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Taxation: Investment vehicles – There is a better way[1]

In *Tax changes and KiwiSaver – a level playing field for superannuation schemes?* we argued that the recent changes to the tax treatment of superannuation schemes, PIEs and overseas shares have left us with an illogical mess.

The tax treatment of 'collective investment vehicles' (CIVs) like superannuation schemes, needed attention but not the attention they got.

The 2005 Discussion Document said "…it is important that the tax rules for investment income operate efficiently and that investors' decisions are not distorted by different tax treatments for income from investments that are similar in nature…."

To achieve that objective, here are the three broad principles that should apply to CIVs:

(a) **Principle 1:** For an investor in a CIV, it should not matter, from a tax perspective, what that CIV is called or under which legislation that CIV is regulated. In principle, individual investors should be treated similarly for tax purposes in superannuation schemes, unit trusts, group investment funds or life insurance funds.

(b) **Principle 2:** For New Zealand tax purposes, it shouldn't matter to an individual investor in which country the CIV is resident. Within reason, international CIVs should be treated similarly for New Zealand tax purposes to New Zealand-based CIVs. How the overseas CIV is treated in its local jurisdiction need not affect its New Zealand status when an investor calculates income tax.

(c) **Principle 3:** Again within reason, the tax the investor pays on the CIV's return should be close to the normal tax the investor would have paid had the investment been held directly. The investor should choose a CIV for reasons other than tax – for example, for convenience, cost, diversification, liquidity, management skills etc.

These principles form the 'gold standard' against which any proposals should have been measured. The old tax regime that governed the different types of CIV violated all three principles. Regrettably, the new regime is not much better in some respects and is worse in others. Income should be 'income' and should be taxed and benefit-tested accordingly. It won't be.

While the tax treatment of CIVs is normally a compromise between principles and practicality, compromise of principle should apply only if there is a combined effect of simplification and increased net returns to investors with no significant loss of tax revenue. Recent changes fail to achieve these objectives and leave a complex patchwork of compromises.

[1] This article is based on a submission that the Association of Superannuation Funds of New Zealand made in September 2005 on the Inland Revenue's *Discussion Document*. That submission was called *Part 1 of our submission on the discussion document concerning collective investment vehicles - Issues of principle.*

Here is what should have happened if the general principles of the 'gold standard' had been followed instead:

a. All CIVs would be subject to a single tax treatment. The new rules fail this objective. Then, as far as practicable, a CIV should be taxed on a basis that acts as a down payment on the true 'final' tax liability - the one that applies to the individual investor. The CIV could aim to get that calculation approximately right but the CIV itself should not calculate the final liability. The only body that has all the information about the taxpayer is the IRD - only it can calculate the liability fairly.
b. If the investor doesn't pay tax (say, because it is a charity) or is an individual with tax losses, the tax paid on its/his behalf by the CIV should be recoverable. For taxpayers with losses, the correct amount of tax should be calculated each year, not an artificial construct that is driven by administrative convenience rather than by principles.
c. For overseas CIVs, whatever its local tax status (in whichever country it operates), if the New Zealand investor would have paid tax on the underpinning transaction had that transaction been carried out directly by the investor, then tax will be payable by the individual's return in the CIV.
d. Defining 'income' is an area in which a prescriptive approach of any kind (especially the 'fair dividend return' regime) will create problems. It is unsatisfactory to leave this matter to statute and the courts (the approach to date). New Zealand law should instead state the principle and then specify a list of considerations that the Commissioner must take into account when deciding whether a CIV (or an individual) is, for example, in the business of buying and selling a particular type of asset.

   Here is how that might work when deciding whether a taxpayer is a 'trader' and liable for tax on gains. The criteria might include, for example, the period for which the assets were held; whether 'intention' can be inferred from conditions that applied at purchase; whether the owner has a history; whether the trading pattern was part of a pre-published 'passive' strategy, the annual rate of portfolio turnover etc.

   Having stated the general rule and enshrined some very general principles in legislation, the detailed and practical application of those rules should be left to IRD practice notes. These could even be as detailed as specifying which particular products qualify as 'traders' and which do not. Or it could fill in some gaps and, essentially leave matters to a product's auditors (or the New Zealand promoters) to specify what, in their view, the position is. Even if the product got it wrong, gaps could still be fixed at an individual investor level by imputation. What we suggest therefore would be almost a self-regulating regime. There could even be an assumption that any CIV is a 'trader' unless the IRD has ruled otherwise. For most overseas CIVs, that is more likely to be right than wrong.

   It is wrong and unfair that a trader should avoid tax on trading gains.

e. Compliance with practice notes would be a continuous requirement. This would let the IRD be a bit more flexible about its initial rulings because there would be less at stake in that initial process. So the complexity and cost currently involved with binding rulings could be replaced with a much less formal process. Loosening up this procedure will increase innovation, lower costs and make individual investors more aware of what they were buying. These are all good things. It will also eliminate artificial distinctions created by product providers.

   It should not matter what a product is called or who issues it - it is the substance of the underlying transactions that matters. The 'gold standard' will let the IRD keep a continuous eye on that substance and change its mind if it thinks that the substance has turned out to be different from the appearance. The role of tax advisers and financial planners will be reduced and that will also be a good thing.

f. Contributions by an employer to a superannuation scheme should be part of the employee's income for tax purposes. That is as it should be – it's income from employment, albeit deferred. So-called 'salary sacrifice' would then disappear.

CIVs should be celebrated and encouraged (that does not need to mean subsidised). Their continued development should be seen as a positive contribution to a successful financial services industry. CIVs perform a number of positive roles in New Zealand's economic life, both at a macro and a micro level.

We should be encouraging individuals to use either CIVs or direct investments for the best reason of all - that it suits their circumstances, not that tax drives the decision. That's what the 2005 Discussion Document said was the basis of the proposed changes. However the outcomes have failed that objective. CIVs are now being established in particular ways specifically for tax reasons. Individuals are setting up CIVs to minimise tax. Employees (particularly the higher paid) will restructure remuneration to reduce tax.

That does not represent progress.

The final article in this series on the new tax environment describes some practical advantages of adopting the 'gold standard'.

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