Taxation of Investment Income

The taxation of investment income changed with the introduction of Portfolio Investment Entities (PIE) on 1 October 2007 and the Fixed Dividend Rate (FDR) method on 1 April 2007.

Portfolio Investment Entities

A Portfolio Investment Entity (PIE) is a new type of entity that invests the contributions from investors in different types of investments. The most common example of a PIE is a managed fund.

The PIE regime came into existence on 1 October 2007 as part of the reforms to the taxation of investments and in conjunction with KiwiSaver. It is a new taxation structure created by the government to achieve a balance in the tax treatment of local and overseas investment income.

Benefits of PIE

- In the past, investments made via managed funds were taxed at 33% regardless of the marginal tax rate of the individual investors. Thus, a taxpayer on a lower marginal tax rate ended up paying extra tax. Under the PIE regime, investment income is taxed at the investor's PIR (Prescribed Investor Rate). There are three PIRs - 0%, 19.5% and 30%. Generally, individual investors who meet both of the following conditions, may use a 19.5% PIR:
  - their taxable income (excluding PIE income) did not exceed $38,000; and
  - their combined taxable and PIE income did not exceed $60,000.
- If the above situation applies to both the spouses in a relationship, there is potential to save tax as $120,000 of income between them can be taxed at 19.5%.
- Companies, trusts, charities, superannuation funds and other PIEs can elect either 0% or 30% as their PIR. Please contact your advisor for more information on this. If one does not elect a PIR, then the default rate of 30% is allocated by the PIE.
- Since the maximum rate is 30%, this means a savings of 9% for an individual investor on a marginal tax rate of 39%. Hence, a major advantage of the PIE regime is that the amount of tax on investment income is significantly less than in the past.
- Another advantage of the PIE regime to investors with PIRs of 19.5% or 30% is that they will no longer be required to return their PIE income if they have provided the correct PIR to their PIE manager.

Pitfalls

- Tax paid in the PIE is the final tax, so if an individual inadvertently provides a higher PIR for their PIE investments, they risk overpaying their tax as they will not be entitled to a refund.

In essence, PIEs were introduced as part of the government's efforts to encourage domestic savings through investment in KiwiSaver, and apart from the pitfalls listed above for the investors it has made managed funds in New Zealand more tax effective than before.

Fair Dividend Rate

The Fair Dividend Rate (FDR) regime, which came into effect on 1 April 2007 as part of the new rules for Foreign Investment Funds, has changed the way income from foreign share investments is calculated. It applies to investments held by a New Zealand resident in an offshore company that is less than 10%.

In the past, investments in the eight grey list countries (Australia, Canada, Germany, Japan, Norway, Spain, the UK & the USA) were taxed only on dividends if they were held on capital account, and capital gains were tax-free. On the other hand, indirect investments through managed funds were taxed on both dividends and realised gains.

The new FDR regime removes this "grey list" exemption and aims to tax all such foreign investments consistently. Broadly, FDR is a method where income from foreign investments is taxed at 5% of the portfolio's opening market value each year.

If the total return on the share portfolio is less than the amount calculated under FDR method, individuals and family trusts have the option to pay tax on the lower amount. Furthermore, if an individual's original cost of such foreign shares is NZ$50,000 or less, the new rules do not apply.

The following is a simplistic run down of how the FDR regime works:

- A valuation of all foreign shares is made at the beginning of the tax year (which is 1 April for most entities). The income that is liable for tax for that year will be 5% of that valuation. However, if an investment is bought or sold in the same year ("Quick Sales"), gains arising from the quick sales have to be calculated separately and included in the income (losses arising from quick sales are not included).

- If the total return for the year is less than 5% of the opening market value, the amount liable for tax is the actual total return made. However this only applies to investments made directly or through family trusts. Companies do not have this option.

- If there is an overall loss for the year, individual investors or those investing through family trusts have no taxable income and no loss to carry forward.

- An opening valuation is done again for the following year and taxable income for that year will be 5% of the new opening valuation. The whole process is repeated every year that the foreign investments are held.

Overall, the new FDR regime is considerably better and fairer, as it removes the imbalance in tax treatment on income from different foreign investment funds. Many foreign companies have a policy of paying low or no dividends, so the previous dividend-only taxation was an inappropriate tax base as an investor who invested directly did not pay tax on gain when share price increased.

The FDR regime also removes the bias towards investing in grey list countries as the new regime treats all overseas investments the same. Hence, tax is applied consistently regardless of the country where the investment is located.

The method is complex however, and only time will tell whether the FDR calculation is "fair" for all types of investors.

Disclosure Requirements

The above mentioned changes have also brought about changes in the disclosure requirements of Foreign Investment Funds (FIP).

If the FIP investment is in a country that does not have a double tax agreement (DTA) with New Zealand as at 31 March 2008 (listed below) then the taxpayer will need to complete an IR447 disclosure form (for FDR method) or an IR448 form comparative value method.

Countries with DTAs with New Zealand (as at 31 March 2008)

Austria Australia Belgium Canada Chile China Denmark Fiji Finland France Germany India Indonesia Ireland Italy Japan Malaysia Mexico Norway Poland Republic of Korea Russian Federation Singapore South Africa Spain Sweden Switzerland Taiwan Thailand The Netherlands The Philippines United Arab Emirates United Kingdom United States of America

Tax Reform to Help NZ Companies to Compete Overseas

Comprehensive reform of our international tax rules, to help New Zealand-based companies compete more effectively overseas, is the main feature of a taxation bill introduced in July.
"The proposed changes represent a fundamentally different approach to taxing New Zealand companies that have offshore operations," Finance Minister Michael Cullen and Revenue Minister Peter Dunne said.

"The cornerstone of the reform is the exemption from tax of the offshore active income of New Zealand's controlled foreign companies, regardless of where it is earned.
"That will bring our tax rules into line with the tax systems of comparable countries, particularly that of Australia, and remove a tax cost that similar companies in other countries do not face," the Ministers said.

At present, New Zealand taxes the active income – such as income from manufacturing – from its offshore subsidiaries, whereas other countries do not.

The change is designed to encourage businesses with international operations to remain in New Zealand and enable them to compete on an equal tax footing in foreign markets.
"Further important features of the proposed changes are an exemption from tax of most foreign dividends paid to companies and measures to protect the tax base as a result of adopting an active income exemption.

"The changes introduced today represent the first stage of the those to emerge from the government's review of our international tax rules and have been greatly influenced by extensive consultation with businesses and their advisors.
"Most aspects of the reforms were signalled in a series of consultative papers, although there has been further work to develop the detail in some areas.

Other Recent IRD Developments

- IRD have recently lifted a hold on the processing of Trust 2008 taxation returns – up until now very few 2008 IR6 returns had been processed creating problems where refunds are due and refunds are transferred to associated taxpayers. Processing of these returns began on 19 September and we are starting to see the assessments come through.

- IRD have updated the tax treaty with Australia to allow both counties to assist each other to collect tax overdues "Arrangements are now in place to allow New Zealand and Australia to help each other collect tax debts".

- An order in council signed on 15 September allows more types of mortgages to qualify for the Kiwisaver mortgage diversion facility.

- The prescribed rate used to calculate fringe benefit tax on low-interest, employment-related loans will rise from 10.57% to 10.90% from 1 October.