

ASFONZ

(The Association of Superannuation Funds of New Zealand)

Part 2 of our submission on the discussion document concerning taxation of investment income

The treatment of collective investment vehicles

Issues of implementation

30 September 2005

Taxation of Investment Income – a discussion document

Comments on implementation issues and industry concerns in relation to proposals set out in the government's discussion document - "The treatment of collective investment vehicles and offshore portfolio investments in shares".

Summary of our approach

ASFONZ agrees that the tax treatment of "collective investment vehicles" ("CIVs") needs to change. What we have is both illogical and unfair. The paper recently issued by the Minister of Finance requested comments on a number of issues of detail concerning the government's recently announced policy.

ASFONZ decided to take a two-stage approach to its submissions on the Discussion Document:

- in our initial paper, released on 7 September, we addressed issues of principle;
- in this follow-up paper, we address practical issues that are raised by the proposals described in the Discussion Document.

Our initial paper says that ASFONZ thinks that a "first principles" approach has not been taken to date. ASFONZ suggests that the Discussion Document's key recommendations are both illogical and unsound. They will inevitably produce unintended consequences. They will introduce an unnecessary layer of complexity that will at the same time raise costs, lower understanding and increase inequity. Because they are unsound, the complexity will inevitably increase as providers game the system and test the boundaries.

ASFONZ strongly believes that New Zealand does not need the Discussion Document's framework in order to develop a logical and fair basis for the tax treatment of both CIVs and their members/investors. In summary, our initial paper suggests a broad, more "natural" framework that should be used instead. ASFONZ continues to urge the government to restart the process of developing a robust and workable framework for the tax treatment of CIVs and their members.

In this paper we address issues that are of concern should the Discussion Document's own proposals proceed. Our particular concern is in respect of the impact of the proposals on employer sponsored superannuation schemes.

The rationale for the Discussion Document's proposals is to fix distortions in the present tax system and make it more attractive for savers to make portfolio investments through CIVs. ASFONZ understands the reasons for seeking to align tax rates with individuals' marginal tax rates. However, ASFONZ suggests that the proposals in the Discussion Document add new distortions (e.g. a possible¹ bias towards investment in New Zealand instead of overseas shares) and also add significant administrative complexities that may increase the overall costs (including tax) of investing in CIVs. If the solution introduces additional costs that mean the net return for an investor with a tax rate less than 33% is the same as, or worse than, at present, the tax alignment has served no useful purpose.

¹ On the face of things the proposals may imply a bias to New Zealand shares. However, the removal of tax on the capital gains (and losses) for New Zealand shares will increase the return volatility (risk). The reverse is the case for overseas shares. Hence on a risk adjusted basis the bias may in fact be to overseas shares.

This submission focuses on aspects of the proposals that are expected to introduce additional costs and create anomalies.

Format of this submission

The Discussion Document raises a significant number of issues, many of which are inter-related. We have structured our submission to follow (as much as possible) the order of the Discussion Document (including the chapter numbers and headings) and offer input on the questions raised, highlight other issues and offer possible solutions.

There is no aspect of this submission that should be withheld on the grounds of privacy, or for any other reason. ASFONZ will be making this submission publicly available at the time when it is sent to the Policy Advice Division of the Inland Revenue.

Chapter 1 – Introduction

1(i) Desired outcomes of the reforms

The introduction to the Discussion Document states (paragraph 1.2) that the objectives of the proposals are to have tax rules that operate efficiently and that avoid distorting investors' decisions by having differing tax treatments for income from investments that are similar in nature.

We strongly support these objectives but are concerned that they will not be met through the implementation of the proposals.

We suggest that the proposals will distort an investor's decisions in that:

- i) the tax treatment of domestic equity investments is favourable relative to the tax treatment of offshore portfolio investments;
- ii) "income" derived via a qualifying collective investment vehicle ("QCIV") will be treated differently to income from direct investments as far as student loans, family assistance and the like are concerned;
- iii) individual investors will qualify for a partial tax exemption (up to the \$50,000 cost price prescribed under the "de minimis" exemption) on offshore portfolio investments;
- iv) complying individual investors will pay tax on offshore portfolio investments on a partially deferred basis due to the operation of the volatility cap. Such tax deferral will not be available to CIVs (or QCIVs).

Paragraph 1.12 of the Discussion Document cites alternative objectives, stating that the proposals outlined are aimed at better aligning the tax treatment of direct and indirect investments in New Zealand shares, and ensuring that a reasonable level of tax is payable on offshore portfolio investments. We see these objectives as being quite different to those set out in paragraph 1.2. In this context it would be useful to have information on the tax that is being paid on offshore portfolio investments to assess the magnitude of the current problem.

We accept that, in the absence of change, there may be a problem with the current regime from a tax base maintenance perspective. However we hear from some commentators that the proposed changes (and the significantly increased tax impost on offshore holdings) may result in lower levels of compliance from direct investors in respect of offshore equity holdings. In the absence of the technology to enforce the new regime, tax base maintenance issues are not resolved by the proposals.

Later sections of the Discussion Document suggest a further objective when considering possible options for reform. This is the avoidance of the need for tax returns as a consequence of the reforms. While we recognise that the completion of returns implies compliance costs for both investors and IRD, we caution against making the avoidance of any need for tax returns an overriding consideration. We believe that technological solutions may well be available to IRD to pre-empt such compliance cost concerns.

1(ii) The tail wagging the dog

The introduction references the Government's KiwiSaver proposal and the need to ensure that earnings from such investments are taxed fairly and consistently. It would be a case of the tail wagging the dog if the timeline for implementation of changes to the taxation regime for existing collective investment vehicles is dictated by the timeline for KiwiSaver.

Assuming an 8% contribution rate for an employee with an income, derived solely from wages, of say \$47,000 (being an income level qualifying for tax under the proposed QCIV regime of 19.5%) the reduction in the tax on the investment earnings assuming a 10% return (and no expenses) over the first year of membership of KiwiSaver would be less than \$40. For a KiwiSaver contribution rate of 4% the tax reduction would be half this.

We believe that changes should not be made in haste for existing schemes due to KiwiSaver. Given the complexities of the changes required, the proposed implementation date of 1 April 2007 seems unrealistic. It would be possible for providers of KiwiSaver vehicles to establish systems that will cope with the mechanics of flow-through yet maintain the current assessable income definitions for portfolio equity investments to allow the changes to progress in a more considered fashion.

Chapter 3 – New Tax Rules for Collective Investment Vehicles

3(i) Elective regime

We support the new regime operating on an elective basis. Paragraph 3.1 appears to contemplate that existing schemes will seek to move into the QCIV regime in a matter of time. This is not necessarily the case, as an election to become a QCIV is likely to increase the tax payable for many schemes and increase the compliance costs. We expect trustees of most schemes to remain outside the QCIV rules while the regime remains elective.

If there is an intention for the “elective period” to be transitional only, then this should be highlighted from the outset. In the absence of such disclosure, trustees may incur unnecessary expenses in making modifications that will be short-lived.

Examples of such modification include arranging transfers out or establishing mirror-schemes for current low marginal tax rate members.

We expect that a condition of being a KiwiSaver scheme will be for the vehicle to be a QCIV. The issue of whether or not it will be acceptable for a new non-KiwiSaver collective investment vehicle to stay outside the QCIV regime is not directly addressed. We assume that this must be the case as it can be achieved in a de-facto way by failing the definitional requirements.

We seek confirmation that non-qualifying (or non-electing) CIVs will be able to continue to operate on the same basis as at present. This includes the continuation of the binding rulings regime (new, current and renewals) in respect of passive NZ equity funds.

3(ii) Principal activity of savings and investment

Registered superannuation schemes are required to have been established principally for the purpose of providing retirement benefits. The Discussion Document suggests that a QCIV must have savings and investment as its “principal activity”. While it might be argued that these two are not the same, we believe that having been established for the principal purpose of retirement saving (on the “benefits side”) is consistent with having a principal activity (on the “assets side”) of savings and investment. Indeed, it is based on similar logic that registered superannuation scheme trustees are treated as being “persons whose principal business is the investment of money” (and therefore not as members of the public) for securities legislation purposes. In applying for QCIV status we would expect that confirmation of registered superannuation scheme status would be adequate proof that the “principal activity” condition has been satisfied for superannuation schemes. We recommend that a specific condition should be inserted to that effect.

