

# The Treasury

## Budget 2011 Information Release

### Release Document

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**Inland Revenue**  
Te Tari Taake

POLICY ADVICE DIVISION

RECEIVED  
17 MAR 2011  
MINISTERIALS



THE TREASURY  
Kaitiaki Takekōwhiri

**Tax policy report: Non-resident investment in portfolio investment entities**

Date:	10 March 2011	Priority:	Medium
Security Level:		Report No:	PAD2011/042 T2011/368

**Action sought**

	Action Sought	Deadline
Minister of Finance	Agree to recommendations and refer a copy of this report to the Prime Minister and the Minister for Economic Development. ✓	15 March 2011
Minister of Revenue	Agree to recommendations and refer a copy of this report to the Prime Minister and the Minister for Economic Development.	15 March 2011

**Contact for telephone discussion (if required)**

Name	Position	Telephone
David Carrigan	Policy Manager, Inland Revenue [1]	
Steve Mack	Principal Advisor, The Treasury	

17 MAR 2011

Minister of Finance  
Minister of Revenue

## **Non-resident investment in portfolio investment entities**

### **Executive summary**

The Jobs Summit and the International Financial Services Development Group (“IFSDG”) both recommended that non-residents investing in foreign assets through a portfolio investment entity (“PIE”) should be taxed at zero percent on foreign-sourced income derived through the PIE, as a way of encouraging the establishment of an international investment funds domicile in New Zealand. Such income is currently taxed at 28 percent, which results in PIEs being unattractive to non-resident investors. By contrast, if the investor invested directly into foreign assets, the income would generally be taxed at zero percent. This is because of the principle that non-residents are only subject to New Zealand tax on their New Zealand-sourced income.

Officials have recently undertaken consultation with managed funds and tax advisors on a proposal which will reduce the tax rates faced by non-residents earning income through PIEs to reflect the rates that would apply if they made the investments directly. This includes introducing a zero percent tax rate for foreign-sourced income earned by non-residents through a PIE.

Accordingly, this report outlines the feedback received from consultation and seeks your agreement to amend the tax treatment of non-resident investment in PIEs.

### **Recommended action**

It is recommended that you:

- (a) **Agree** to the introduction of a new category of PIE which entities could elect into (“Category 1”) that has both resident and non-resident investors and only foreign-sourced income taxed at zero percent, subject to a 5 percent de minimis for New Zealand-sourced interest income and a 1 percent de minimis for New Zealand-sourced income from equities.

Agreed  Not agreed

Agreed / Not agreed

(b) **Agree** to the introduction of a new category of PIE which entities could elect into ("Category 2") that has both resident and non-resident investors and both foreign-sourced income and New Zealand-sourced income, with the following tax rates applicable:

- 0 percent on foreign-sourced income
- 0 percent on dividends derived from New Zealand companies that are fully-imputed;
- 15 percent on dividends derived from New Zealand companies that are unimputed where the investor is from a country with which New Zealand has a double tax agreement ("DTA");
- 30 percent on dividends derived from New Zealand companies that are unimputed where the investor is from a country with which New Zealand does not have a DTA;
- 1.44 percent on New Zealand-sourced interest income (being the effective approved issuer levy ("AIL") rate if the borrower is allowed a deduction for the AIL paid).

Agreed /  Not agreed

Agreed / Not agreed

(c) **Agree** that the new PIEs will not be able to invest directly into New Zealand land or land investment companies.

Agreed /  Not agreed

Agreed / Not agreed

(d) **Agree** that no deductions for expenses will be attributable to non-resident investors in a Category 1 or Category 2 PIE (as deductions are not permitted against income that is foreign-sourced or taxed on a gross basis e.g. interest and dividends paid to non-residents).

Agreed /  Not agreed

Agreed / Not agreed

(e) **Agree** that the two new PIE categories would generally be required to meet the existing eligibility criteria (subject to rec (c)) (and exclusions) set out in the legislation for entities to be treated as PIEs.

Agreed /  Not agreed

Agreed / Not agreed

(f) **Agree** that the two new PIE categories would generally be required to meet the existing PIE information and return requirements, with the exception of being required to request certain additional information in order to satisfy New Zealand's obligations to exchange information with other jurisdictions.

Agreed /  Not agreed

Agreed / Not agreed

- (g) **Agree** that Category 2 PIEs should have the option to withhold non-resident withholding tax on unimputed dividends paid to non-resident investors instead of paying PIE tax on that income.

Agreed / Not agreed

Agreed / Not agreed

- (h) **Agree** that legislative amendments should be made to ensure that New Zealand resident investors cannot benefit from the lower tax rates applying to non-resident PIE investors by investing into the two new PIE categories via foreign entities.

