance

	AP	BE	AFI	DRR	CV	FDR	COST
Income years starting pre-1 July 2011	✖	✖	✖	✔ 2nd Default if no CV	✔ Default	✔	✔
Income years starting post-30 June 2011	✖	✖	✖	✖	✔	✔ Default	✔ 2nd Default

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Superannuation and life insurance policies: Cost measurement

- If cost cannot be measured because of multiple acquisitions/disposals:
  - Cost is measured on a FIFO basis
- The cost of a life policy excludes premiums for life cover in earlier years if:
  - The policy's surrender value was not increased

Superannuation and life insurance policies: Market value measurement

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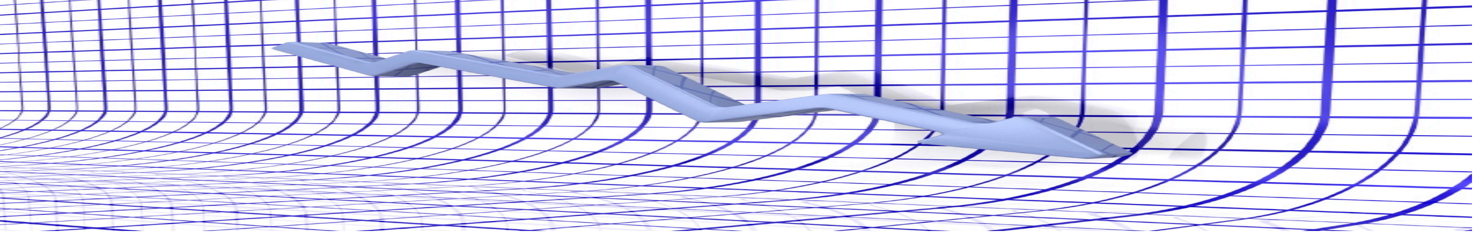
- The total costs incurred on acquiring a superannuation entitlement is treated as market value, if:
  - It is not practical to calculate MV; and
  - The person has derived no material gain
- The market value of rights to benefit under a life insurance policy is the surrender value when the FIF rules start to apply due to:
  - Becoming a NZ resident; or
  - An exemption ceasing to apply.



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Deductibility of FIF losses

- FIF losses under the AP method can be deducted from other income (but this method is being repealed)
- FIF losses under the BE or AFI methods can only be deducted from other BE income or AFI income from FIFs in the same jurisdiction
- FIF losses on guaranteed return shares under the CV method can be deducted from other income
- No FIF losses arise under the CV method for ordinary shares (including ≥ 10% interests from 2012-13), or under the DRR, FDR or Cost methods

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FIF tax rules vs general rules

- If income is taxed under the FIF rules, dividends and gains on sales are not taxed under the general rules
- However, losses can only be deducted under the FIF rules
- This can provide opportunities:
  - for example, gains on sale of shares on revenue account that would be taxed under the general rules may effectively not be taxed under the FIF rules if the FDR deemed 5% income rule applies

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Concluding comment

- The FIF tax rules:
  - Are complicated
  - Provide a choice of calculations
  - Contain a number of exemptions
- Inland Revenue helpfully suggests:
  - If there is a choice of calculation methods: "you should consult your (tax) agent or financial advisor"