3(iii) Minimum number of investors

It is proposed that a minimum of 20 non-associated investors will apply. While we expect that, in general circumstances, this requirement will not be onerous, there will be times when it may be breached. Rules need to allow for temporary breaches of the minimum without jeopardising the scheme’s QCIV status. An example of a situation where the minimum may be breached is when a corporate restructuring requires transitional arrangements. A transfer-out on equivalent terms may be offered with any member who does not make such an election remaining in the current scheme (given that written consent for the transfer is a regulatory requirement), which may then be wound up or may continue. In such situations, the 20 member minimum may be breached. More particularly, any scheme that is closed to new members and allowed to “run out” will inevitably breach the requirement at some point.

We note from section 3.15 of the Discussion Document that this “minimum number” requirement will be satisfied if the QCIV invests into another QCIV (e.g. where a wholesale fund provides investment management services for a retail fund that is a QCIV). We believe that this concession should extend to other CIVs that are widely held (e.g. where the wholesale fund is a widely held CIV that has not elected to be a QCIV) and would see confirmation that this is intended as helpful.

3(iv) Owners are portfolio investors

It is proposed that a QCIV have a maximum holding in any one asset of 10%. An exception allowing a QCIV to have more than a 10% interest in another collective vehicle is essential and we support this exception. It would be helpful for confirmation also to be given that “above 10%” can equal anything up to 100%, as a number of schemes are invested entirely in a single wholesale superannuation scheme. Again, we do not believe that the other CIV should need to be a QCIV itself and clarification is sought that this will be acceptable in circumstances where the other CIV is well diversified (e.g. the investment held could be an Australian unit trust holding Australian equities – not an uncommon arrangement for this asset class where local fund managers are using the expertise of an Australian parent).

We note the comments in relation to the difficulties that may be encountered by property trusts. Exposure to property holdings is commonplace for registered superannuation schemes and access to suitable pooled arrangements is important. In addition, it is not clear how a scheme that owns 100% of a commercial property or properties will fare in meeting the portfolio investor requirements.

3(v) One class of unit on issue

Paragraph 3.36 refers to QCIVs that do not offer units (such as defined benefit schemes) as not being subject to this requirement as they do not operate on a unitised basis. In fact, a significant number of defined contribution schemes also operate without unit pricing and we would expect these schemes also to be exempt. The point here is that the vehicles ought not to operate in such a way that sources of income are streamed to different investors. We understand that there is no intention to prevent a QCIV from offering a range of investment options (and if unitised therefore a range of units). We suggest that the terminology “unit” may create confusion relative to current industry terminology.

3(vi) QCIV a taxable entity

The Discussion Document proposes that the investment management fees derived by a QCIV would be taxable. It is not clear what this means in practice for an employer sponsored superannuation scheme. The trustees of such a scheme will almost invariably employ professional investment managers to manage the assets on a day-to-day basis. This may be via a collective investment arrangement or as a direct mandate. In this situation investment management fees are not “derived” by the trustees rather they are paid out.

If such a scheme has attributed all of its income and expenses under the flow-through regime, we do not understand why the scheme would have a tax obligation in respect of its operations.

This aspect of the proposal needs to be clarified. There is further reference to the rationale for making investment management fees assessable in Chapter 4. We discuss that later in this submission.

Chapter 4 – Proposals to Achieve Neutrality and Align Marginal Tax Rates

4(i) An alternative proposal – who should be responsible for final tax calculations?

Chapter 4 of the Discussion Document sets out the mechanics for the “flow-through” model. The objective is to align the rate of taxation on investment income with a rate appropriate to the marginal tax rate of the individual.

The proposals in the Discussion Document impose the tax administration burden squarely on the trustees and providers of QCIVs. We believe that this role more appropriately falls within the responsibility of the IRD and that a model with IRD at its core will improve the efficiency and accuracy (and therefore fairness) of the final result.

In Part 1 of our submission, we suggested an alternative proposal. Our proposed alternative is described below and has features similar to the withholding tax system that applies to millions of New Zealand bank accounts:

1. Investors provide IRD numbers to QCIV providers on entry, and if appropriate (depending on whether optional withholding tax rates are offered by the QCIV) nominate a withholding tax rate. If no IRD number is provided, the top withholding tax rate applies (39%). A possible variation would be for new members and/or existing members to be required to provide IRD numbers as a condition of entry.
2. On attribution dates, the QCIV providers deduct withholding tax at the nominated or default rate and this is remitted to the Inland Revenue. We suspect that for ease of administration, and to minimise administration costs, some QCIVs might choose not to offer a choice of rates and would apply the same rate across all investors.

The IRD could regulate this so that vehicles were required to use the withholding tax rate expected to minimise the numbers of investors or investor accounts that IRD would later need to deal with.

3. At the end of year, and on final exit from the QCIV, the QCIV provider would provide the investor and the IRD with summarised details of the transactions through the investor’s account. This would include the gross income, deductible expenses, imputation credits, foreign tax credits and withholding tax deductions. Under the new taxation regime, collective investment vehicles will no longer accumulate deferred tax assets and liabilities, so only transitional measures will be required to accommodate any residual tax losses currently held by collective vehicles.
4. The IRD would then match the investor’s QCIV details with the taxpayer’s file and determine whether there was further tax to pay, or whether a credit was due. To avoid the need for taxpayers to file returns the “square-up” process would take place between the IRD and the QCIV with credits being applied to the investor’s account in the QCIV and tax payments being deducted from the investor’s accounts. The end of year file supplied to the IRD would note exited investors and the IRD

would need to deal directly with such taxpayers in respect of the “square-up” process. We envisage that QCIV providers would warn exiting investors of their potential tax obligations.

These proposals represent a significant change from current practice and would necessitate significant changes to systems to accommodate the “flow-through” aspects of the model (see the comments on the complexity of flow through administration made in the 2nd paragraph of section 4(vii) below. Similar issues are relevant here). The IRD would also need to modify its systems to manage the square-up process. QCIVs should be permitted to use the IRD number of the investor as a unique identifier to simplify the matching process. We understand that the Australian Tax Office runs aspects of its superannuation taxation system using a similar approach, in which money transfers are managed between the scheme and the ATO without the need for direct involvement of the taxpayer in most cases.

Despite the inherent complexities, we think that this proposal offers a better result than the “flow-through” model described in the Discussion Document. Our reasons for this include:

- a) The entity with access to an individual’s tax records is responsible for the final tax determination. This moves the burden from a large number of providers of QCIVs (each of which would need to develop its own processes) to a central body (where only one process would be required).
- b) Responsibility for an individual’s losses, excess imputation credits and the like falls to the IRD. This will improve portability for investors between QCIVs as they will no longer forfeit tax credits held in particular QCIVs and will reduce the complexity for the providers of QCIVs with each such provider maintaining such details for each of its investors.
- c) It removes the need to set arbitrary tax thresholds as proposed in the Discussion Document’s model because the final tax is imposed at the correct marginal tax rate for the investor. The obligation on QCIV providers to collect information each year from taxpayers is removed, although those that offer optional withholding tax rates may still choose to do this and to vary the rates at the request of the investor. A pragmatic approach to timing issues should be taken to avoid complex use of money interest issues.
- d) The information held by the IRD will enable policymakers to make robust policy decisions, as income information that would otherwise not be made available will now reside in the tax-payer’s file. The Discussion Document takes an unusual stance on the relationship between returns from a QCIV and social policy initiatives.

At paragraph 4.86, we read:

More importantly, the requirement for investors in a QCIV to file a return would also affect a number of social policy initiatives that are delivered or collected through the tax system. They include:

- *payment of family assistance;*
- *collection of child support payments;*
- *student loan repayments.”*

The Discussion Document (paragraph 4.88) then went on to suggest that QCIV-derived income should be excluded from the definition of “income” for these purposes.

In our view, income arising in QCIVs should be considered when developing social policy initiatives. The fact that information is made available does not of necessity mean that the information needs to be taken into account in determining the payments made to or required from a taxpayer. Under previous legislation only 50% of a pension from a registered superannuation scheme was taken into account in determining a person’s New Zealand Superannuation entitlement under the “surcharge” provisions. With advances in technology, we are sure that policy decisions on the extent to which QCIV income is taken into account could be managed.

- e) The model we propose offers an optional extra. At present, employer contributions to superannuation schemes are subject to SSCWT at rates which, at the employer’s election, may be set to reflect the income paid to an employee in the preceding income tax year. The mechanics of this have led growth in the practice referred to as “salary sacrifice”. Under a salary sacrifice arrangement, an employee can forgo salary for future pay periods in exchange for employer contributions to a registered superannuation scheme which are then taxed at a full and final SSCWT rate lower than that of the PAYE tax that would otherwise be payable. The tax avoidance opportunity this creates has led to complex Fund Withdrawal Tax legislation.