Agreed / Not agreed

Agreed / Not agreed

- (i) **Agree** that officials may consult on draft legislation, if practicable, with the managed funds industry and tax advisors.

Agreed / Not agreed

Agreed / Not agreed

- (j) **Note** that Cabinet has previously agreed to introduce legislation to implement the proposed changes on or around Budget day this year, with a shortened referral to the Finance and Expenditure Committee and enactment by the end of August 2011.

Noted

Noted

- (k) **Agree** that legislation to implement the proposed changes be included in a Budget 2011 tax bill.

Agreed / Not agreed

Agreed / Not agreed

- (l) **Agree** that the application date for the Category 1 PIE should be the date of enactment of the legislation.

Agreed / Not agreed

Agreed / Not agreed

- (m) **Agree** that the application date for the Category 2 PIE should be 1 April 2012.

Agreed / Not agreed

Agreed / Not agreed

- (n) **Refer** a copy of this report to the Prime Minister and the Minister for Economic Development.

Referred

Referred



**Steve Mack**  
for Secretary to the Treasury



**David Carrigan**  
Manager, Policy  
Inland Revenue



**Hon Bill English**  
Minister of Finance

**Hon Peter Dunne**  
Minister of Revenue

## **Background**

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1. The purpose of this report is to outline officials' preferred approach to amending the tax treatment of non-resident investment in portfolio investment entities ("PIEs"), which includes introducing a zero percent tax rate for foreign-sourced income earned by non-residents through a PIE.
2. The Jobs Summit and the International Financial Services Development Group ("IFSDG") both recommended that non-residents investing in foreign assets through a PIE should be taxed at zero percent on foreign-sourced income derived through the PIE, as a way of encouraging the establishment of an international investment funds domicile in New Zealand. Such income is currently taxed at 28 percent, which results in PIEs being unattractive to non-resident investors. By contrast, if the investor invested directly into foreign assets, the income would normally be taxed at zero percent. This is because New Zealand operates a source-basis taxation system in relation to non-residents. In other words, non-residents are generally only subject to New Zealand tax on income that is New Zealand-sourced.
3. Officials have been working on a proposal which will reduce the tax rates faced by non-residents earning income through investing in PIEs to reflect the rates that would apply if they made the investments directly.
4. An officials' issues paper *Allowing a zero percent tax rate for non-residents investing in a PIE* was released in April 2010. The paper outlined two options. Option 1 allowed resident and non-resident investors to invest in a PIE that derived only foreign-sourced income. Option 2 allowed a PIE to have both resident and non-resident investors and New Zealand and foreign-sourced income but with different PIE tax rates applying to different types of income derived by non-resident investors.
5. Officials reported to you in July last year (T2010/1302; PAD2010/154 refers) seeking agreement to undertake further consultation on Option 2, in light of the general view expressed in submissions received on the officials' issues paper favouring that option. While Option 1 was favoured by the IFSDG in their report on establishing New Zealand as a funds domicile, we note that this option is in fact a subset of Option 2, i.e. an Option 1 PIE could be established under Option 2.
6. Accordingly, officials have recently undertaken consultation on how best to achieve the objective of removing the current over-taxation of non-resident investment into PIEs. This report outlines the feedback received from consultation and seeks your agreement to implementing the proposal outlined.

## **Proposal consulted on**

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7. The proposal that officials consulted on would allow funds to elect into two new categories of PIE (corresponding to the two options outlined in the April issues paper).

8. The first category of PIE (“Category 1”) could have both resident and non-resident investors and derive only foreign-sourced income but with a de minimis of 5 percent for New Zealand-sourced interest income. The rationale for the de minimis was to ensure that PIEs could hold sufficient cash reserves in order to meet applications, redemptions and day-to-day expenses, without disqualifying the Category 1 PIE. We also proposed a de minimis of 1 percent for holding New Zealand shares, as it would allow funds which track a global index, and hold some New Zealand equities as part of this, to elect into the Category 1 PIE option.

9. The second category of PIE (“Category 2”) could have both resident and non-resident investors and both New Zealand and foreign-sourced income. Non-resident investors would be subject to roughly the same tax treatment on the income that they earn as would apply if they had invested directly. Accordingly, the PIE would have to track different income types and apply different rates as follows:

Foreign-sourced income	0 percent
Imputed dividends from NZ equities	0 percent
Unimputed dividends from NZ equities	15 percent (DTA), 30 percent (no DTA)
Gains on NZ equities	0 percent <sup>1</sup>
Interest income from NZ financial arrangements	1.44 percent <sup>2</sup>
Other NZ income	28 percent

10. With respect to deductions and expenses, we proposed that the same treatment should apply as would be the case currently where a non-resident invests directly – no deductions are allowed in relation to foreign-sourced income or New Zealand-sourced income taxed on a gross basis (e.g. interest and dividends paid to non-residents). Therefore, the only deductions that would be allowed to non-resident investors were those relating to New Zealand-sourced income, which is taxed on a net basis (essentially income from land).

