POLICY ADVICE DIVISION

Tax policy report: Tax rate for savings vehicles - including PIEs

Date:	26 February 2010	**Priority:**	High
Security Level:		**Report No:**	PAD2010/035 T2010/296

Action sought

	Action Sought	**Deadline**
Minister of Finance	Agree to recommendations	4 March 2010
Minister of Revenue	Agree to recommendations	4 March 2010

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**	
Steve Mack	Principal Analyst, Treasury	[deleted – privacy]	[deleted – privacy]
David Carrigan	Policy Manager, Inland Revenue	[deleted – privacy]	[deleted – privacy]

Minister of Finance
Minister of Revenue

Executive summary

The tax advantages associated with portfolio investment entities (PIEs) mean that they are the preferred structure for managed fund investments. All KiwiSaver funds are required to be PIEs. PIEs are designed so that peoples' investment income is taxed at a rate that reflects their own personal tax rate. Importantly, however, the top PIE tax rate is capped at 30% - which provides a tax incentive for investors on the 33% and 38% tax rates to invest using a PIE.

The top PIE rate was capped at 30% when the company tax rate was reduced from 33% to 30%. If the top PIE rate had not been reduced at that time there would have been incentives for managed funds to structure themselves as unit trusts or investment companies rather than PIEs. While sound reasons existed for capping the PIE tax rate at 30%, it has resulted in coherence and integrity issues as high income earners can use PIEs to shelter investment income and have it taxed at a 30% final rate.

The Tax Working Group recommended that the top PIE tax rate should be aligned with the top personal tax rate under this approach. If the top personal tax rate were increased to 33% to align it with the trustee tax rate, the top PIE tax rate would be increased to 33%. The issues associated with how the top PIE tax rate should be set are complex. For example, it would be necessary to consider the effect any change would have on KiwiSaver investment and other forms of saving.

It is therefore recommended that you agree not to increase the top PIE tax rate as part of Budget 2010. Instead it is recommended you agree that officials report to you after the Budget with further advice on whether it is feasible to align the top PIE tax rate with the top personal rate. It is further recommended that, if reductions are made to the personal tax rates below 30%, you agree, as part of the Budget, to lower the PIE tax rates to reflect these reductions.

Recommended action

It is recommended that you:

(a) **Agree** not to increase the top PIE tax rate and the tax rate applying to other widely-held savings vehicles as part of Budget 2010.

Agreed / not agreed | Agreed / not agreed

(b) **Note** that officials will report to you after Budget 2010 with further advice on whether it is feasible to align the top PIE tax rate with the top personal rate.

Agreed / not agreed | Agreed / not agreed

(c) **Agree** that, if the personal income tax rates below 30% are lowered as part of the Budget 2010 with no changes to the personal tax rate thresholds, the PIE rates are lowered accordingly – with application from 1 October 2010.

Agreed / not agreed | Agreed / not agreed

(d) **Agree** that, if additional personal tax rates below 30% are inserted as part of Budget 2010 (bringing the number to more than 2) the PIE rates are changed to reflect the new personal rates below 30% – with application from 1 April 2011.

Agreed / not agreed | Agreed / not agreed

(e) **Agree** that, if the personal tax thresholds are changed as part of Budget 2010 the PIE tax thresholds are changed accordingly – with application from 1 April 2011.

Agreed / not agreed | Agreed / not agreed

(f) **Note** that if you agree to recommendation (c) and the PIE rates are changed on 1 October 2010, the fiscal cost would be $20 million for 2010/11 and $24 million for later fiscal years.

Noted | Noted

Steve Mack
for Secretary to the Treasury

David Carrigan
Policy Manager, Inland Revenue

Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background to PIEs

1. Portfolio investment entities (PIEs) are an optional set of tax rules for managed funds and other collective investment vehicles. The PIE rules were introduced in October 2007 to align with the launch of KiwiSaver.

2. The PIE rules are designed to reduce investment distortions caused by the tax rules by removing tax barriers to investing via managed funds by making the tax treatment more consistent with the tax treatment that would apply if the underlying investments were held directly. This is achieved by:

- investors in the PIE being able to elect a tax rate with the PIE that reflects their marginal tax rate (although this is currently capped at a maximum of 30%); and
- not taxing the PIE on any profits from selling shares in New Zealand companies or Australian listed companies (thereby approximating the tax treatment of a direct investor holding those shares on capital account).