With the information transfer to the IRD in place for investment income, it would be a relatively simple extension for the information and money flow between the QCIV and the IRD to include details and deductions in respect of the employer contributions made on behalf of the employee. Policy options for managing or removing the “salary sacrifice” option would become available under such a system that simply cannot be managed from a logistical perspective under the current model. The obligation to manage SSCWT would be removed from the employer. This is likely to make it more attractive for employers to make contributions to KiwiSaver schemes on behalf of employees. The need for superannuation schemes to manage the complex process of calculating and remitting Fund Withdrawal Tax, “FWT” (pointless complexity in most cases, as FWT liabilities are almost never triggered given the available range of exemptions) would also disappear.

Adopting this proposal would still involve considerable amendments to systems and processes, at some cost. Nonetheless, we believe that it would result in a much more robust and fairer system. Issues relating to unvested amounts and defined benefit entitlements would need to be resolved with either proposal.

4(ii) A new definition of assessable income for domestic equity holdings in QCIVs

We do not support the proposed changes to the definition of assessable income for QCIVs. Our recommendations are set out in Part 1 of our submission. In summary, we believe that the determination of assessable income should be based on a look-through approach. We believe that the appropriate tax treatment for traders of domestic equities is for the capital gain to be taxed. However trustees need to be confident that shares which are acquired on capital account will not be treated as revenue account investments by the IRD. We agree that trustees in some situations have defaulted to holding investments on revenue account due to uncertainty as to the stance that would be taken by the IRD and the need to avoid intergenerational equity issues. We recommended in Part 1 of our submission that, rather than applying a blanket exemption for capital gains (as suggested in the Discussion Document) practice notes are issued to allow trustees to operate capital account holdings with confidence.

The proposal to exempt trading gains within QCIVs yet continue to tax trading gains for direct investors seems to contradict the stated objectives for the new regime. On the face of things, the establishment of a small share-club (with no one investor holding more than 10% and at least 25 investors) would allow existing share traders to form a QCIV for domestic share investments and avoid paying the tax they pay now on trading gains. The Discussion Document contemplates that such investors ought not to be taxed as they will have ceded control over investment management and will incur investment management charges. We do not see that either of these premises will necessarily be satisfied. They are also not founded on principle.

The example following paragraph 4.21 in the Discussion Document appears to suggest that taxing the investment management fees will in some way act as a proxy for taxing the trading gain. We do not believe this to be the case. If the fee were at a level commensurate with the potential active management gain, then no right minded investor would invest actively as the active management gain would be lost through fees.

The conclusion reached in this example seems to be, essentially, that because the investor has paid a fee and ceded control of the decision making process to the CIV, then the CIV should not be subject to tax on capital gains made. This conclusion seems to suggest that the perceived IRD approach to such gains (that they are taxable as the CIV is a trader) has been incorrect and unjustified for a number of years.

This supports the view that it is not reasonable or necessary to link the “removal” of gains from NZ equity investments to the implementation of a flow through regime.

4(iii) What is a “New Zealand share”?

We see the proposed changes, which afford favourable tax treatment to NZ equities (0.1% of world share markets by capitalisation) compared to offshore markets (99.9% of world share markets) being viewed as a challenge by the investment industry. There will be an incentive for providers to game the rules to establish vehicles that look like New Zealand shares but may, in reality, be something quite different. If this leads to uncertainty and complexity in the definition of a New Zealand share it will be a backward step.

Clearly the definition of a New Zealand share cannot simply be a share that is listed on the New Zealand Exchange. Based on the apparent principles underpinning the Discussion Document’s proposed concession, we assume that companies that pay tax on their incomes and pass a dividend with imputation credits to New Zealand shareholders would be treated for this purpose as a “New Zealand company”. Many would be surprised to discover that a number of listed entities would not qualify under that principle. Companies like BIL, Nufarm, the main trading banks and listed UK trusts would all be excluded. Taking Westpac as an example, New Zealand shareholders own shares in the Australian listed company. That has a subsidiary in New Zealand that probably pays tax to the New Zealand government. That tax is not reflected in the dividends that a New Zealand shareholder receives. Despite the main Westpac shares being listed locally, it presumably will not qualify as a “New Zealand company.” Most New Zealanders would be surprised at that outcome and we suggest that this undermines the Discussion Document’s thesis.

Furthermore we are concerned about the tax distortion that the proposed treatment of New Zealand shares may introduce to decisions in respect of access to property investments. Why invest directly in property if an investment in an LPT (listed property trust) will remove tax on the capital gain? Tax will be driving the investment decision, the very situation the Discussion Document proposals are supposed to be rectifying.

We note that the Discussion Document makes no attempt to define “New Zealand share”.

Our preference (refer to Part 1 of our submission) is for the differential treatment of equity holdings based on the issuer’s domicile not to proceed. In the absence of any success in this area, we encourage policy makers to ensure that absolute clarity is provided on this matter as soon as possible.

4(iv) Linking flow-through and changes to domestic share taxation

As mentioned above, the proposed exemption from taxation of capital gains on domestic share holdings is conditional on the adoption of the flow-through proposals. However, changes to the taxation of international equity portfolio investments will apply regardless. There is no explanation of why the other change has been made conditional. However, it could reasonably be assumed that the rationale may well be not to give the tax on trading gains away without the imposition of an increased rate of tax on other asset classes. This leads to a difficult position for trustees which we discuss further under the heading, “A Trustee’s Dilemma” on page 11.

The requirement also seems open to being legally avoided. A possible response may be for the trustees of an existing vehicle to cease to incorporate an allocation to domestic equity in their non-QCIV scheme, transfer any current domestic equity holdings to a second scheme which is a QCIV. This second scheme will apply flow-through and with only domestic equity holdings in the portfolio, the only assessable income will be dividends which are subject to tax at the investor's marginal rate. The portion of future contributions that would ordinarily have been directed to domestic equities will be channelled to the second QCIV vehicle. The investor will have assets in two vehicles but will have almost the same tax imposed as would have applied had the new assessable income rules applied in the original scheme. The difference in the tax will simply be an extra tax obligation on the dividend receipts for the domestic equity investment. There would also be some additional administration costs. If such a construct is possible we question why it is necessary to impose the conditionality.

Describing this type of response to the conditionality allows us to emphasise a point that we made in part 1 of our submission (and also in this part 2 submission) – regulators could write rules to prevent the operation of the structure we describe. However more (and more detailed) rules usually open up further opportunities to create tax-efficient arrangements. The process becomes more complex and more expensive to administer for all, including the regulators. That is one of the main reasons we support more “natural” definitions of “income”.

The Discussion Document does not make it clear whether or not the current binding rulings for passive New Zealand equity funds will continue to apply nor whether extensions and new rulings will be available. This is an important issue for providers in determining whether or not to opt in to the QCIV regime.

For the reasons given above, we suggest that CIVs should not be automatically considered traders, as is generally the case currently, in the absence of a binding ruling. The proposal to link flow through and exemption from tax on capital gains from NZ equity investments should be removed.

4(v) The Trustee's Dilemma

The proposals are structured so that becoming a QCIV is to be elective. This means that the trustees of a registered superannuation scheme will need to consider the appropriate course of action for their scheme.

This is likely to be a complex and vexed decision.

On the one hand, electing into the QCIV regime will allow them to avoid tax on domestic equity capital gains; on the other, electing into the regime will come with an increase (from 33% to 39%) in the tax imposed on members with incomes in excess of \$70,000 with respect to all other asset sectors and on NZ dividend payments. In addition, it can be expected that the costs of complying with the administrative requirements of the QCIV regime will not be insignificant.

It will be of concern to trustees that compliance with their duty to “act in the best interests of all beneficiaries” (as required by trust law) may be called into question by at least some members regardless of the decision made.

In employer-sponsored schemes, assets can be expected to be held predominantly in respect of members on high incomes. Accordingly, for a balanced mandate, it can reasonably be expected that by reason of opting in, the tax payable by the scheme will increase. Thus from an asset perspective, trustees ought not to “opt-in”.

However for some schemes (particularly where sponsoring employers operate in a low wage sector), it will be the case that the majority of members are on incomes that will allow for tax rates lower than 33% to apply within a QCIV. From a “member numbers” perspective, perhaps these trustees ought to “opt in”.

Typically though, schemes will have significant numbers of both higher and lower earning members, presenting trustees with a “no-win” scenario as they cannot advantage either group without disadvantaging the other.