11. The new PIEs would be required to meet the normal eligibility criteria (and exceptions) in the existing legislation for being treated as a PIE. This is to ensure that these PIEs are passive portfolio investment vehicles and are not able to undertake investments in active businesses.

12. We also proposed that in cases where a retail PIE invests into a wholesale fund, the new rates would be available to non-residents.

13. The application date proposed was 1 April 2012.

14. Consultation was undertaken on a mechanism for allowing the new PIEs to elect to deduct non-resident withholding tax (“NRWT”) on unimputed dividends instead of paying PIE tax on the income. This would enable non-resident investors to receive a credit in their home jurisdiction for New Zealand tax paid on their PIE unimputed dividend income.

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<sup>1</sup> This is the existing treatment for gains on New Zealand equities earned by PIEs.

<sup>2</sup> This is equivalent to the net rate of AIL, which is deductible to the approved issuer.



15. We also consulted on information and return obligations for the new PIEs. We proposed that these would generally be the same as those that currently apply to PIEs, with some amendments. The key addition is that the new PIEs will be required to request certain information from their non-resident investors, in order to facilitate meeting OECD exchange of information obligations, i.e. the tax file number of the non-resident in their home country, or if this cannot be provided, a declaration stating that the investor is unable to provide this information.

16. A further matter discussed with submitters was options for taxing hedges of assets that are subject to the fair dividend rate ("FDR") method, the issue being that there is currently a mismatch between the taxation of assets under FDR and the financial arrangements designed to hedge those. It was intended that any changes to the rules would be introduced at the same time as the proposed introduction of the new rules for non-resident investment in PIEs.

## **Feedback from consultation**

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17. Consultation was undertaken with a range of managed funds and advisors. There was widespread support for both the proposed PIE tax changes, as well as the wider financial hub proposal. Furthermore, submitters considered it important that the new rules are optional for funds to elect into.

18. The key issue that was raised during this process was the need for simplicity and flexibility to cater for the diverse range of systems which PIEs have in place. Concerns were raised about the complexity of Category 2, in particular, the need to track different types of income and apply different rates to these types. Accordingly, a key theme from feedback was the desirability of reducing the number of rates that would need to apply under Category 2. In particular, applying AIL at 0 percent instead of 1.44 percent, in line with the changes contained in the October International Tax Bill in relation to widely-held bonds was mooted. In addition, submitters floated the idea of removing the 30 percent rate for unimputed dividends where non-resident investors are from countries with which New Zealand does not have a DTA.

19. Some submitters considered that the de minimis for New Zealand cash reserves held for applications, redemptions and day-to-day expenses should be increased from 5 percent to 10 percent. This is because some fund mandates allow for up to 10 percent cash holdings. However, other submitters supported the proposed 5 percent threshold.

20. Another suggestion was to bring forward the application date for the Category 1 PIE to the date of enactment, as this would enable some funds to launch prior to 1 April 2012.

21. Some submitters thought that the proposal should be extended to cover listed PIEs (a type of portfolio investment entity that is a listed company).

22. A number of minor technical issues were also raised, which officials are working through. These are outlined in the attached appendix.

## **Revised proposal in light of consultation**

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23. The key change to simplify the proposal outlined above is to add a restriction preventing the two new PIE categories from investing directly into New Zealand land. This would remove the need for PIEs to attribute deductions and expenses with respect to their non-resident investors. We could then have a blanket rule prohibiting any deductions for non-residents investing in Category 2 PIEs.

24. Furthermore, we agree that the application date for the Category 1 PIE may be brought forward to the date of enactment.

25. We consider that AIL should remain at 1.44 percent and the NRWT rate for unimputed dividends paid to non-resident investors from non-DTA countries should remain at 30 percent. Retaining the 1.44 percent rate of AIL and 30 percent NRWT rate will ensure that non-residents investing in the Category 2 PIEs will be subject to the same tax rate on their foreign and New Zealand-sourced income as if they invested directly.

26. We are still considering the tax treatment of FDR hedges, given the fiscal risks involved with possible solutions. Accordingly, any changes to the rules will not be implemented in the same tax bill as the PIE tax changes. We will report back to you on this issue later this year.