3. All KiwiSaver funds are required to be PIEs. Also, the tax benefits associated with PIEs means that PIEs have become the preferred investment vehicle for most managed funds.

Savings vehicle tax rate aligned to company tax rate

4. From the 2008/2009 income year the company tax rate was reduced from 33% to 30%. From 1 April 2008 the top tax rate for PIEs and the tax rate for non-PIE savings vehicles that were taxed as trusts (such as superannuation funds), was reduced from 33% to 30%. The rationale for the reduction was that there are a number of investment vehicles that are taxed as companies that are close substitutes for PIEs and non-PIE savings vehicles taxed as trusts. These include non-PIE unit trusts and investment companies. If the tax rate had remained at 33% it was considered that substantial investment would have shifted from PIEs (including KiwiSaver funds) to investment vehicles that are taxed as companies, thereby effectively circumventing the higher rate in any event but creating unproductive restructuring costs.

30% PIE rate causes integrity and coherence issues

5. The 30% top PIE tax rate is a final tax. This provides a tax advantage to investors that have a marginal tax rate of 33% or 38% as investment income is taxed at 30% at the PIE level and there is no further tax when the investor sells their units in the PIE or receives a distribution. This tax incentive has resulted in PIEs being marketed heavily to 33% and 38% investors. It has also seen the evolution of “cash PIEs” whereby standard bank account investments are structured as PIEs so that interest is taxed at 30% rather than 33% or 38%.

6. The 30% capped PIE rate causes integrity and coherence issues as it creates artificial biases (through tax arbitrage) for people to use PIEs instead of direct investments or

investments through non-PIE vehicles. It also causes equity issues as the tax advantage is only available to people that have a marginal tax rate of 33% or 38%. The Tax Working Group also recognised these integrity and coherence issues and recommended that PIEs and other widely-held savings vehicles be taxed at the marginal tax rate of investors.

Increasing the top PIE tax rate is a complex issue

7. Officials agree that, ideally, the PIE tax rate structure should mirror the personal tax rate structure. This would result in the top PIE tax rate being increased to the top personal tax rate.

8. Officials have recommended that Ministers indicate a preference for reducing the top personal rate from 38% to 33% to align it with the tax rate that applies to trusts as part of the 2010 Budget (T2010/191; PAD2010/16 refers). This preference was confirmed by the Ministers' Tax Sub-Group meeting of 22 February 2010.

9. Therefore, if the top personal tax rate is reduced to 33% as part of Budget 2010 (in-line with Ministers' preferences), there is an argument that the top PIE rate should be increased to 33% at the same time to address the coherence and integrity issues discussed above.

10. There are, however, a number of complex issues that would need to be addressed if the top PIE tax rate were to increase to 33%. The complexity arises because the company tax rate would remain at 30% or be reduced (depending on final Budget decisions).

11. If the PIE tax rate were higher than the company tax rate, investment vehicles that were taxed as companies would gain a competitive advantage over PIEs. Such vehicles include non-PIE unit trusts that are taxed as companies and listed investment companies. The tax advantage would arise because the investment income would be taxed at the lower company tax rate. While the investor would have to pay tax at their marginal tax rate on any dividends earned, there are various mechanisms available to ensure that the investor can receive the investment income with no additional tax – essentially resulting in the company tax being a final tax. These mechanisms include redeeming units in a unit trust directly with the investment manager for a capital gain rather than receiving a dividend (so-called 'manager buyback') and the sale of shares in a listed investment company for a tax-free capital gain.

12. The competitive advantage that vehicles such as non-PIE unit trusts and investment companies would have over PIEs (if PIEs were taxed at the top personal tax rate) may be able to be addressed by various integrity measures designed to ensure that investors in such vehicles are taxed at their marginal tax rate. Such measures could include the removal of the manager buyback mechanism for unit trusts. However, the design of a comprehensive set of integrity measures would require careful consideration and consultation.

13. Without the adoption of a comprehensive set of integrity measures there is a real risk that a number of PIEs would elect out of the PIE rules in order to access the lower company tax rate. This could have adverse consequences on PIE investors that have PIE tax rates below the company tax rate. It would also undermine the PIE regime.