It has been suggested that some trustees may look to create a mirror scheme – establishing the new scheme as a QCIV to allow low income investors the benefit of the reduced tax rates. We are concerned that such a perverse outcome is clearly detrimental to investors, as there is no appreciable change in the tax that will be collected by the IRD yet there will be a significant increase in administration costs that will be borne by the investors. This is almost certain to fall most heavily on low income investors (given that, in any mirror scheme, it will be the QCIV that bears those costs). Under current arrangements it is commonplace for collective vehicles to charge fees as a percentage of assets under management. In many cases this represents an implicit cross-subsidy from investors with high account balances, who generally speaking are on higher incomes.

Rather than implement a regime that simply results in additional administration costs it may be preferable for the top withholding tax rate simply to be set at 33%.

Given that only an estimated 12% of taxpayers have incomes that put them in the top tax bracket, and the Government’s stated desire of improving the savings rate of New Zealanders, this may not be a perverse decision. It may also reduce the level of non-compliance from investors who might otherwise be tempted to invest directly and not make full income declarations. Furthermore, with a company tax rate of 33%, the imposition of the 39% rate may be avoided by the more highly paid through the use of corporate and trust structures in any event.

4(vi) Direct versus QCIV treatment

Paragraph 4.27 states that the flow-through tax rules are designed to ensure that, as far as possible, tax rates do not disadvantage investors from investing via a QCIV rather than on their own account. We support this objective but would go further to suggest that the rules should seek to not create any unintentional advantage to an investor through using a QCIV. In 4(i), we describe an

alternative method that we think affords the tax base better protection from investors who may seek to avoid very high effective marginal tax rates through the use of QCIVs.

4(vii) Attributions

The Discussion Document proposes two methods of attribution - quarterly (or more regularly) or annually with extra attributions at the time of exit for members who leave the scheme during the year. The Discussion Document (pages 32 and 33) sets out examples of the operation of the attribution process. We think that the operation of the periodic attribution process suffers from the potential for inequities to arise.

In practice, most funds will experience inward and outward cash flows on a daily basis, and investment activity will take place daily. Equity issues have led large schemes to operate daily unit pricing systems, and we expect that the natural corollary to this will be for notional allocations of assessable income on a daily basis with “memoranda accounts” recording the individual investors’ associated tax obligations. Providers of collective investment vehicles with fluctuating income levels will not wish to attribute to investors too frequently as negative allocations (in the absence of an ability to seek an immediate refund from the IRD for the tax loss) will complicate systems.

We are concerned that the complexity of the flow through regime may have been underestimated. In the Appendix to this submission we set out a model of a unitised CIV with very simplified cash flows along with some options for income attributions. It does not take much imagination to appreciate how complex the management of flow through will become with more realistic cash flows.

The Appendix also implies that the current proposals may have the unintended consequence that the introduction of considerable complexity in the registry functions and in accounting for tax will create barriers to entry and reduce competition amongst providers of investment management services. We already have seen significant contraction in the number of providers in New Zealand. We face the issue that New Zealand is a small market lacking the scale that enables the efficiencies available in bigger market places.

We believe that it must be possible to devise a simpler, cost effective way of achieving a flow through regime. We have made several suggestions to achieve this.

4(viii) Cancellation of units / determination of earning rates – trust deed changes

The attribution process required under the flow through methodology may well require the cancellation of units and/or the use of a range of unit prices reflective of the investors’ tax rates. As noted in the Discussion Document, this may require legislative empowerment to over-ride amendment limitations in trust deeds. For collective vehicles that operate on a non-unitised basis, trustees will need to be able to declare investment returns that vary by investor. We suspect that many superannuation scheme trust deeds may not accommodate carrying forward tax losses and imputation credits at the individual member level. Empowering legislation may also be required in this area.

On a similar note, the potential to establish mirror schemes as QCIVs for the benefit of 19.5% taxpayers has already been noted. It would be beneficial if the advantages of doing so were to be recognised by legislation which allowed bulk transfers of superannuation scheme members to another scheme with identical provisions (without trustees first having to elicit members' prior written consents or comply with prescriptive notice requirements). The Superannuation Schemes Act 1989 does not currently allow this. If the trustees conclude that such a transfer is clearly in the interests of either all or a particular group of beneficiaries then we suggest that they should have the power to move the members without written consent.

In addition, it should be permissible for a mirror scheme to be a separate section of the same scheme, with each section recording assets that are only nominally allocated to it (the many superannuation schemes featuring different sections at present are single legal entities and all investments are owned by the entity rather than each section). Legislation will need to ensure that such arrangements do not fall foul of any requirements relating to offering a single class of unit (see section 3(v) above).

4(ix) Natural persons

Membership of registered superannuation schemes is restricted to natural persons and trustees of other registered schemes. If a superannuation scheme elects to become a QCIV will this requirement be waived? In the absence of a change superannuation schemes may be at a disadvantage to other CIV types that will be able to attract as investors, both trust and corporate investors. We suggest that the requirement should be relaxed.

4(x) Tax remissions

The model proposes that tax will be remitted to the IRD by the 20th of the month following attribution. Provisional tax obligations will disappear. Depending on the frequency of attributions, this will either advance or defer the payment of tax to the IRD. The Discussion Document appears to suggest that there would be use of money interest determinations made for the year.

We hope that we have misunderstood this. The system requirements for managing attributions at investor level are complex enough without adding a further complication through the need to make adjustments for use of money interest. We recommend that use of money interest does not apply in respect of QCIVs unless the IRD itself takes the responsibility for allocating the use of money interest amongst investors.

In practice, we expect that the majority of QCIVs will have redemptions, or exit payments, every month. This means that a tax payment will be made every month. In some instances, these will be for very small amounts. As a minimum we suggest a "de minimus" provision that exempts QCIVs from use of money and penalties on tax payments below, say, \$1,000. As a preference, we suggest that no use of money payments should apply to regular payments of this kind other than in exceptional circumstances.

4(xi) Anti-avoidance rules

We note the proposal to develop “wash-sale” rules. Registered superannuation schemes sometimes allow in-service access to account balances. It would not be uncommon for a member seeking an access payment nonetheless to continue with his or her regular contribution programme following the access payment. Contributions are therefore highly likely to occur within the 30 day period contemplated by the Discussion Document. The rules need to be drafted to exclude such situations from being deemed to be taxable events.

4(xii) The superannuation marketplace in practice

The Discussion Document contemplates a marketplace that consists of fully allocated defined contribution schemes. The reality is more complex.

a) *Defined contribution schemes*

The majority of employer sponsored defined contribution schemes operate a reserve account and hold unvested amounts in respect of members. These arise through the operation of what is known as “vesting”. An example may assist.

Example of vesting

An employer contributes \$1 for each \$1 contributed by the member. This amount, less SSCWT, is credited periodically to the member’s Employer Account in the scheme. The contributions made by the member are credited to his or her Member Account. Both accounts are updated with investment earnings net of investment expense and administration expenses.

On leaving the service of the employer, the benefit payable from the scheme is a lump sum equal to the balance of the Member Account plus the “vested percentage” of the Employer Account. Vesting scales vary in length from immediate vesting to as long as 20 or 25 years and may relate to service with the employer or membership period in the scheme.

If a Member has a Member Account balance of \$60,000 and an Employer Account balance of \$40,000 and he has reached the 25% vested level then his vested benefit is \$70,000 (i.e. his Member Account plus 25% of his Employer Account). If he leaves at that point then the residual \$30,000 is not paid back to the Employer but is retained in the scheme and credited to the Reserve Account. Reserve Accounts can be used in a variety of ways, commonly to meet expenses, to enhance the credited earning rate or in some cases where the trust deed permits, to pay the employer contributions or meet the cost of insured benefits.

The operation of vesting scales of the kind used in the example complicates the flow-through process.

The Discussion Document suggests that unallocated amounts should be taxed at the rate of 33%. Using the example above, we assume that this means (if our Member has a QCIV tax rate of 19.5%) that, of the money held in his Employer Account, the income on \$10,000 is subject to a tax rate of 19.5% and the income on the balance of \$30,000 to a rate of 33%. Conversely, for a Member on the QCIV rate of 39%, the income on \$10,000 would be subject to tax at 39% and the income on the balance of \$30,000 to tax at 33%.

How should these two Members' Employer Accounts be updated to account for the differential tax on the vested and unvested portions? It should be understood that "vesting" is normally a continuous process – during a year, a member usually becomes steadily vested in a greater share of the Employer Account as more service/membership is completed.

