

Key Submission Points for the Institute of Financial Advisers on the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill

1. The Institute supports the proposed qualifying portfolio investment entity regime, permitting alignment of taxation with a lower income individual's marginal tax rate (19.5%) and capping tax at the rate of 33% for other investors.
2. The Institute supports the proposal to exempt NZ resident shares and Australian resident listed companies from the unrealised capital gains tax.
3. The Institute opposes the proposal to introduce a tax on 85% of unrealised gains for investments in international shares outside of the permitted NZ and Australian exemptions. Briefly, the rationale behind the Institute's view is as follows:
 - a. The proposal encourages tax driven over investment in New Zealand and Australia at the expense of international exposure. This will result in an inappropriate concentration of portfolio investment in local investments, placing New Zealanders' savings at increased risk at a time when the current account balance and demographics of an aging population demand something very different.
 - b. The proposal fails "fairness" and "equity" tests, fundamental precepts of NZ taxation law.
 - c. The 85% level proposed is too high to approximate taxable earnings, resulting in significant over taxation.
 - d. The proposal is too complex, and will result in significant compliance costs for qualifying funds and investors. This is insufficiently mitigated by the \$50,000 total cost exemption, available to individuals only.
 - e. The complexity will result in inadvertent and deliberate non-compliance.
 - f. The unfairness will result in deliberate non-compliance
 - g. The proposal encourages New Zealanders to leave and discourages new immigrants from coming to New Zealand and expatriates from returning.
 - h. The proposal is open to a range of avoidance mechanisms. Examples include restructuring ownership, changing the domicile of the investment, avoiding repatriation until death, leaving the country to lose tax residency, and development of local securities "mirroring" offshore securities.
4. The Institute instead proposes that the exemption included for NZ shares and Australian resident listed companies be extended to investments in all other international shares for all investors.
5. The Institute also submits that, if the proposal to introduce a tax on unrealised capital gains on certain investments proceeds, then the following should be addressed:
 - a. The 85% level of gains to be taxed should be significantly reduced
 - b. The \$50,000 total cost exemption for individuals making direct investments outside of the Australasian exempt investments should be increased and extended to:
 - i. Permit trusts and other entities with less than exempted total cost in such investments to enjoy the exemption
 - ii. Permit an individual or entity with less than the exempted total cost invested in local managed funds investing in international equities to also benefit from the exemption.

- c. That individuals and entities be able to elect either actual cost or an alternative higher market value calculated as at 1 April 2007, irrespective of the date of purchase, to determine whether an exemption is available.
- d. That the rollover relief available for reinvestment offshore be extended for six months beyond the end of the tax year.
- e. All listed entities in NZ and Australia should be exempt the proposed tax, irrespective of country of residence
- f. All unlisted entities resident in Australia should be exempt the proposed tax.

Submission Points on the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill

Proposal to allow low marginal tax payers to elect the 19.5% tax rate - supported

The Institute of Financial Advisers supports the proposal to tax income within New Zealand based portfolio investment entities at a lower marginal tax rate in respect of lower income investors. This is recognised as essential to support the introduction of KiwiSaver and to encourage saving for retirement for such investors.

We note, however, that there does not appear to be any provision for a 19.5% individual taxpayer to benefit from a lower tax rate if they have a joint holding in a portfolio investment entity with another security holder on a higher tax rate. This also has potential implications for estate planning, as it is quite common for securities to be held jointly to facilitate transfer of assets on death to the surviving holder without the need for probate or estate administration. This benefit would not be available if securities have to be held in individual names to obtain an advantageous tax treatment.

We submit that these issues should be addressed by permitting election of an alternative tax rate that reflects the average of the tax rate of the lower tax rate individual when combined with the tax rate of the other joint holder.

Proposal to exempt NZ resident shares and Australian resident listed shares - supported

The Institute of Financial Advisers also supports the proposal to remove the realised capital gains tax payable by managed funds on New Zealand and Australian shares, placing portfolio investment entities on an equal footing with direct investors investing on capital account.

We note, however, that this benefit for portfolio investment entities does not extend to provide equal treatment for direct investors investing on revenue account, the latter now being disadvantaged, implying that the difference between investment on capital and revenue account still requires further clarification.