14. In addition, when considering whether the top PIE tax rate should be increased to the top personal tax rate, it would be necessary to decide whether the higher rate should apply to savings that were in KiwiSaver PIEs (and other locked-in superannuation funds). While there is an argument that investment income from KiwiSaver funds should be taxed at investors' marginal tax rates, an increase in the top PIE rate applying to KiwiSaver funds is likely to be perceived as discouraging long-term saving. Changes that affect the taxation of KiwiSaver and other savings vehicles should be considered as part of the Government's wider strategy on savings and investment. This implies that the taxation of PIEs needs to be carefully considered as part of the broader system of taxation of savings and investment.

15. Also, before a decision is made on whether to increase the top PIE tax rate the appropriate tax rate for a number of other investment vehicles would also need to be considered - including income earned by life insurance companies on behalf of policyholders and bonus bonds.

Further work required

16. Depending on how the policy issues discussed above are weighted, the top PIE rate should be aligned with the top personal tax rate or the company tax rate. However, given the complexity of the issues described above, officials recommend that you agree not to change the top PIE tax rate and the tax rate applying to other widely-held savings vehicles as part of Budget 2010. Officials will report to you after the Budget with further advice on whether the top PIE tax rate should be aligned with the top personal tax rate, or with the company tax rate.

17. It should be noted, however, that reducing the top personal tax rate to 33% in the 2010 Budget would significantly reduce the tax benefit received by higher income earners investing through a PIE. This change alone reduces substantially the coherence and integrity issues associated with the current 30% PIE tax rate. However, they would remain.

18. If Ministers decide to reduce the company tax rate as part of Budget 2010 the 30% PIE rate will not be aligned with the top personal or the company tax rate. Officials consider that this intermediate outcome, while somewhat unsatisfactory, is preferable to a premature decision on this complex issue. Any difficulties associated with an intermediate PIE rate will be minimised if Budget announcements include comment to resolve this issue within a certain timeframe.

Should the PIE rules be removed?

19. Some may suggest that, given the complexity of the PIE rules and the integrity and coherence issues associated with the 30% top PIE tax rate, the PIE rules should be removed. While this may appear a simple solution, it would give rise to adverse tax consequences to a number of ordinary, lower income investors. This is because, unlike other investment vehicles, the PIE rules provide that lower income investors can have their PIE income taxed at

a rate that reflects their personal tax rate (e.g. 21% for somebody who earns $40,000 per year). This aspect of the PIE rules is particularly important for investors in KiwiSaver funds.

Changing the lower PIE tax rates

20. Currently New Zealand resident natural person PIE investors can elect a tax rate with the PIE that reflects their personal tax rate. These rates are as follows:

- 12.5% (if taxable income in either of the previous 2 years is $14,000 or below and taxable income plus PIE income is $48,000 or below)
- 21% (if taxable income in either of previous 2 years is $48,000 or below and taxable income plus PIE income is $70,000 or below)
- 30% (if both tests above do not apply)

21. Officials have recommended that Ministers indicate a preference for reducing the lower rates of personal tax as part of the 2010 Budget (T2010/191; PAD2010/16 refers). This preference was confirmed by the Ministers' Tax Sub-Group meeting of 22 February 2010. If the lower personal tax rates are reduced as part of Budget 2010 it is recommended that the PIE tax rates below 30% (currently 12.5% and 21%) are reduced accordingly. If it is also decided to change the tax thresholds applying to these rates as part of Budget 2010, it is further recommended that the PIE thresholds are changed accordingly.

22. It is likely that, provided there are no additional personal tax rate bands inserted below 30% and there are no changes to personal tax thresholds, PIEs would be able to implement changes to the lower PIE tax rates by 1 October 2010. Under this scenario, it is recommended that you agree to changes to the lower PIE tax rates applying from 1 October 2010. However, any additional personal tax rate bands below 30% or changes to personal tax rate thresholds would require significant systems' changes for PIEs. Under this scenario, it is recommended that you agree to changes to the lower PIE tax rates and thresholds applying from 1 April 2011.

Revenue implications

23. A personal tax structure of 10.5%, 17.5%, 30% and 33% applying at the same income thresholds as the current personal tax structure has been discussed in the context of personal tax rate reductions (T2010/191; PAD2010/16 refers). Under this personal tax rate structure, the 12.5% PIE tax rate would be reduced to 10.5% and the 21% PIE tax rate would be reduced to 17.5%. The approximate revenue cost if this change were adopted would be $20 million in the 2010/11 year and $24 million in future years.