Regardless, it would be a perverse result if the member with the higher marginal tax rate were "advantaged" through the use of a rate lower than his marginal rate while a low income member is "disadvantaged".

We recommend that the proposals be modified so that unvested but allocated accounts are subject to tax at the same rate as applies to the Member's vested accounts. Whilst technically this creates the potential for tax to be applied at a rate lower than the marginal tax rate of the individual who ultimately derives a benefit, we think the scope for this being abused is slim.

The matter of what level of QCIV income the Member should include in assessing the appropriate QCIV rate for the next year also arises. If all accounts (including those not fully vested) are subject to tax on a flow-through basis at the member's QCIV rate then, despite the less than 100% vesting the full level of QCIV income should count.

Any Reserve Account held could reasonably be taxed at 33% for simplicity provided that the trustees have a Reserve Account distribution policy which ensures that members are treated equitably. In situations where the Reserve Account is used to meet employer contributions the rate of 33% is clearly appropriate, being equivalent to the corporate tax rate.

b) Defined benefit schemes

Defined benefit arrangements in the pure sense are the means of funding for an agreement between an employer and an employee to provide specified benefits, usually related to the employee's salary, at a future date and subject to contingencies. In the New Zealand context, the benefits are expressed net of tax due to the operation of the TTE regime.

We will illustrate the difficulties proposed by the Discussion Document with an example:

Example defined benefit scheme

A defined benefit arrangement provides that, on retiring from the employer's service on or after the age of 60, a lump sum will be payable in respect of each year of membership of the scheme of 12% of the average annual amount of base remuneration paid to the employee in the 36 months leading up to retirement.

The benefit is in no way linked to the investment return that is achieved on the scheme. The risk of poor investment performance falls to the sponsoring employer. A change in the tax imposed on the assets of the scheme alters the cost to the employer of funding the benefits and, in the absence of the employer seeking to adjust benefits as a result of tax changes, does not alter the benefits due in any way.

The same applies where benefits are paid as a pension rather than a lump sum – the change in the after-tax returns earned by the trustees has no connection with the on-going obligation to meet pension payments. It may change the balance of the cost of providing the pensions but not the pensions themselves.

As an extreme situation, consider a defined benefit scheme that operates on a pay as you go basis. The employer makes contributions on a ‘just-in-time’ basis to meet the promised benefit payments. In this scenario, there is no tax on the investment income (because there are no assets) so there is no scope to adjust benefits. The employer may have retained a reserve within its own accounts to fund the ‘just-in-time’ payment to the beneficiary. This reserve, being part of the employer’s assets, would have been taxed at the corporate rate of 33%.

In most situations however, assets are held by the trustees to fund the benefits. This does not alter the suggested approach as the appropriate rate of tax on trust assets is 33%. In view of the complexity, compliance costs and the sponsoring employer’s assumption of very significant investment risks and balance of cost funding obligations in order to meet a benefit promise, we do not believe that such an approach to defined benefit arrangements will result in a resurgence in the number of defined benefit schemes as a means to avoid the top marginal tax rate of 39%.

4(xiii) Significant QCIV income

The proposals include a suggestion that, where an individual has QCIV income in excess of \$15,000 and had elected a QCIV tax rate for an income tax year that does not reflect his income in that tax year, he will be required to file a tax return (and one assumes find the money to meet any resulting tax obligation).

This seems a relatively low threshold and, given the volatility of returns from one year to the next, it will not be a simple matter for investors to select the correct QCIV rate in any year.

We believe that our suggestions in respect of the IRD having the final tax responsibility (see section 4(i) above) will avoid the tax maintenance issue this provision is designed to ameliorate.

4 (xiv) Standardisation of income year

The costs of preparing statements for withholding tax obligations for an income tax year and completing annual review processes at some other balance date are likely to be considerable. Accordingly, the Discussion Document’s proposals lend themselves to collective investment vehicles balancing on 31 March. In fact, only 52% of registered superannuation schemes currently have a March balance date. These schemes rely on a relatively small number of providers for services and there will almost certainly be capacity issues if a significant number of existing schemes elect to be QCIVs. Consideration could be given to allowing QCIV income years for existing schemes to elide with the next standard income tax year. Thus QCIV income for a scheme with a balance date of 30 June would be taken into account in the following tax year.

4(xv) Turning the industry on its head (taxation and expenses)

Under the current regime, most superannuation schemes invest assets in pooled vehicles, generally unit trusts or registered superannuation schemes. This practice enables schemes to operate in a cost effective manner. Tax calculations are handled in the master pool and the investing trustees are able to pass deductible expenses up in exchange for tax-credits.

The move to flow-through will transfer the compliance expenses down to the individual schemes, thereby increasing operating costs. In addition, if the tax impost is at investing scheme level, how does the master vehicle obtain credit for the expenses that it has incurred; will these be passed down to the investing trustees?

The trustees of such master-trust vehicles need to have the flexibility to offer their investing trustees the option of maintaining the status quo (i.e. net returns and tax on domestic equity gains) or moving to the new regime and providing investing trustees with a gross return which they can then attribute to members.

This role reversal pushes costs down and has the potential to make smaller funds unviable. In addition, master trust providers need to have plenty of time to make the system and process adjustments to accommodate the new rules.

Finally, we raise the issue of the 19.5% rate itself. The Discussion Document seems concerned with the implications of the current 33% tax regime on members of the new KiwiSaver schemes. For the lower-paid members (less than \$38,000 of wages/salary) the Discussion Document's proposed "flow through" rate of 19.5% has no direct relevance. For employee members of KiwiSaver schemes, the tax rate on pay will be either 15%, 21%, 33% or 39%. The "flow through" rate of 19.5% will be relevant only to those who have no wage/salary and whose taxable income is less than \$38,000.

The regime that we suggested in part 1 of our submission (where the IRD does the final tax calculation) will correct this anomaly.

Chapter 5 – New Tax Rules for Offshore Portfolio Investment in Shares

- 5(i) Part 1 of our submission covered the concerns that we have about the proposed changes to the taxation regime for portfolio investments. As noted earlier, we accept that changes need to be made to the current regime but we do not believe that implementation of the Discussion Document's proposals will lead us to a better position.

Chapter 6 – Transitional and Outstanding Policy Issues

6(i) Unrealised gains on domestic equities

The proposed notional wind-up transition arrangements suggest that any unrealised gain on domestic equities will create an immediate tax obligation. This appears to be based on the premise (see Discussion Document section 6.16) that CIVs turn over portfolios on a regular basis. We believe this is not an accurate contention and that, in fact, core holdings may be retained for quite some years.

Further investigation is warranted to ascertain whether a discount (or some form of spread forward) ought to apply. We think it should.

6(ii) Certainty of position on transition

Investors who hold domestic equity investments on capital account prior to the transition to the new regime may wish to seek certainty from the IRD as to the tax treatment that has been adopted historically. This will avoid difficulties that may arise if the IRD subsequently claims that there was a liability on transition. We suggest the installation of a cost effective regime that allows investors to obtain that certainty in the form of binding rulings at the transition.

6(iii) Offshore portfolio investment in shares

Individuals, on the basis of the current proposals, will have the option for their grey list holdings of moving to the new regime with an opening value of the higher of cost or the market value at the transition date. For the “passive” investments of collective investment vehicles the proposed transition opening value is the market value on transition.

The commentary seems to miss the fact that many collective vehicles have these “passive” offshore portfolio investments. Bringing these into account at market value on the transition date will mean that, where such holdings are in a loss position, the recovery back to cost price will apparently be subject to tax. Given that they have been effectively holding these investments to capital account, there should be no question of a tax liability until the values exceed cost.

We believe collective vehicles should also be able to start with the higher of the two values.

Our organisation

The Association of Superannuation Funds of New Zealand Inc. ("ASFONZ")

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.

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APPENDIX

Unitised Collective Investment Vehicle (CIV)

Comparison to Show:

(1) The Current Basis of Operation (Simplified)

(2) Possibilities/Issues under a Flow Through Regime

A. Current Basis – Using Net of Expenses & Net of Tax Unit Prices (excluding Group Investment Funds [GIFs] which tend to deduct tax at the investor's nominated rate). These examples assume that there is no buy/sell spread in prices.