Proposal to introduce an unrealised capital gains tax on international share investment - opposed

The Institute of Financial Advisers is opposed to the proposal to introduce an unrealised capital gains tax on international share investments while investments in New Zealand shares and Australian resident listed companies and other investments such as residential property are not taxed on a comparable basis. The tax proposal is flawed in that it fails to meet the stated objective of placing different types of share investment on an equal footing, continuing to favour investment in some countries over other countries. One set of distortions is simply being replaced by another. This needs to be addressed.

Our key concern is that there is a strong incentive under the proposal for investors to increase Australasian share exposure at the expense of international exposure as a natural result of focusing investment decisions on the negative tax impact. This will result in an inappropriate concentration of portfolio investment, placing New Zealanders' savings at increased risk. This risk is exacerbated by the small size of the local Australasian market (in comparison with global markets) and by other limiting features of our investment market, at a time when the current account deficit and the demographics of an aging population demand something very different.

We also believe that there is a failure to understand the implications for investors in many managed funds, noting that investments in passive funds with binding tax rulings previously exempt tax on gains will now be caught. This will mean that the investments of thousands of smaller New Zealand investors with direct holdings in passive funds with binding tax rulings or indirect holdings via superannuation funds that hold passive investments will now become subject to tax on unrealised gains on international share investments. We consider this to be an inappropriate change.

In addition, investors in KiwiSaver funds investing in international shares will incur the tax, noting that investors in KiwiSaver funds cannot benefit from the \$50,000 cost exemption. There is therefore a risk that, in order to fulfill their professional obligations to provide the best possible advice for each investor's circumstances, this will result in our members becoming obliged to advise potential KiwiSavers that there are better and more tax efficient options, thus inadvertently resulting in the undermining of the government objectives for KiwiSaver. This would be unfortunate and warrants change of the tax proposal.

The Institute of Financial Advisers submits that the simplest solution is to exempt all investments in shares listed on recognised stock exchanges throughout the world and investments in Australia (including unlisted entities) from the proposed tax. Such an approach will gain automatic public acceptance, remove almost all of the distortions, greatly simplify the structure, reduce costs and assist with implementation of KiwiSaver on the government's preferred timetable. The fiscal impact is acknowledged but will be offset by taxation received on dividend income. The fiscal cost is, we believe, a price worth paying when compared with the alternative being proposed.

If this solution is not adopted, then we submit there will need to be significant modification to the proposal to remove newly introduced inconsistencies. Those of particular interest to our membership are laid out in the following submissions.

The 85% level proposed is too high to approximate taxable earnings, resulting in significant over taxation.

As well as dividends and 85% of gains from international share investment being taxable in New Zealand, taxation will generally be levied first on profits in the overseas jurisdiction, creating a double taxation impost that is extremely harsh. Further, the 85% level is not a good proxy for year to year earnings.

The solution is to significantly reduce the 85% level to better approximate annual corporate earnings and to give some proxy recognition for average tax paid overseas.

The proposal is too complex

The complexity will result in significant compliance costs for qualifying funds and investors.

The \$50,000 total cost exemption, available to individuals only, is not sufficient to mitigate this. Neither is the increased exemption potentially available for shares purchased prior to 1 January 2000.

To obtain the relief under either of these provisions, investors will need to be able to identify purchase date and/or cost. Events such as share splits, consolidations, bonus issues and shares in lieu of dividend, to provide some examples, will make it impractical for many to identify dates of purchase or true accounting cost to determine whether the exemptions may be available. Further, there has been no need for investors on capital account to retain records of purchase date or costs for securities, so the date of 1 January 2000 is arbitrary and irrelevant. Consequently, many investors will be unable to take advantage of the exemption relief simply because they will not have sufficient records to claim the relief.

Then there is the opportunity to avoid tax on realised carried forward gains by rolling over the investments offshore before the end of the tax year rather than repatriating monies. This means that the relief period varies between 1 and 365 days. Such variation in the relief time period is inappropriate.