27. Officials consider that further consideration is required with respect to extending the current proposal to encompass listed PIEs (a type of PIE that is a listed company). Accordingly, we do not recommend that any changes to the treatment of non-residents investments in listed PIEs be included as part of the existing proposal.

## **Fiscal implications**

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28. We have previously advised (T2010/325; PAD2010/039 refers) that our understanding is that less than 1 percent of investors in the New Zealand funds management industry are non-resident. Therefore, the proposed changes would not have a significant impact on the amount of tax collected.

29. In addition, as previously reported, the total cost of the proposal is estimated to be less than \$10 million per annum for each of the options identified.

## **Administrative costs**

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30. Preliminary estimates of the administrative cost of adapting current systems and processes in order to implement two new categories of PIE are in the range of \$450,000 to \$650,000 for operating and \$800,000 to \$1m for capital costs and are expected to be incurred in 2011/12. Compliance costs relating to additional ongoing audit activity have not been included in the administrative costs associated with this proposal and will be assessed by Inland Revenue, in the context of overall affordability of all Budget 2011 initiatives.

31. These initiatives have been marginally costed based on our initial assessment of implementing this solution and should be treated with caution. The estimated administrative costs are dependent on proposal development and final decisions on the most appropriate approach.

32. Inland Revenue is currently looking to manage between \$40m and \$50m of operating cost pressures in 2011/12; including remuneration, investment into transformation initiatives, the escalating costs of supporting the aging technology infrastructure, the residual impacts from Budget 2010 and legal costs associated with pending complex litigation. In anticipation of the collective quantum of the Budget 2011 initiatives <sup>(2)</sup>

Inland Revenue has limited ability to self-fund these costs and is likely to seek an increased operating baseline appropriation.

### **Compliance costs**

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33. We would note that the proposed rules are optional for funds to elect into.

34. We do not anticipate significant compliance costs for the Category 1 PIE. However, there may be considerable compliance costs for the Category 2 PIE from systems changes required to track different types of income and apply different rates, in particular, for wholesale funds which may be required to adopt the new rules due to commercial pressures.

### **Process**

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35. Cabinet agreed late last year to include legislation enacting the proposal in a tax bill on or around Budget day this year, with a shortened referral to the Finance and Expenditure Committee ("FEC") and enactment by the end of August 2011 (CAB Min (10) 44/19 refers). This could be done in a bill introduced on Budget day under urgency for immediate first reading and referral to FEC on Budget day.

36. We will report to you later this month with a Cabinet paper and Regulatory Impact Statement for signing and referral to the Cabinet Office for consideration by the Economic Growth and Infrastructure Committee. Subject to your agreement, the proposed legislation could then be included in a Budget 2011 tax bill.

37. We recommend that you refer a copy of this report to the Prime Minister and the Minister for Economic Development.

## Design of Foreign Investor PIE rules – issues raised in responses 23 February 2011

Number	Issue	Submitters
1	<p>Reduce rates for Category 2 PIE/merge two PIE categories into one:</p> <ul style="list-style-type: none"> <li>• Remove 30% rate for unimputed dividends.</li> <li>• De minimis: 15% DTA rate should apply where 75% on non-resident investors are from DTA countries.</li> <li>• AIL should be 0% in line with proposed AIL exemption for widely-held bonds.</li> </ul>	ASB, FNZ, CTG, ISI, Kiwibank
2	<p>Allow classes of PIEs to elect into the new PIE rules (cf just allowing entity-based election) – this would enable multi-class KiwiSaver/Super funds to elect in.</p>	ASB, ISI, Kiwibank, PwC
3	<p>The new PIEs should be able to exceed 20% investment in company if total market value of all investments where the cap is exceeded is not more than 10% of the market value of total investments of PIE or investor class, i.e. s HM 13(5) should apply.</p>	ASB, KPMG, NZLS, CTG
4	<p>De minimis for cash holdings under Category 1 PIE option:</p> <ul style="list-style-type: none"> <li>• Should be 10%.</li> <li>• The de minimis should include income from derivatives entered into with NZ counterparties.</li> <li>• Clarify how “cash” will be defined.</li> <li>• There should also be an exemption from the threshold for funds that are starting up or winding down, as they are likely to hold high amounts of cash during these periods.</li> </ul>	ASB, FNZ, CTG, Elevation, NZLS, SaturnInvest
5	<p>De minimis for NZ equities</p> <ul style="list-style-type: none"> <li>• Should be 5% irrespective of whether fund tracks global index (this would allow some direct holding of NZ equities).</li> </ul> <p>Alternative is to have one 10% de minimis for both cash holdings and NZ equities.</p>	CTG
6	<p>Bring forward the application date for the Category 1 PIE.</p>	Appello, SaturnInvest, Elevation, MMc
7	<p>Exclusion of New Zealand land:</p> <ul style="list-style-type: none"> <li>• Will Category 2 PIEs be able to hold shares in land investment companies/listed property trusts? (ISI suggests defining “land” to exclude investment in listed property trusts but include unlisted property PIEs).</li> <li>• Suggest third category of PIE which allows for direct investment in land.</li> </ul>	KPMG, ISI, Kiwibank, PwC, CTG