1. At day 1 of CIV:

1.1. Contributions received	=	\$100,000
1.2. Assets purchased (ignore expenses)	=	\$100,000
1.3. Number of units	=	100,000
1.4. Unit price	=	\$1.000

2. At, say, day 10 (assuming no other transactions):

2.1. Purchase price of Assets	=	\$100,000
2.2. Increase in value (taxable)	=	\$2,100
2.3. Income received (taxable)	=	\$2,100
2.4. Less Deductible Expenses	=	\$100
2.5. Less Fees (deductible), say	=	\$100
2.6. Net Taxable Income (2.2 + 2.3 – 2.4 – 2.5)	=	\$4,000
2.7. Less tax on \$4,000 @ 33%	=	\$1,320
2.8. Total Net Value of fund	=	\$102,680
2.9. Number of units	=	100,000
2.10. Unit price = \$102,680/100,000	=	\$1.0268

3. Distribution of Income (see also 4.2 below).

- 3.1. A number of CIVs, generally unit trusts, make regular distributions of income to investors (a dividend distribution). Distribution may involve the distribution of some or all of the net investment income, including or excluding any realised capital gains. Distributions are made net of tax @ 33%.
- 3.2. The unit price is reduced to reflect the income distributed.
- 3.3. Imputation credits are issued for use as tax credits for the tax deducted from the amount distributed.
- 3.4. If insufficient imputation credits are available to cover the full amount of 33% deductible, an additional RWT deduction is made such that total credits (imputation credits plus RWT) totals 33% of the nominal gross dividend (i.e.

so that the net amount distributed equals 67% of the nominal gross dividend).

- 3.5. NRWT will also be deducted if the investor is not a NZ tax resident.
- 3.6. NZ investors who are 19.5% taxpayers can use the imputation credits to reduce the tax rate to 19.5% if they have other income to offset the credits against. RWT may be refunded in cash. The investor will be liable for additional tax if the investor is a 39% taxpayer.
- 3.7. Net distribution amounts are commonly reinvested in additional units – this is effectively treated as an additional contribution (capital).
- 3.8. Many CIVs, including superannuation schemes, life insurance ‘investment’ type policies and some unit trusts, do not distribute. The accrued net investment income continues to be included in the unit price.
- 3.9. GIFs do usually distribute investment income, but on a basis which reflects the investor’s nominated tax rate (in effect, flow through). The income is treated as interest income (as opposed to dividend income from a unit trust) and is therefore subject to RWT. Most retail funds of this nature are not subject to capital gains and often use a fixed unit price, particularly for purchases. Investment income is allocated in a similar manner to a bank savings account, depending on the effective rate of return on the fund over the distribution period and the number of days during the period that each unit has been held.

4. Redemptions (excluding GIFs) use a unit price calculated as at A.2.10 (which is net of any tax @ 33%):

- 4.1. Redemption of 5,000 units @ \$1.0268 = \$5,134 tax paid
- 4.2. If the CIV is a unit trust, the investor may have the option to redeem units under the “direct redemption” basis. If they do so they will receive imputation credits (if sufficient available) which assume that tax @ 33% has been paid on the gain made on the total amount invested (includes reinvestments). They may be able to use the imputation credits to reduce the effective tax rate to 19.5% of all gains if the investor is a lower rate taxpayer. A 39% taxpayer is not likely to opt for this basis.

5. Replacement units, and additional units for further contributions, (again excluding GIFs) would be issued at the same price (as per A.2.10):

- 5.1. Replacement investor’s contribution of \$5,134 @ \$1.0268 = 5,000 units (with no liability for tax on the fund’s accrued investment income for the purchaser)
- 5.2. Further contribution of \$10,000 @ \$1.0268 = 9,738.9949 units (again, there is no liability for tax on the fund’s accrued investment income for the purchaser). This is based on:

5.2.1. Net Value of Fund (from 2.8.)	=	\$102,680
5.2.2. New contribution	=	\$10,000
5.2.3. New Total Fund Value	=	\$112,680
5.2.4. New Total of Units	=	109,738.9949

B. Flow Through Basis – Proposal - Using Net of Expenses & Gross of Tax Unit Prices to allow for deduction of tax at an investor’s nominated tax rate

1. At day 1 of CIV, as for current basis:

1.1. Contributions received	=	\$100,000
1.2. Assets purchased (ignore expenses)	=	\$100,000
1.3. Number of units	=	100,000
1.4. Unit price	=	1.000

2. At, say, day 10 (assuming no other transactions):

2.1. Purchase price of Assets	=	\$100,000	
2.2. Increase in value			
2.2.1. Non-taxable	=	\$1,000	
2.2.2. Taxable	=	\$1,100	
2.3. Income received (taxable)	=	\$2,100	
2.4. Less Deductible Expenses	=	\$100	
2.5. Less Fees (deductible), say	=	\$100	
2.6. Net Taxable Income (2.2 + 2.3 – 2.4 – 2.5)	=	\$3,000	
2.7. Total Value of fund (net of expenses)	=	\$104,000	
2.8. Number of units	=	100,000	
2.9. Unit price	=	$\$104,000/100,000 =$	\$1.0400
2.10. Taxable income per unit	=	$\$3,000/100,000 =$	\$0.0300

3. Distribution - or Attribution, of Income (the term “attribution”, for the purposes of this example, is used to mean a permanent allocation of income and the deduction of tax at the appropriate rate).

- 3.1. The Flow Through basis, for taxation, requires that the taxable investment income for the period (up to one year) be physically attributed (but not necessarily distributed) to individual investors such that tax may be paid at each investor’s nominated rate.
- 3.2. Attribution would also generally occur on redemption prior to the normal attribution date – see 4 below. See also section B.5.5.
- 3.3. Attribution will apply to all CIVs. It could also include a distribution (as described in A.3.1 above), but need not. The exercise could equally involve the automatic reinvestment of the net of tax amount attributed.
- 3.4. The unit price would be reduced immediately following the attribution to reflect the income attributed. The unit price would then be comprised of all capital invested (including reinvested amounts) and non-taxable capital gains.

4. Redemptions would use a unit price calculated as at B.2.9 to determine the gross amount payable and taxable income per unit (as per B.2.10) to determine the amount of tax to deduct at the nominated rate in respect of taxable income earned since the last attribution:

4.1. Redemption of 5,000 units @ \$1.0400	=	\$5,200
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4.2.	Attributed taxable income = 5,000 x \$0.0300	=	\$150.00
4.3.	Less tax on \$150 @, say, 19.5%	=	\$29.25
4.4.	Amount paid net = \$5,200 - \$29.25	=	\$5,170.75

5. Replacement units, and additional units for further contributions – what price to use?

5.1. Option a) is to use the calculated unit price, as currently:

5.1.1. Replacement investor's contribution of \$5,200 @ \$1.0400 = 5,000 units

5.1.2. However, this price includes taxable income per unit of \$0.0300. If these units were redeemed without any further changes, tax at the nominated rate would be deducted. The purchaser is taking on the liability for tax that was due on income earned prior to purchase, but this is not taken into account in the unit price. Furthermore, in the case of units issued purely as replacement units for those redeemed by another investor, the redeeming investor has already paid the tax due.

5.1.3. The same issue arises in respect of additional units for further contributions. In this case, however, no tax is due as only a return of capital is involved.

5.1.4. Option a) is therefore not equitable.

5.2. Option b) is to introduce a purchase price that differs from the release price by the amount of the accrued taxable income per unit (a price based on the capital value of the fund at the time, assuming that non-taxable investment income equates to capital):

5.2.1. Purchase unit price = \$1.0400 - \$0.0300 = \$1.0100

5.2.2. Replacement investor's contribution of \$5,050 @ \$1.0100 = 5,000 units

5.2.3. This equitably recognises that the purchaser is not purchasing any taxable income. However, how would a redemption amount for these units be calculated?

5.2.3.1. If these units are redeemed and there are no further changes to the unit price (i.e. no new investment income), the redemption price is \$1.0400, subject to tax at the nominated rate. The amount payable is determined as for B.4. above. If the investor is liable for tax @ 19.5%, they will receive a net payment of \$5,170.75. This represents a profit of \$120.75 (\$5,170.75 - \$5,050) even though the fund has not received any additional investment income. Similarly, an additional tax payment has been made when it is not due. These amounts can come only from the accrued benefits of other unit holders.

