P O Box19194, Wellington
Level 3
49-53 Courtenay Place
Wellington, New Zealand
Tel: ++64 4 381 3382
Fax: ++64 4 381 3392
Email: info@asfonz.org.nz
Web-site: www.asfonz.org.nz

7 July 2006

Clerk of the Committee
Finance & Expenditure Committee
Select Committee Office
Parliament Buildings
WELLINGTON

To the Chair of the Select Committee

ASFONZ SUBMISSION ON THE TAXATION (ANNUAL RATES, SAVINGS INVESTMENT, AND MISCELLANEOUS PROVISIONS) BILL ("the Bill")

We wish to submit the attached in respect of the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill released on 17 May 2006.

ASFONZ is an independent national, non-profit organisation founded in 1969. Its current membership comprises around 100 major workplace superannuation schemes and around 50 organisations and individuals representing the various product and service providers for workplace superannuation.

The mission of ASFONZ is to promote workplace superannuation in New Zealand.

ASFONZ seeks to achieve that mission through:

1 **Advocacy** – being the recognised voice for all employers and trustees involved in workplace superannuation, through:
   (i) advocating legislative and public policy initiatives beneficial to the industry;
   (ii) making submissions and commentary on existing legislative and public policy initiatives;
   (iii) issuing regular press releases and other public commentary on matters of wider concern or interest to members; and
   (iv) staying in regular contact with responsible Ministers, regulatory and industry bodies, the Retirement Commissioner and Government Departments to project, promote and advance members' interests.

2 **Education** – promoting trustee, employer and member education through dedicated training programmes, newsletters and special interest seminars.

3 **Networking** – providing trustees, employers and service providers involved in workplace superannuation with a regular forum for sharing ideas and information on industry matters.

Contact:

Bruce Kerr
Executive Director, ASFONZ
PO Box 19 194, Wellington, NZ
Ph. (04) 381 3382
Fax (04) 381 3392
Mob. (027) 284 0481
Email bruce.kerr@asfonz.org.nz
Web Site www.asfonz.org.nz

I would be pleased to answer any queries in relation to the submission. We would like to appear in person at Select Committee hearings.

Thank you for the opportunity to make this submission.

Yours sincerely

John Melville
Chairman

ASFONZ

(The Association of Superannuation Funds of New Zealand)

Submission to the

Finance & Expenditure Select Committee

on the

Taxation (Annual Rates, Savings Investment and Miscellaneous Provisions) Bill ("the Bill")

July 2006

Summary of our submission

ASFONZ agrees that the tax treatment of "collective investment vehicles" ("CIVs") needs to change. What we have now is both illogical and unfair. ASFONZ is, in principle, supportive of moves to align the tax treatment of CIVs and individuals and to remove the over-taxation of investment income for those on lower marginal tax rates that is inherent in the current system.

In 2005, the Minister of Finance issued a Discussion Document concerning the taxation of investment income. ASFONZ made detailed submissions on the Discussion Document concluding that, in summary, we believed that the proposals introduced an unnecessary layer of complexity that would at the same time raise costs, lower understanding and increase inequity. We suggested that there were more "natural" ways of calculating the income of CIV investors and of ensuring that those investors paid an appropriate amount of tax on the part of their income attributable to their CIV investment.

We understand that similar reservations were expressed in many other submissions made on the Discussion Document. However, while there has been much subsequent consultation by officials and modifications to the initial proposals have been made, changes proposed in the Bill to the current tax regime still appear to result in a significant level of additional complexity.

ASFONZ's prime concern is that alterations to the tax regime applied to, in particular, employer-based superannuation schemes should not only remove the current inequities, but be designed such that trustees of schemes can enthusiastically put the new regime into effect. We do not believe this to be the case as the Bill is currently drafted. We fear that likely outcomes will include further terminations of employer-based schemes and schemes not electing the revised basis.

The ASFONZ preference continues to be for the current tax regime to be reviewed on a "first principles" basis. If the objective of change is to align the tax treatment of CIVs and individuals and to remove the over-taxation of investment income for those on lower marginal tax rates, we think that a first principles approach can achieve this. Our thoughts in this area were outlined at length in our submissions on the Discussion Document.