To enhance the proposal and address these issues, the Institute of Financial Advisers submits as follows:

That the \$50,000 total cost exemption for individuals making direct investments outside of Australasian exempt investments should be increased and extended to:

- Permit trusts and other entities with less than the exempted total cost in such investments to enjoy the exemption
- Permit an individual or entity with less than the exempted total cost invested in local managed funds investing in international equities to also benefit from the exemption. One solution, that would also encourage lower income earners to save, would be to permit such individuals to elect a 0% final tax rate within a portfolio investment entity on provision of an appropriate declaration that the total cost of such investments held is less than \$50,000.

That individuals and entities be able to elect either actual cost or an alternative higher market value calculated as at 1 April 2007, irrespective of the date of purchase, to determine whether an exemption is available.

That the rollover relief available for reinvestment offshore be extended for six months beyond the end of the tax year. This is a practical solution as it can be structured such that it simply defers determination of the potential tax liability into the next tax year, dependent upon whether repatriation or reinvestment occurs within that time frame.

The complexity will result in inadvertent and deliberate non-compliance.

It is worth quoting from the bill commentary *in this same tax bill* regarding the exemption being granted to certain Australian superannuation funds.

Consultation with the private sector has indicated that people with Australian superannuation interests may not be complying correctly with their tax obligations under the FIF rules and, indeed, might not even be aware that they have to account for tax. This non-compliance is not unique to people with Australian superannuation interests. For those people who are aware of their tax responsibilities, determining whether they have a FIF obligation can involve high compliance costs. Although the current exemptions provide some relief from these rules, members may have difficulty in determining which exemption applies to them and what their future obligations are.

We can't say it better ourselves in respect of the complexity being introduced into identifying exempt and non-exempt entities listed on the ASX and NZX.

It is difficult for investors to distinguish between those entities listed on the NZX and ASX that are caught under the new tax and those that are not. In New Zealand, this will require investors to correctly identify that the entity is resident here, or, despite not being resident in New Zealand, it is exempt, like GPG. In Australia, an investor will not only need to check for listing and residence, but whether the entity is a company or not. Newspaper reports and listings of security prices, even those on the ASX and NZX websites, do not generally include such information. This will increase compliance costs as prudent investors will have to seek and pay for advice before purchasing shares in these two markets to ensure that they are not inadvertently failing to meet the requirements.

Despite the best intentions of an investor, inadvertent non-compliance is very likely to occur, with significant penalties potentially applying when "found out."

Rather than having to repeat the above bill commentary some time in the future in another amending bill, the Institute of Financial Advisers submits that the exemption proposed for NZ Shares and Australian resident listed companies be extended now to all companies, trusts and equivalent entities listed on the ASX or NZX.

Australian Unlisted Trusts

A significant number of New Zealand investors have placed investments in Australian based unit trusts that will become subject to the new tax. The reason behind inclusion of Australian unlisted trusts within the regime is not understood, since Australian tax law requires all realised profits to be distributed, thereby creating taxable income in New Zealand.

Further, the proposed tax applies, irrespective of whether the Australian unlisted unit trust invests in NZ shares and Australian resident listed companies that would otherwise be exempt if the investment was made direct or indirectly through a New Zealand based portfolio investment entity.

If the tax proposal remains unchanged, this will drive structural change to the extent that investors will demand New Zealand based portfolio investment entities be established to access New Zealand and Australian shares, or they will invest direct in such shares, thereby incurring significant costs of change solely for tax reasons, without necessarily gaining or maintaining access to the fund manager otherwise best suited for the purpose.

The Institute of Financial Advisers submits that all unlisted entities resident in Australia that require profits to be distributed should be exempt the proposed tax.

The unfairness will result in deliberate non-compliance

As all tax systems are dependent upon voluntary compliance to some extent, any perception that a tax is unfair can lead to otherwise law abiding citizens deliberately and illegally evading tax. We think that the tax will be regarded as unfair by many investors who are attempting to prudently diversify, thereby increasing risks of deliberate non-compliance in a situation where it will be extremely difficult for the revenue authorities to detect this.

The proposal encourages New Zealanders to leave and discourages new immigrants from coming to New Zealand and expatriates from returning.

It is worth quoting again from the commentary in this same tax bill regarding the exemption proposed for certain Australian superannuation schemes.

In addition, the potential tax consequences under the FIF rules facing certain people with interests in particular superannuation schemes could be a disincentive for them to take up long-term or permanent employment in New Zealand.