5.2.3.2. A similar problem arises even where the fund receives further investment income.

- 5.2.4. The answer to this would be to determine a redemption unit price that allowed for investment income received only from the date of purchase of the units. This would result in:
- 5.2.4.1. separate purchase and redemption unit prices for each day that unit prices are calculated during any “attribution period”;
 - 5.2.4.2. each successive day’s purchase price having its own series of redemption prices to reflect the change in investment income received since the purchase date;
 - 5.2.4.3. units would need to be tracked such that the redemption price appropriate to units purchased at a particular price is applied on the redemption of those units. An investor redeeming units purchased at different times would therefore be subject to differing unit prices (and taxable income per unit) on each tranche of units.
- 5.2.5. A common unit price would become applicable to all units immediately following an actual attribution of investment income and the deduction of any tax due to date. However, the process of determining taxable income at that time, and therefore tax payable, would be similar to that for a redemption – as described at 5.2.4 above.
- 5.2.6. Option b) seems to be impractical in practice.
- 5.3. Option c) is to exclude taxable investment income from the unit price calculation in much the same way as is currently used for a number of GIFs.
- 5.3.1. The unit price would reflect non-taxable investment income and capital. In terms of the calculation at B.2:
 - 5.3.1.1. $\text{Unit price} = \$101,000 / 100,000 = \1.0100
 - 5.3.2. Taxable investment income could be held separately as a dollar amount (\$3,000 in this case). It would be attributed to each unit held at the end of each attribution period, dependent on the number of days that each unit had been held during that period, assuming that the income had been earned at an equal rate each day throughout the period. Similarly, for equity reasons, it should also be attributed if an investor redeems units during the attribution period and tax deducted accordingly.
 - 5.3.3. A redemption of units at day 10 would result in:
 - 5.3.3.1. $\text{Redemption of 5,000 units @ } \$1.0100 = \$5,050$
 - 5.3.3.2. Plus attributed income:
 - 5.3.3.2.1. $\text{Total of all units x days held} = 100,000 \times 10 = 1,000,000$
 - 5.3.3.2.2. $\text{Investor's units x days held} = 5,000 \times 10 = 50,000$
 - 5.3.3.2.3. $\text{Proportion of total taxable income} = 50,000 / 1,000,000 = 0.05$
 - 5.3.3.2.4. $\text{Attributable income} = \$3,000 \times 0.05 = \$150.00$
 - 5.3.3.3. $\text{Less tax on } \$150 \text{ @, say, } 19.5\% = \29.25
 - 5.3.3.4. $\text{Amount paid net} = \$5,050 + \$150 - \$29.25 = \$5,170.25$

- 5.3.4. Replacement units, and additional units for further contributions would also be issued at this unit price:
- 5.3.4.1. Replacement investor's contribution of \$5,050 @ \$1.0100 = 5,000 units
- 5.3.4.2. This equitably recognises that the purchaser is not purchasing any taxable income. Unlike option b), it does not see the investor become eligible for an attribution of investment income if the units are redeemed immediately (see B.5.2.3).
- 5.3.4.3. However, even if the fund earns no more taxable investment income, a redemption from the next day does result in the units attracting an attribution of income:
- 5.3.4.3.1. Total of all units x days held = 100,000 x 11 = 1,100,000
- 5.3.4.3.2. Investor's units x days held = 5,000 x 1 = 5,000
- 5.3.4.3.3. Proportion of total taxable income = 5,000/1,100,000 = 0.0045
- 5.3.4.3.4. Attributable income = \$3,000 x 0.0045=\$13.50.
- 5.3.4.4. Option c) therefore suffers from the same equity issues as option b), albeit to a lesser degree. Whether or not the level of inequity generated is material would depend largely on the frequency of attributions of taxable investment income.
- 5.4. Option d) is a development of option c) designed to overcome issues of equity between unit holders:
- 5.4.1. The unit price would reflect non-taxable investment income and capital, in the same way as under option c). In terms of the calculation at B.2:
- 5.4.1.1. Unit price = \$101,000/100,000 = \$1.0100
- 5.4.2. Taxable investment income would be allocated daily (or whenever a unit price is determined) and held separately as a dollar amount at the investor level. It would be allocated based on the gross amount of taxable investment income received by the fund on that day and the number of units held at the end of the day as a proportion of the total of units on issue.
- 5.4.3. Each day's allocation would be accrued until the end of the attribution period. An attribution period could be for up to a year. At the point of attribution, tax would be deducted at the nominated tax rate.
- 5.4.4. Units being redeemed would, similarly, attract an attribution of the accrued taxable investment income and the deduction of tax.
- 5.4.5. This method addresses the equity issue described above under option c). Additionally, it removes the need to assume that income received during an attribution period arises at the same rate each day.

- 5.5. Option e) is a further variant based on a suggestion in the Discussion Document (the example to section 4.45) that the government would accept that payment of tax at the time of redemption would not be required if attributions are made at least quarterly.
 - 5.5.1. This concept may be attractive, as it would result in no tax being paid on investment income allocated to any of the investor's units that are redeemed prior to the next attribution date.
 - 5.5.2. The Discussion Document goes on to suggest that this would result in the remaining unit holders becoming liable to the tax on the investment income paid on the redeemed units, but it is not immediately evident why this would be so as the remaining units do not attract any further allocation of investment income (it has already been allocated to the redeemed units). This suggests that the legislation would be written in such a way as to require that all investment income must be "attributed" at, or before, each attribution date, which could result in investors paying tax on income paid to someone else.
 - 5.5.3. On this basis, option e) is not equitable and is not pursued further.

C. Questions and Issues arising.

1. **Source of Investment Income.** The Discussion Document envisages that the various sources of income are identified and that income attributed to investors retains its character.
 - 1.1. It is not clear why this might be necessary for NZ tax resident investors, bearing in mind that, in general, tax paid on attributions from a CIV will be a final tax:
 - 1.1.1. Investment income attributed by the CIV will be liable to deduction of a withholding tax (RWT?),
 - 1.1.2. Interest income received by the CIV for NZ fixed interest securities will, in most cases, be received gross under an exemption certificate. It may be received net of RWT,
 - 1.1.3. Rental income from property and income from overseas investments (subject to the confirmation of current proposals) would be received gross of any NZ tax. Any overseas tax paid may be deductible,
 - 1.1.4. Dividend income from NZ equities will be received net of tax @ 33% and will include an allocation of imputation credits (ICs) and/or been subject to RWT,
 - 1.1.5. Any tax due to be paid by the investor can be offset by the amount of any tax already paid (ICs and/or RWT),
 - 1.1.6. Any surplus ICs could firstly be offset against any other taxable income arising in the CIV. Remaining surplus ICs could be carried forward in the CIV (or allocated to the investor?). Surplus RWT would be refundable (through the CIV or by the investor claiming via a return?)
 - 1.2. For investors who are not NZ tax resident, it is proposed that NRWT is deducted at the rate appropriate to the source of income in line with the philosophy of flow through.
 - 1.2.1. This results in differing rates of NRWT being applied - 15% on dividend income (assuming residence in a DTA country), 10% on interest income (DTA country).
 - 1.2.2. As it is, potentially, possible for any investor to become non-resident, it would be necessary to separate the taxable income arising from the different sources.
 - 1.3. Separate records, at investor level, would appear to be needed for each income type. For option d) from B.5.4, therefore, two separate accruals of investment income appear to be required.
2. **Recording Tax Credits.** The Discussion Document envisages that NZ tax credits (ICs and/or RWT) and foreign tax credits and foreign non-resident withholding tax would be allocated to individual investors in a similar manner to taxable income.
 - 2.1. This is a logical extension of flow through.
 - 2.2. To be equitable, allocations to investors would be made whenever an allocation of taxable investment income is made to the investor. In terms of option d) from B.5.4, this would generally be daily and would be accrued until the next attribution date.

- 2.3. Separate totals for ICs and for RWT credits would be required as the treatment of any surplus credits arising differs.
 - 2.4. With regard to C.1.3 above, it would also be necessary to retain separate totals for each type of income arising (although no ICs would arise under the interest income total).
 - 2.5. In practice it may be felt that sufficient equity between investors will be retained if the allocation of credits takes place only at the point of attributing the investment income to investors and deducting tax due. In these circumstances, accruing credits under each heading would be recorded only at fund level during the attribution period.
3. **Surplus Imputation Credits.** The Discussion Document raises the issue of whether surplus ICs should be retained in the fund (but at investor level) or issued to the investor for use against other income.
- 3.1. While this is not likely to be an issue, from a practical perspective of record keeping, it is likely to impact investors in “pure” NZ equity funds. Allowing for the deduction of expenses, it is likely that there will always be a surplus of credits for all but 39% taxpayers.
 - 3.2. The question of whether or not to pass surplus credits through to investors could be at the discretion of the investor.
 - 3.3. A taxpayer is obliged to complete a tax return if taxable income from investments exceeds \$200. It would be reasonable for an investor to expect that all ICs would be passed through in circumstances where the before tax investment income from a CIV would be \$200 or more.
4. **Tax Losses.** The Discussion Document also raises the issue of whether tax losses should be allocated to investors, held in the fund at investor level or retained at CIV level.
- 4.1. CIVs currently operate on the latter basis, as it is the fund that is the actual taxpayer at present. Losses are not always recognised within a unit price for tax purposes. Tax assets are commonly limited to the extent that the manager is confident that the losses will be recovered.
 - 4.2. The flow through regime seems to suggest that holding losses at fund level is no longer appropriate, although the Discussion Document indicates that this would still be acceptable to the government.
 - 4.3. The current basis would be the least disruptive to operate in practice.
 - 4.4. Allocating to investors or holding losses in the fund at investor level would involve additional record keeping.
 - 4.5. However, either results in more equitable use of losses incurred in that the investors suffering a loss would use the losses. The current basis allows the benefits of accrued losses (that are not recognised within the unit price as a tax asset) to be used by new investors.