That said, ASFONZ recognises the difficulties faced by officials and that the changes proposed in the Bill reflect the intended way forward. We commend both the consultative approach adopted by officials and the clear desire on their part to involve interested parties in the development of this legislation wherever considered practicable.

This ASFONZ submission concentrates on our views for making the operation of these proposals more workable.

By way of a summary of the ASFONZ submission on the Bill:

- A CIV should not have to establish a flow through basis of operation to receive capital gains on Australasian equities on a non-taxable basis;

- Recognising that the adoption of "flow through" is elective, we believe that the time allowed to introduce flow through systems by 1 April 2007 is insufficient to ensure that the required replacement administration systems are robust in design;

- We believe that the costs associated with the design and implementation of replacement registry and financial administration systems, and the demands on scarce resources needed to undertake these tasks, have not been adequately considered;

- There should be flexibility for issuers of PIEs to attribute income and determine the tax payable, at their option on a daily, quarterly or annual basis and for tax payable to be calculated on the proposed weighted average basis or as an aggregate of tax determined by reference to the income attributed to each individual investor using a more refined income attribution process;

- The requirement for managers to be independent is unreasonable in some circumstances;

- The penalties for breaches are too inflexible and harsh;

- There should be some additional flexibility for investors in setting the rate of tax to be applied by a PIE, to avoid over-taxation of investment income;

- The proposed regime for the calculation of SSCWT is likely to result in progressive SSCWT being used infrequently and the introduction of another set of thresholds is confusing;

- Inequities that could arise at transition should be removed.

Detailed comments for the ASFONZ submission

1. **Requirement for a PIE to offer "flow through" to be able to treat capital gains on Australasian equities as non taxable:**

   1.1. The removal of capital gains on Australasian equities from the definition of taxable income for a CIV is welcomed to the extent that investors using CIVs will not be disadvantaged compared to those investing directly. This recognises that, in general, individuals are rarely taxed on such gains and thus treats investors who use CIVs for their investments on a basis that is aligned with the current practice adopted by direct investors. (As indicated in our earlier submissions on the Discussion Document we do not believe that the introduction of this distortion to the usual rules is really necessary);

   1.2. In this regard we find the exclusion of capital gains from Australian unit trusts and the like of concern in that such vehicles are now commonly used by NZ CIVs to obtain their exposure to Australian equities. Their exclusion will logically lead to their replacement by listed Australian companies that will qualify, achieving very little other than additional costs for investors. (This appears to be an example of the sorts of problems referred to in section 1.1

above). We submit that Australian unit trusts that invest in Australasian equities should be included in the exemption;

1.3. The option for investors to be able to be taxed at a rate based on their income is also welcomed. Again, this more closely aligns investors using CIVs with those investing directly;

1.4. The linking of the removal of these capital gains from the definition of taxable income to introducing a flow through basis for taxing the investments of CIV investors is not logical. The two are entirely different issues and should be treated as such;

1.4.1. The government has recognised that CIV investors have been overtaxed (compared to those investing directly) for many years;

1.4.2. We submit that the decision to stop one part of the over-taxation, by excluding these gains from the definition of taxable income, can and should be made unilaterally in respect of all CIVs;

1.4.3. We submit that the decision on whether or not to adopt a flow through basis for taxing investors should be made by the product provider, taking into account the costs involved and the likely benefit to that product's investors, if any;

1.4.4. To suggest that investors can have the over taxation removed only if both measures are adopted is unreasonable.

2. Costs associated with implementing and maintaining a flow through system:

2.1. It is only over recent weeks, since the introduction of the Bill, that trustees and managers have started to consider the potential cost implications of a flow through system as proposed;

2.2. The same people who are considering this question are similarly considering the impact of the operation of KiwiSaver, and may well also be involved with the MED's review of investment products and providers;

2.3. We believe that the costs involved in implementing the proposed flow through tax regime have not been adequately assessed at this time and that decisions relating to the adoption of flow through may be deferred by many for that reason;

2.4. While the adoption of a flow through basis is elective, there is pressure to view 1 April 2007 as the target date for implementation with certain transitional provisions only available to PIEs. The adoption date is mandatory for those interested in becoming KiwiSaver default providers;

2.5. The linkage of flow through with the removal of tax on Australasian equities is also putting pressure on providers to implement new systems by 1 April 2007. We are concerned that the limited resources available will preclude adequate system design and testing, to the detriment (and cost) of investors;