## Design of Foreign Investor PIE rules – issues raised in responses 23 February 2011

Number	Issue	Submitters
8	Expense apportionment: how to achieve no deductions for non-residents in the legislation – can we draft legislation outlining the intended result without prescribing the process?	KPMG
9	Retention of “investment in” tests in relation to non-resident investors is not necessary.	Tyndall, FNZ, MMc
10	It should be left up to wholesale funds to decide whether or not to provide additional information (i.e. additional information should not be mandatory).	BNP, PwC, CTG
11	Allow an option for RWT to be a final tax on all unimputed dividends paid to PIEs to the extent of their non-resident investors (i.e. the PIE would not use its exemption certificate and would have 15% RWT deducted, with the PIE then applying a 0% PIR for non-resident investors. For residents, the 15% tax would wash through the elected PIR calculation per the elected rate).	CTG
12	More certainty in legislation regarding correcting PIE errors.	FNZ
13	<p>Income from financial arrangements:</p> <ul style="list-style-type: none"> <li>• Does AIL apply to all income from financial arrangements or just to coupon interest income?</li> <li>• Clarify the tax treatment of realised and unrealised gains and losses on financial arrangements.</li> </ul>	KPMG, Fonterra, ISI, Kiwibank, PwC
14	<p>Non-resident withholding tax (“NRWT”) for unimputed dividends:</p> <ul style="list-style-type: none"> <li>• Suggest ordering rule instead of “paid or vest absolutely in interest” (KPMG) OR require Category 2 PIE to pay a dividend to non-residents equivalent to any unimputed dividends received in order to get NRWT treatment (Fonterra).</li> <li>• Clarify whether NRWT applies to gross or net income.</li> <li>• Foreign Investor Tax Credit (“FITC”) should be available.</li> <li>• NRWT should be able to be included in PIE periodic return.</li> <li>• Fund must be able to track information only for those investors who are paid dividends during the year.</li> <li>• Amounts of PIE tax deducted by Fund on Fonterra dividends should be treated as “voluntary payments” under section HM 45.</li> </ul>	Fonterra, KPMG

## Design of Foreign Investor PIE rules – issues raised in responses 23 February 2011

Number	Issue	Submitters
15	Expenses should be deductible – investors will incur admin/management fees.	Fonterra, KPMG
16	Process for electing to be one of the new PIEs should be incorporated into current registration process for a PIE e.g. separate web-form for existing PIEs.	KPMG
17	Clarify treatment of income from NZ equities: taxable bonus issues (suggest 0% for imputed and 15%/30% for unimputed), non-taxable bonus issues (non-taxable), non-renounceable rights issues (non-taxable), renounceable rights issues (non-taxable – comment that it is not clear from section CX 55 whether gains/losses on renouncement are taxable. From a policy perspective, such gains should be tax free, as should sale of an option to purchase the underlying share).	KPMG, Fonterra
18	Suggest clarifying that the maximum shareholding in investments requirement does not need to be met if a share in a company carries voting rights but the voting rights are not able to be exercised by the PIE.	KPMG, Fonterra
19	Treatment if non-resident investor fails to provide some or all required information – will they be taxed at 28%?	KPMG, Fonterra
20	Unimputed dividends received from listed PIEs should be treated as excluded income in line with current rules.	ASB
21	Clarify what will qualify as a non-resident investor e.g. if offshore nominee or custodial platform is used.	KPMG
22	Clarify treatment where investors change residence mid-year: <ul style="list-style-type: none"> <li>• Applying the change prospectively is not consistent with current treatment of resident investors.</li> </ul>	Fonterra, ISI, Kiwibank
23	Clarification of source rules required to ensure that income earned through a PIE is not treated as being New Zealand-sourced solely because the PIE is in business in New Zealand.	PwC, CTG, NZLS
24	The proposal should be extended to listed PIEs.	ASB, CTG

## Design of Foreign Investor PIE rules – issues raised in responses 23 February 2011

Number	Issue	Submitters
25	The residence test for a unit trust may need to be amended.	NZLS