5. **Recording of Expenses.** The Discussion Document envisages that expenses and fees incurred would be allocated to investors and deducted from taxable income before tax is deducted.
 - 5.1. In the examples shown above, it is assumed that expenses and fees would be deducted at fund level with taxable investment income (and unit prices) expressed as being net of expenses.
 - 5.2. In practice, some fees – those calculated at individual investor level (e.g. deductible initial fees, account fees, exit fees and management fees determined by length of membership or size of account balance) may need to be accounted for at individual investor level.
 - 5.3. Where applicable, therefore, a total of deductible fees/expenses that are calculated at investor level would need to be maintained during each attribution period.
 - 5.4. In terms of C.1.3 above:
 - 5.4.1. a separate total relating to each type of income arising in the fund would be required;
 - 5.4.2. in practice, the IRD may be able to accept that the total of such expenses arising in the attribution period can be allocated between the income types on a pro-rata basis at the time of the attribution being made.

6. **Recording of Capital Invested.** The Discussion Document envisages that entities that are not individual investors (or individuals holding the investment on revenue account?) will continue to use CIVs for their investments. If any such investors are, or may become, unit holders there will be a continuing need to record, at investor level, the total of investments made to the fund, less, if any part withdrawals have been made, capital amount withdrawn. Investments made would include net, after tax, investment income that is reinvested following attribution.

7. **Addition of Use of Money Interest.** The Discussion Document suggests that it would be reasonable for use of money interest to be payable as the payment of tax to the IRD would be deferred – CIVs are currently provisional taxpayers.
 - 7.1. It is not clear whether there is any proposal to make such a charge.
 - 7.2. Any penalties of this nature would be difficult for investors to understand as the amount of tax deducted from their attributed investment income would exceed the rate nominated by them for deductions.

8. **Attribution more Frequent than Annual.** Calculations completed above have assumed that attribution has been completed annually or earlier on redemption of units. The Discussion Document suggests that more frequent attributions could be made – presumably these could be daily if the QCIV provider decided to do so. More frequent attribution than annually might result in an issue:
 - 8.1. It is assumed that the amount of tax payable by an investor in any one tax year is based on the total taxable income allocated to that investor from the QCIV during the year (assuming that the investment is held for the full year).

- 8.2. An attribution at the end of the year will therefore include all of that year's income and tax for the year can be calculated accordingly.
 - 8.3. Investment income received by the CIV will not necessarily be received on a regular basis.
 - 8.4. It can also be expected that taxable investment income for the year will be reduced from time to time due to capital losses.
 - 8.5. The more frequently the investment income is attributed, the more likely it is that an overpayment of tax for the year to date will occur.
 - 8.6. For example:
 - 8.6.1. A QCIV attributes monthly;
 - 8.6.2. For the first, say, three months investment income is positive. The income is attributed at the end of each month and tax deducted;
 - 8.6.3. Month four shows a loss for the month, although taxable income for the year is still positive;
 - 8.6.4. A mechanism is required which allows for the CIV to reclaim what is now overpaid tax and for this to be fed into investors' accounts;
 - 8.6.5. A refund is preferable to merely waiting for the loss to be recovered as it may not be recovered prior to the end of the tax year;
 - 8.7. There is a difference between the situation described above, where the total taxable income for the year is positive, compared to the situation where the fund records an overall loss for the year.
9. **Investors Holding Units for Less than Full Tax Years.** The probable volatility in the total of taxable investment income recorded during any year may mean that taxable investment income for the year for an individual investor will be different from that of the fund as a whole if units are held for only a part of the year.
- 9.1. An investor who redeems units during the year will be liable to tax based on the accrued investment income at the time of leaving. This is equitable as the investment income is withdrawn at this time and will not be affected by future movements, whether up or down;
 - 9.2. An investor purchasing units during the year will not, under option d) from B.5.4, gain any value from investment income accrued at the point of purchasing the units. Similarly, they will not be liable to any tax on historic earnings. Their liability to tax will, therefore, relate only to investment income accrued since the date of purchase. Again, this is equitable.
10. **Summary.**
- 10.1. All of the above appear to suggest that there will need to be a significant number of records maintained at investor level, many on a daily basis.
 - 10.2. Where it may be more practical to defer some actions until income is actually attributed, the calculations require the allocation of various accrued amounts to enable the tax due from each investor to be determined.

- 10.3. While some of the following may already be recorded, in addition to the investor's IRD number and tax rate declaration, and assuming that option d) from B.5.4 is accepted as a base, accruals might be required, for each investor, for:
 - 10.3.1. Taxable investment income arising from:
 - 10.3.1.1. dividends;
 - 10.3.1.2. interest;
 - 10.3.2. Tax paid in respect of investment income arising from:
 - 10.3.2.1. dividends
 - 10.3.2.2. interest;
 - 10.3.3. Imputation credits arising from dividends received;
 - 10.3.4. RWT arising from dividends received;
 - 10.3.5. RWT arising from interest received;
 - 10.3.6. Foreign tax credits and foreign non resident withholding taxes;
 - 10.3.7. Tax losses;
 - 10.3.8. Expenses incurred relating to:
 - 10.3.8.1. dividends received;
 - 10.3.8.2. interest received;
 - 10.3.9. Total of capital invested.
- 10.4. While the production of these records could be largely automated, establishing the number of records which appear to be necessary, and the updating of these records on a regular basis, will be challenging and may deter many providers from offering flow through.
- 10.5. The intention of unitising an investor's accrued savings in a fund was two-fold:
 - 10.5.1. to provide a simple method of allocating investment income to the investor on a continuous basis as the earnings arose and the expenses were incurred. This meant that an investor could keep track of his/her investment values merely by applying the latest unit price to the number of units held. If an investor wishes to cash in the investment the investor knows what the fund will pay and can make decisions accordingly.
 - 10.5.2. to provide a transparent way of maintaining equity between investors who, at any time, are investing, divesting or maintaining their interest in the fund and also between different generations of investors.

It is apparent that the adoption of option d) from B.5.4, which appears to be the equitable approach to take, will take us away from this intention and undermine the whole point of unitising.

- 10.6. Are there easier ways of achieving flow through? (even if it proves to be less precise). For example:
 - 10.6.1. We do currently operate a nominal flow through regime for unit trusts. However, to gain the benefits, 19.5% taxpayers need to submit tax returns.
 - 10.6.2. The Discussion Document clearly shows that one of the principal aims of the reform is to avoid the need for the completion of tax returns.
 - 10.6.3. However, it seems likely that the costs of establishing and maintaining the registry records of a significant number of CIV operators to cope with flow through might outweigh the costs of additional IRD involvement.

- 10.6.4. To minimise the number of returns required to be completed, CIVs could deduct tax at the rate of 19.5% from all taxable investment income. Where the total investment income exceeds \$200, a return would be required in the same way as it is currently.
- 10.6.5. In reality, this would ensure that the vast majority of taxpayers subject to tax at 33% or above would be required to make a balancing payment.
- 10.6.6. The IRD would be able to match investor returns to information supplied by CIVs.
- 10.6.7. The IRD could be empowered to issue payment notices to CIVs such that the CIVs could surrender units and make payment to the IRD.

On balance, we suggest that the Discussion Document has not given sufficient consideration to the detailed, practical implications of its proposals. We think that the complexities that we have described make the proposed implementation date of 1 April 2007 impracticable, given that the earliest probable date for final legislation on the changes will be in the second half of 2006. As already suggested, we think that deferring the implementation date is much more sensible.