2.6. The tight timeline for introducing such important changes (tax and KiwiSaver) together has received much comment already. We reiterate that we have major concerns over these timeframes and recommend a longer period for both initiatives to be developed;

2.7. The Bill proposes that all PIEs have an income year ending 31 March. The increasingly complex requirements for scheme accounts and annual audits are already putting pressure on the limited resources available to ensure completion within statutory time limits. A significant number of current schemes have balance dates at other than 1 April and it is not clear that an additional workload at that date can be managed. We submit that this requirement should be removed;

2.8. We are also concerned that compliance with the requirements to determine tax payable within relatively short timeframes each quarter will not be possible with the limited pool of skilled resources available.

3. Attribution of taxable income and payment of tax:

3.1. As currently drafted, PIE tax will be payable no less frequently than quarterly based on the asset weighted average tax rate of investors over the relevant period;

3.1.1. Many trustees unitise member account balances and currently determine unit prices on a daily or weekly basis. These unit prices make provision for estimates of income and expenses, taxable income and tax (currently at 33%). It would be perverse to move to a system that is less accurate;

3.1.2. We submit that trustees should have the option of determining the tax liability of the PIE based on the taxable income attributed to each investor on a more accurate basis as an alternative (without requiring more frequent payment of PIE tax);

3.2. The Bill envisages that tax will be payable by the PIE by no later than the end of each quarter where the taxable income is positive. However, it appears that where the taxable income for the quarter is negative, losses are to be allocated to investors and refunds will be made direct to the investor by IRD:

3.2.1. It is likely that negative returns will be experienced in many funds at least once a year. This will create a significant workload for IRD;

3.2.2. In many cases it will result in over-taxation as investors will not claim (or may not be in a position to claim) refunds. This is likely to be more prevalent for those whose investments are relatively small, where the actual amounts overpaid are similarly relatively small;

3.2.3. It is not likely that the amounts refunded will be reinvested;

3.2.4. We submit that the tax liability of the PIE should, at the option of the trustees, be determined on an annual basis as now so that losses can be

carried forward in the PIE until the end of each financial year. This reduces the probability of IRD intervention, as it is not so likely that the return for the year will be negative. This would include the continued payment of provisional tax on the same basis as now;

3.2.5. The washing out of losses will also make returns from PIEs appear uncompetitive with tax applying on all quarters with gains and quarterly losses being reflected fully in the investor's interest in the PIE. Performance measurement will be problematic.

4. Requirement for "independent management":

4.1. The Bill as drafted introduces an independent management requirement for a PIE such that no investor, or associated person, can have a power to influence making or disposing of investments:

4.2. A common feature of employer based superannuation schemes is that employees (who are usually also members) will become trustees. Indeed, in some countries, this is compulsory. As drafted, the Bill appears to preclude a PIE operating on this basis;

4.2.1. While these people would be in a position to influence investment decisions, it is hard to see that they would be able to do so for some tax advantage. They are unlikely to be involved in the day to day investment of fund assets;

4.2.2. We submit that this requirement should be drafted so as to make it clear that this exclusion does not apply in these circumstances;

4.3. It is often the case that an employer sponsor of an employer based superannuation scheme will have a degree of control over the trustees (for example the employer may be able to appoint and remove trustees) and the employer can often determine to wind-up the scheme.

4.3.1. Employer appointed trustees might well be directors of the employer and also scheme members. Removing trustees and instigating the wind up of the scheme are expressions of influence over making and disposing of investments

4.3.2. We similarly submit that this requirement should be drafted so as to make it clear that this exclusion does not apply in these circumstances;

4.4. Many CIVs offer investment choice whereby investors' choices can influence the investment strategy of the CIV and, ultimately, the making or disposing of investments. This requirement must reflect the availability of investor choice and ensure that investment choice facilities will not lead to a breach.