The same can be said for the proposal to impose an unrealised capital gains tax on direct investment in equities outside of the Australasian exemptions for immigrants and expatriates returning to New Zealand. The recent law change permitting a four year exemption from New Zealand tax on foreign income for those entering New Zealand who have not been tax resident here for the previous 10 years is, in our view, insufficient to offset the disadvantage.

This also begs the question why new immigrants or returning expatriates who have been away for at least 10 years should be granted such an advantage at almost the same time that existing residents are to be made subject to an unrealised capital gains tax on foreign equity investment.

Further, the proposed tax is a direct incentive to existing residents to leave the country, either to avoid the tax in total, or to avoid having to pay the tax on significant carried forward profits that may be generated in the future. Leaving the country for long enough to lose tax residency before selling the assets is an obvious strategy for someone with a significant contingent liability.

The proposal is open to a range of avoidance mechanisms.

Examples include changing the domicile of the investment, development of local securities “mirroring” offshore securities, restructuring ownership of securities, avoiding repatriation until death, and, as noted earlier, leaving the country for a sufficient period to lose tax residency before selling the investments.

Unequal Treatments

To further illustrate some of the Institute’s concerns over the uneven application of the proposed tax, an appendix is attached providing examples of “unequal treatments.” This is not intended to be a complete list.

Appendix - Table of Unequal Treatments

Investment not subject to unrealised capital gains tax	Investment subject to unrealised capital gains tax
<p>Investments in NZ shares and Australian-resident listed companies</p> <p>Investments in selected Australian superannuation schemes that meet certain criteria, irrespective of where these superannuation funds invest – this exemption is proposed to be introduced in the same piece of legislation stated to be introducing investment on an equal footing.</p>	<p>Listed equities on exchanges outside of Australasia</p> <p>Investments in unlisted Australian funds or other international shares or funds outside of Australasia that invest in Australian-resident listed companies or New Zealand shares. Investments in listed entities on the ASX that are not companies, such as all the property and infrastructure trusts, irrespective of whether the investments of those trusts are in Australia or not.</p>
<p>GPG, a UK resident listed company that provides a managed exposure to international and New Zealand equities</p>	<p>UK resident and listed Investment Trusts that provide a managed exposure to international, Australian and New Zealand equities.</p>
<p>Australian resident listed companies providing hybrid exposure to companies resident and listed in other jurisdictions.</p> <p>e.g. Rio Tinto PTY Ltd, providing exposure to both Rio Tinto PTY Ltd and Rio Tinto PLC</p> <p>Other examples include BHP Billiton and Brambles.</p>	<p>Listed companies resident outside of Australia providing hybrid exposure to companies resident and listed in Australia</p> <p>e.g. Rio Tinto PLC, providing exposure to both Rio Tinto PLC and Rio Tinto PTY Ltd</p>
<p>Individuals with investments in funds or shares resident outside of New Zealand with a total cost less than \$50,000</p>	<p>Individuals with investments in New Zealand resident funds, those funds investing in shares outside of the Australasian exemptions, with a total cost of investment less than \$50,000 to the individual investor.</p> <p>Trusts, companies and other entities with investments caught under the regime, with a total cost less than \$50,000</p>
<p>Australasian-resident listed company investing in shares outside of the Australasian exemption</p> <p>Fisher and Paykel Healthcare Ltd, a NZX listed New Zealand resident company whose principal business is selling health products to the rest of the world, including to New Zealand and Australia</p>	<p>New Zealand resident fund investing outside of the Australasian exemption.</p> <p>Resmed, an ASX listed USA resident company whose principal business is selling health products to the rest of the world, including to New Zealand and Australia</p>
<p>New Zealand resident entity investing in Australian property</p>	<p>An Australian resident property trust, listed or unlisted, investing in Australian property.</p>
<p>Expatriates returning after 10 years absence and new immigrants having a four year holiday from this tax</p>	<p>Current New Zealand residents suffering this tax.</p>
<p>Individual investor on 19.5% tax rate being able to elect this rate in a portfolio investing entity, avoiding over taxation</p>	<p>Joint investors, one on 19.5% tax rate, one on 33% tax rate, being unable to elect the 19.5% tax rate in a portfolio investing entity, thereby resulting in over taxation</p>