4.5. In addition, we do not believe that it is possible for managers to satisfy this requirement in respect of associated persons. They simply may not know;

4.6. It also needs to be recognised that many CIVs will have the opening units (seed capital) purchased by the manager;

5. Difficulties with other requirements:

5.1. We anticipate that employer based superannuation schemes may find it difficult to comply with the investor class requirement, the investor interest adjustment requirement, the investor interest size requirement and the investor interest repurchase requirement;

5.2. The investor class requirement in particular may be problematic for such schemes offering investment choice facilities if each investment choice is considered to be a separate portfolio investor class and less than 20 members use a particular option. We believe that this requirement should not preclude schemes offering investment choice and submit that the Bill should be clearly worded accordingly;

5.3. The investor interest adjustment requirement could cause difficulties for trustees of defined contribution schemes that operate on the basis of an annual declared interest rate for the distribution of investment income. The requirement appears to require quarterly distributions;

5.3.1. To enable this requirement to be met would require trustees to amend their trust deeds at some cost;

5.3.2. Changes of this nature can more easily be achieved by the legislation including an enabling power for the trustees;

5.3.3. We do not believe that the Bill as drafted includes an enabling power as the wording would need to empower the trustee to act notwithstanding anything in the trust deed for the relevant scheme or anything in the Superannuation Schemes Act;

5.4. For defined benefit schemes the investor interest adjustment requirement seems to be inappropriate as all taxable income will be subject to tax at the 33% rate. We believe that the wording must clearly indicate that this requirement does not apply to these schemes.

6. Penalties for breaches of PIE requirements:

6.1. We understand that breaches of the PIE requirements (other than those referred to) cannot be condoned, and it is reasonable for there to be penalties;

6.2. As presently drafted however, it appears that there is little flexibility for the Commissioner to review any particular situation, even after some time has elapsed;

6.3. The significant number of requirements that must be met on an ongoing basis could well lead to unintentional breaches;

6.4. We submit that the Commissioner should be able to review applications to be reinstated as a PIE in circumstances where the applicants can show that such a review is reasonable - for example, where the persons responsible for an earlier breach have been replaced or the breach was inadvertent.

7. Investors advising the rate of tax to be applied to their taxable income in a PIE:

7.1. We do not believe that it is practical for investors to be required to advise their applicable tax rate every year. The same basis as is currently applied in respect of interest bearing deposits should be satisfactory (i.e. on commencement and whenever a different rate becomes applicable);

7.2. In many cases it will be difficult for investors to judge which tax rate to advise. Market volatility (particularly in respect of overseas investments with the additional currency risk) is relevant in this regard. Using the previous year's taxable income will often result in the wrong rate being used inadvertently, particularly as it must include the amount of PIE income in the year concerned. Finalisation of the amount of taxable income would not usually be completed in time for the first quarterly attribution each year;

7.3. Investors selecting the wrong rate should not be penalised arbitrarily, other than where there is reason to believe that a lower rate has been selected deliberately;

7.4. We also submit that the balancing payment arrangements applied for bank deposits should be applied in respect of PIE income (i.e. balances or refunds should be dealt with through IRD at the end of each year);

8. Rate of SSCWT:

8.1. The Bill introduces measures to prevent abuse of the progressive SSCWT basis by excessive salary sacrifice. We acknowledge that abuse is possible although ASFONZ does not believe it to be widespread. We have seen no evidence of the prevalence of excessive salary sacrifice;

8.2. We believe that the proposed changes will result in most employers that have offered progressive SSCWT reverting to the deduction of the full 33% rate as the calculation basis becomes more complicated;

8.3. The introduction of a further set of thresholds is likely to prove confusing (there is one set for income tax, another proposed for the selection of tax rates by investors, and yet another for determining the progressive SSCWT rate). We recommend that further thought be given to reducing the number of different thresholds.

9. Inequities arising from transitional arrangements:

9.1. CIVs becoming PIEs are given a three year period for the payment of tax in respect of gains arising at the point of transfer. Other CIVs are not given any transition period;

9.2. We believe that given the long-term nature of these investments, this is not a reasonable period and creates unnecessary inequities between investors. This applies particularly to investors withdrawing just before and just after the change;

9.3. We submit that tax arising at 1 April 2007 should be spread for all entities and that the spread should be over a longer period, and suggest that at least 5 years is required;

9.4. Certain holdings of CIVs are also required to be valued at market value on transition, whereas individuals would be able to use the higher of market value or cost. It is not clear why this distinction has been made and we believe that it is inequitable;

9.5. We submit that CIVs should be able to use the higher of market value or cost to determine the gain on transition. CIVs do after all only reflect the collective holdings of individuals.